

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

STRATEGY FOR THE KYRGYZ REPUBLIC

As approved by the Board of Directors on 12 June 2007

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I. EXECUTIVE SUMMARY

The Kyrgyz Republic is committed to and is making progress towards the implementation of the principles of multi-party democracy, pluralism and market economics referred to in Article 1 of the Agreement Establishing the Bank. The political upheaval in March 2005 resulted in a change of power and presidential elections, which took place in summer 2005 and marked tangible progress towards meeting international standards for democratic elections. In terms of political pluralism, the Kyrgyz Republic, with many functioning political parties, a relatively free media and a network of active civil society organisations, continues to feature well in the regional context.

Nevertheless serious problems remain. Poverty, unemployment, deep-seated corruption and nepotism, which were major driving forces behind the 2005 “Tulip Revolution”, still exist. Local entrepreneurs still complain of bribery, bureaucracy and burdensome taxes, while foreign investors are concerned about political and legal instability. Organised crime is also a spectre on the political and economic scene, including instances of criminal elements attempting to exert undue influence on the Government. Those problems triggered a political crisis in November 2006, which was resolved in a peaceful and negotiated manner and led to an agreement, reflected in the country’s new Constitution. However, the Constitution has been amended again at the end of December, reversing changes that had limited the President’s authority. The December reversal, combined with the termination of the Kyrgyz President’s political alliance with Feliks Kulov and the latter’s joining the ranks of opposition, led to a new wave of protests in April 2007 with protesters demanding early presidential elections and constitutional reforms restoring a parliamentary form of governance.

The authorities managed to retain prudent macroeconomic policies throughout the Strategy period, despite the political upheaval in March 2005, presidential elections and the November 2006 political crisis. Although growth for 2005 registered a small decline (0.2 per cent), the country continued to restrain the fiscal deficit and reduce external public debt – albeit from a very high level. The trade deficit increased in part due to lower output from Kumtor Mining Company (KMC) and significant imports of equipment at the mine have been financed by remittances, foreign direct investments (FDI) and funding from donors including debt forgiveness under the Paris Club. The economy grew by 2.7 per cent in 2006 primarily driven by the service sector, while growth in agriculture, which still accounts for 30 per cent of GDP, remained sluggish. The Kyrgyz Republic has made progress in reducing poverty as the official poverty rate declined from 50 per cent in 2003 to 44 per cent in 2005.

Notwithstanding these positive macroeconomic developments, the country continues to be at risk to exogenous and internal shocks. Therefore, the country should take care to protect existing investments and create an attractive environment for new investments; unfortunately, recent political and legislative instability has raised questions about the overall investment climate. The country also continues to deal with a high debt burden - public external debt to GDP (at end 2006) remained at 69 per cent and debt service is projected at about 3.5 per cent of GDP (approximately USD 100 million) per year in the Strategy period. While in April 2006 the country was found to be eligible for debt

relief under the enhanced heavily indebted poor countries (HIPC) initiative, the Kyrgyz authorities decided against participation in February 2007.

Progress on key transition measures has been insufficient, primarily due to lack of government implementation. The investment and business climate, as recorded in the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey and the World Bank's Doing Business Survey 2006, leaves scope for significant improvement. Small positive steps - a new pledge law; ratification of the UN Convention against Corruption; and strengthened supervision in the National Bank - do not make up for overall poor progress on structural reforms. In the past few years, there has been practically no progress on infrastructure reforms - in transport, energy and telecoms - where state-owned entities continue to deplete government resources. Therefore, in the forthcoming period, the key challenge remains to further build an environment to foster a sustainable private sector which can contribute to growth and further poverty alleviation, in line with the country's development strategy for 2007-2010. The Government's key goals must be: (i) to further improve the investment climate and avoid actions which threaten existing investments; (ii) to take concrete measures to tackle corruption, improve the court systems and lessen bureaucracy; (iii) to increase transparency and corporate governance of enterprises (particularly in the state sector); (iv) to improve tendering and licensing procedures, particularly in the natural resources sector (v) to improve tariff regulations, particularly in the power sector, in order to attract private investment; and (vi) to facilitate the deepening of the financial sector by avoiding unnecessary interference while further strengthening the regulatory independence and remit of the regulator.

The Bank will support the Kyrgyz Republic in the following priority areas to address the above mentioned transition challenges. Among donors and international financial institutions, the Bank is uniquely placed to support private sector development; its projects and assistance have a significant demonstration impact despite relatively modest volumes. The Early Transition Countries Initiative has opened new opportunities for the Bank to reach a wider range of clients, thus widening its overall impact.

Fostering the Private Sector

Development of private businesses remains the Bank's key operational objective. Direct financing will be targeted to agribusiness, textile, property and tourism, consumer services, as well as natural resources should there be opportunities with credible investors, thus contributing to diversify the economy and expand external trade. Through these activities, the Bank also will promote energy efficiency measures in private sector enterprises.

Given the importance of agriculture (30 per cent of GDP), the Bank will strengthen efforts to reach this sector and ETCI products should help widen opportunities with smaller foreign and local investors. For example, the Bank has financed smaller agribusiness companies via the MSEFF as well as the new Direct Lending Facility and Medium-sized Co-Financing Facility.

The Bank will continue to expand its successful programme to finance micro and small

enterprises through financial intermediaries. In the past two years, the Bank has increased its focus on facilitating financial access to rural borrowers, and in 2006 began working with Aiy Bank, the country's largest provider of agricultural finance. The Bank has increased the number of commercial bank partners. From a sectoral perspective, by working with an array of financial institutions, the Bank would like to increase competition, which will increase lending volume, reduce interest rates and lengthen tenors for borrowers.

The Bank has successfully financed regional cross-border investments involving investors from Russia, Kazakhstan and the Kyrgyz Republic. Given rapid growth in the region, the Bank expects to be able to support other regional investors coming to the Kyrgyz market from CIS countries, as well as from countries such as Turkey, Korea and China.

Strengthening the Financial Sector

The Bank's impact on the financial system is significant, with exposures to nine financial institutions accompanied by substantial technical assistance. Overall, the sector has strengthened due to continuing capital increases, growing depositor confidence and increased competition. The Bank has supported the sector by developing a stronger pledge law and enhancing the operation of the credit bureau. Moreover, the Kyrgyz Republic has been at the forefront of the Bank's efforts to work with non-bank microfinance institutions.

The Bank will be focusing on strengthening (in terms of capital, corporate governance and general competitiveness) its partner financial institutions. In the forthcoming period, the Bank could participate in capital increases and where appropriate support consolidations between banks and non-bank institutions. The Bank also considers supporting the conversion of NBMFIs into deposit-taking institutions.

As the Government intends to privatise Aiy Bank and the Savings and Settlement Company, which would further strengthen the overall quality of the financial sector, the Bank will seek how best to support this initiative. Also the Bank will seek ways to develop new products which reduce financial institutions' foreign exchange risks. As a first step, the Bank has developed a guarantee facility product which enables NBMFIs to raise local currency funding more competitively.

As the Bank is at or near prudent lending levels with a number of partners, it will work with donors to share risks as a means of leveraging Bank financing. At the same time, the Bank will work with the NBKR on bank supervision issues to strengthen the sector and hope to find additional partners. The Bank will maintain a close dialogue with other donors to ensure targeted assistance for the sector more generally. Such assistance in the coming period could include further support on bank supervision, development of deposit insurance system, implementation of the new anti-money laundering law and further support for the credit bureau.

Support for Critical Infrastructure

The Bank's direct financing of infrastructure has been limited due to the country's

restricted capacity for external borrowing and also due to inability to proceed with key reforms. For example, efforts to finance the energy sector are most likely possible only after tariff reforms and willingness to allow commercial (private) management. In light of its high debt burden, the Government must continue to avoid significant new state borrowings, and it is expected that new sovereign loans will continue to be limited to those with a 45 per cent grant element.

Therefore, the Bank will continue to seek non-sovereign infrastructure projects. These could include financing for privatisations (telecoms) or concessions (power, roads, gas pipelines). Where possible, projects may be regional in nature. Considering the level of the country's sovereign indebtedness, the Bank's ability to finance sovereign guaranteed projects in the strategy period will be limited, particularly if there is not access to a stable and predictable source of co-financing grants.

Policy Dialogue

The Bank is a key counterpart to the Government and provides advice on private sector development and the investment climate. Following the 2005 political changes, the Bank has retained its dialogue with the new authorities as well as civil society. Building on success of the International Business Council, the Bank has proposed to work with the President and Prime Minister to form a new advisory council which will bring attention to key barriers to private sector development. Considering recent discussions of potential nationalisation of an existing high-profile investment, it remains extremely important to maintain policy dialogue regarding the investment climate and its impact on long-term development. Other key TC projects include ongoing training for judges and a legal reform programme to address obstacles to investment.

The Bank worked with other donors to harmonise approaches to improve the business environment, this included support for the first joint country strategy developed by the World Bank, Asian Development Bank, United Nations Development Programme and key bilateral donors. The Bank will continue to coordinate with other IFIs, donors and the business community. The Bank's Environmental Policy and Public Information Policy will apply to all projects developed in the Kyrgyz Republic.

LIST OF ABBREVIATIONS

ADB	Asian Development Bank
AML	Anti-money laundering
BEEPS	EBRD/World Bank Business Environment and Enterprise Performance Survey
CARSSF	Central Asia Risk Sharing Special Fund
CACO	Central Asian Cooperation Organisation
CDF	Comprehensive Development Framework
CDS	Country Development Strategy
CIDA	Canadian International Development Agency (Canadian Government)
CIS	Commonwealth of Independent States
CPI	Corruption Perceptions Index
DfID	Department for International Development (UK Government)
DIF	Direct Investment Facility
DKIB	Demir Kyrgyz Republic International Bank
DLF	Direct Lending Facility
EAP	Environmental Action Plan
EH&S	environment, health and safety
EITI	Extractive Industries Transparency Initiative
ETC	Early Transition Countries
ETCI	Early Transition Countries Initiative
EU	European Union
EUR	European Currency Unit
FDI	foreign direct investment
FI	financial institutions
FSU	Former Soviet Union
GDP	gross domestic product
HIPC	Heavily Indebted Poor Countries
HRW	Human Rights Watch
IBC	International Business Council
IDB	Islamic Development Bank
IFC	International Financing Corporation
IFI	international financial institution
ILO	International Labour Organisation
IMF	International Monetary Fund
IRR	internal rate of return
JICA	Japan International Cooperation Agency (Japanese Government)
JSC	joint stock company
KA	Kyrgyz Altyn
KAC	Kyrgyz Agricultural Company
KAFC	Kyrgyz Agricultural Finance Corporation
KGS	Kyrgyz Som, the national currency of the Kyrgyz Republic
KICB	Kyrgyz Investment Credit Bank
KMC	Kumtor Mining Company
KOC	Kumtor Operating Company
KT	Kyrgyz Telecom
MCFF	Medium-sized Co-Financing Facility
MDRI	Multilateral Debt Relief Initiative

MIGA	Multilateral Investment Guarantee Agency
MSE	micro and small enterprises
MSEFF	Micro and Small Enterprise Finance Facility
NBKR	National Bank of the Kyrgyz Republic
NCA	National Communications Agency
NEAP	National Environmental Action Plan
NGO	non-governmental organisation
NPRS	National Poverty Reduction Strategy
ODIHR	Office for Democratic Institutions and Human Rights
OSCE	Organisation for Security and Cooperation in Europe
PB	participating bank
PRGF	Poverty Reduction and Growth Facility
SCO	Shanghai Cooperation Organisation
SDC	Swiss Agency for Development and Cooperation
SDR	Special Drawing Rights
SECO	Secrétariat d'Etat à l'économie (Government of Switzerland)
SME	small and medium-sized enterprises
SSC	Savings and Settlement Company
TACIS	Technical assistance to the CIS
TAM	Turn Around Management
TC	technical Co-operation
TFP	Trade Facilitation Programme
UNDP	United Nations Development Programme
USAID	US Agency for International Development (US Government)
USD	US Dollar
WB	World Bank
WTO	World Trade Organisation

II. COUNTRY STRATEGY

1. The Bank's Portfolio

1.1 Overview of Bank Activities to Date

In the last Strategy period, the Bank began implementing the Early Transition Countries Initiative (ETCI). Utilising ETCI policies and products, the Bank has been able to complete a number of small to mid-size deals with local and foreign investors, such as Interglass (construction materials), Karven Village (property and tourism) and Abdysht Ata (agribusiness). The Bank continued to support larger partners, such as Kumtor Mining Company (KMC) (which has now been restructured and the exposure relates to the Bank's shareholding in Centerra) and Hyatt Hotel and managed a small sovereign portfolio in telecoms and electricity transmission.

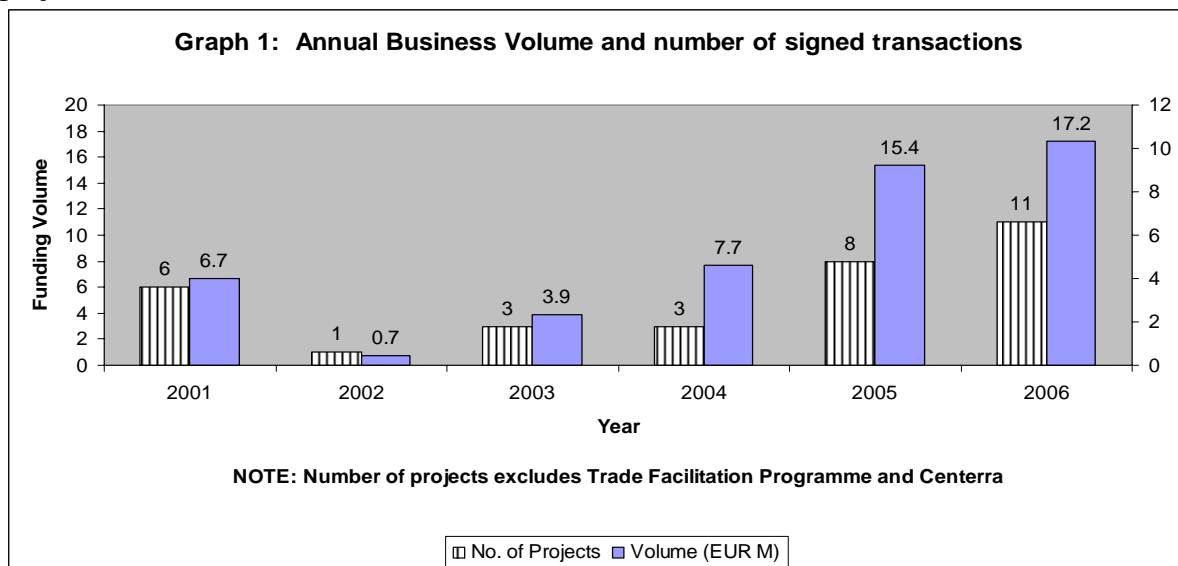
The Bank's net commitments are EUR 172 million (at current Euro/USD exchange rates) at end December 2006.¹ This figure compares to an end-2005 committed portfolio of EUR 174 million. Despite continued signings and disbursements, net exposure reduced in size slightly, primarily due to exchange rate movements and continued repayments.

Table 1: Bank's Finances at end December 2006

	No. of Projects	Total Project Value (EUR million)	EBRD Finance (EUR million)	Debt guarantees (EUR million)	Equity (EUR million)	% Share of Commitments
Private	14.0	619	114	83	30	66%
State	5.0	92	58	58	0	34%
Bank Equity	3	14	5	2	4	3%
Bank Lending	2	10	10	10	0	6%
Small Business	1.5	26	16	16	0	9%
General Industry	1.3	18	8	6	3	5%
Agribusiness	4.1	24	15	15	0	9%
Property and Tourism	2	40	17	16	1	10%
Power & Energy	2	48	46	46	0	27%
Natural Resources	2	489	47	25	22	27%
Telecoms	1	40	7	7	0	4%
Totals	19	711	172	141	30	100%

¹ The Bank signed 8 new commitments in 2005 and 11 in 2006.

As can be seen in Graph 1 below, the ETC Initiative, launched in April 2004 has led to a substantial increase in the number and volume of project signings since that date. In 2005 and 2006, the number of projects signed increased to 8 and 11 respectively, and corresponding commitments to EUR 15.4 million and EUR 17.2 million. The average project size over 2005/2006 has been EUR 1.7 million.



1.2 Implementation of the Previous Country Strategy

The Bank's previous Strategy, approved in November 2004, reflected a difficult investment environment and limited sovereign borrowing capacity, and primarily focused on private sector development. The Bank's operating environment continues to be impacted by uncertainty since the March 2005 political changes, although the Bank has been able to implement its Strategy.

1.2.1 Fostering the Private Sector

The Kyrgyz economy depends on small and medium size companies, particularly in the agricultural, services and retail sectors. Some companies were directly impacted by civil disorder in 2005 although most did not suffer a long-term impact (within a year, most stores impacted directly by the rioting and looting had reopened). However, the uncertain political climate over the past two years has been a reason for some companies and banks to delay major investments. Renewed investment was evident in 2006, particularly in banking, property and tourism.

In order to foster development of SMEs, the previous Strategy outlined key sectors of the Bank's operations - agribusiness, textile, property and services and natural resources. More specifically, the Strategy called for use of the ETCI to work with regional and international investors in these sectors. Despite the difficult environment, the Bank's operations developed relatively well:

- MSE Facilities expanded rapidly. By end 2006, the Bank's partner banks in the MSE programme had disbursed 70,496 loans for USD 163 million. The outstanding portfolio was over USD 63 million, around 20 per cent of total

banking sector lending. Agriculture and rural borrowers accounted for 5,884 loans and USD 7.4 million of these amounts.

- The Bank signed its first DLF projects: in textiles, agribusiness and property and tourism sectors.
- The Bank signed its first sub-project with an MCFE partner bank with a locally-owned agribusiness company.
- In natural resources, the Bank signed a loan to a local fuel services company, designed to improve quality and higher transparency. The Bank's presence as a shareholder in KMC's parent company, Centerra Gold, allows the Bank to continue monitoring environment, health and safety (EH&S) and operational standards, and may offer new financing to KMC which recently extended the life of its mine until at least 2012.
- During the Strategy period, the Bank sold its stakes in five DIF investments, which had been approved prior to implementation of ETCL. The Bank has since signed one equity investment.
- Business Advisory Service (BAS) programme began operations in the country in late 2004 with the main office located in Bishkek. A total of 98 BAS projects were undertaken by end 2006 (with increasing efforts, nearly half of all projects were located outside Bishkek). Turnaround Management (TAM) programme has supported 4 companies. The synergy of TAM/BAS operation and Bank's banking activities has been increased during the strategy period.

1.2.2 Strengthening the Financial Sector

The banking sector continues to develop, albeit from a very small base. The Bank helped to strengthen its partners via a capital increase for one of its three existing equity partners while monitoring capital needs at the other two (further increases are possible in the near future). The Bank lent funds to two additional banks in the MSE programme and began working with three non-bank micro finance institutions. The Bank's TC component of the KMSEFF programme has helped to expand the commercial bank lending; lending and advisory support to NBMFIs also has been critical to growing their lending programmes.

The Bank continues to achieve some results in strengthening financial sector infrastructure. The Bank encouraged and advised on the passage of the AML Law (achieved in June 2006) and an improved Pledge Law (achieved in 2005). The Bank's TC to local banks helped upgrade internal AML procedures. The Bank continues to advise the Credit Bureau, is implementing credit scoring training, and is considering additional support in banking supervision and deposit insurance.

1.2.3 Support for Critical Infrastructure

Despite a consistent policy dialogue, infrastructure reforms have not been implemented in light of limited political commitment. Due to high external debt levels, the Kyrgyz Republic has limited borrowing capacity. Infrastructure investment during the Strategy period has therefore been financed by the state budgets by means of highly concessional loans.

The Bank has pursued various infrastructure projects, including government-owned entities, but without sovereign guarantees, including natural resources, transport, water and energy sectors. These discussions have been coordinated with donors and IFI partners, but have yet to produce concrete transactions. The Bank is seen as a long-term potential partner in:

- Telecoms - the Bank has worked at all levels of Government and Parliament to promote the potential privatisation of Kyrgyz Telecom (KT) and at the same time, monitored its existing sovereign exposure to KT;
- Energy - While monitoring its existing exposure to the transmission company, the Bank has been discussing non-sovereign transactions with companies implementing commercial operations (for example, after implementing a privatisation, concession or management contract);
- Gas and oil pipelines - the Bank has been reviewing financing to support the country's gas pipelines which can be supported by Clean Development Mechanism credits.

These projects require significant technical assistance resources (both for preparation and implementation) but also may require grant co-financing from donors.

1.2.4 Policy Dialogue

Following recent political changes, the Bank has re-established relationships with the Authorities, including the President, Prime Minister, and NBKR and at various levels of Government and Parliament, as well as civil society. The Bank works closely with donors and has participated in joint approaches with the donor and IFI community on a series of issues, including those impacting investment such as the new Tax Code, improved management of infrastructure and removing obstacles to bank lending.

As evident in business surveys, private business continues to be concerned about the investment climate, particularly tax policy and administration, bureaucratic interference and corruption and effectiveness of the legal system (contract enforcement). The Bank is providing training on judicial competence through the Judicial Capacity Building Initiative and, together with donors and the business community, consistently encourages Government to implement measures to improve the investment climate.

The Bank has continued to play a lead role working with the International Business Council (IBC) and other business organisations to support reform initiatives. The increased donor support for ETC countries has allowed the Bank to implement some key TC projects, including telecoms reform, legislation impacting financial investors and judicial training. The above mentioned Bank's focus on banking sector infrastructure should help widen access to financing.

As a result of its participation in KMC, the Bank remains involved in implementation of the Extractive Industries Transparency Initiative (EITI), in coordination with the World Bank and the UK's Department for International Development (DfID). In 2005 the country published its second report on implementation of EITI. The Bank is working with other donors to encourage greater transparency in the licensing of natural

resource projects and could consider additional TC projects to support this development. Both EITI implementation and improved licensing mechanisms will require further attention in the coming period.

The Bank participated with the IMF and World Bank led negotiations regarding potential debt relief under the HIPC initiative. However, the Government determined not to enter this programme in February 2007, which may have been partly due to difficulties meeting proposed HIPC conditionalities (particularly in energy tariff and mining concession reforms). Donors are now developing renewed responses to support the Kyrgyz Republic's revised strategy objectives.

1.3 Transition Impact of the Bank's Portfolio & Lessons Learned

1.3.1 Influence on the Transition Process

Enterprise Sector

The Bank's partners (foreign and domestic investors) have consistently been at the forefront of establishing standards of corporate governance and quality operations. This includes the Bank's large foreign partners such as KMC (now Centerra) and Hyatt Hotel.² In the Strategy period, the Bank worked with "regional" investors such as Steinert Industries (Interglass) and Techimsnab Russia (Limatex textiles), which has increased interest by local entrepreneurs to achieve similar standards of operation with an expectation of raising international finance. The Bank was also able to support improvements in corporate governance and business standards of smaller and regionally based enterprises throughout the ETCI. For example, Bank financing for high-quality property and tourism projects has created a model which local and foreign investors are emulating.

Financial Sector

The Bank continues to make an impact on the financial sector by setting high business standards and improving corporate governance through equity participation, on-lending activities and provision of training and advice. The Bank's partners in the banking sector are sector leaders - in terms of capitalisation and operations and are expected to set the highest corporate governance standards. The Bank is taking an active role to continue moving our partners forward in this regard, via strengthening external and internal audit, improving shareholder transparency and implementing better internal policies and procedures. In 2006, the Bank began working with NBMFIs providing micro finance. These institutions are also providing high quality service to their clients, while meeting the highest corporate standards.

The Bank's TC to help banks improve their operations has strengthened skills and know-how in recipient banks relating to micro finance, trade credits and corporate loans. The Bank also conducted AML training for its partner banks and will continue

² It is worth noting that both Hyatt and KMC have experienced difficulties due to political and legal instability and both have benefited from their relationship with the EBRD.

to support better AML standards both at Government and bank levels.

At the sector level, the Bank supported improvements in the pledge law, and Bank-funded TC helped the Credit Information Bureau to become fully functional.

Infrastructure

The Bank's impact in infrastructure during the past two years has been limited to policy dialogue and ensuring continuing performance of its telecoms and power sector clients. With the latter, the Bank's conditionalities helped strengthen corporate management. Following the success of the structure used to finance a new electricity transmission line on the south shore of Lake Issyk Kul, where repayments to electricity purchases by KMC, the Bank has worked with other IFIs and donors to encourage the Government to implement commercial structures which might support increased investment in state and municipally owned infrastructure. Despite stated intentions, the authorities have not proceeded with significant reforms in the sector and therefore the Bank had limited transition impact. Lack of structural reforms also makes financing energy efficiency measures very difficult, although the Bank continues to explore various mechanisms.

1.3.2 Financial Performance of Existing Portfolio

The Bank continues to maintain a high disbursement ratio of its portfolio in the Kyrgyz Republic. The portfolio of signed commitments is nearly fully disbursed. Performance is satisfactory and there are no specific provisions. As the portfolio has moved from public sector to private sector, profitability of the portfolio has increased due to higher margins on private sector operations.

The Bank converted its quasi-equity financing of KMC into equity in the newly formed Centerra; the Bank registered a profit on the transaction. Due to high international commodity prices, the Bank could register a further profit on this shareholding. The Bank also has positive results in each of its three bank equity investments. Kyrgyz Investment Credit Bank (KICB), Demir Kyrgyz International Bank (DKIB) and Ineximbank are among the most profitable banks, providing potential dividends and capital gains.

The Bank has now exited its five DIF portfolio investments entered into in 2001, with a net loss of USD 470,000 reflecting losses on three of the transactions. The Bank has one small DIF investment in the property and tourism sector, entered into in 2006, which is performing well. The Bank's portfolio also includes five DLF debt transactions, all entered since 2005. All projects are at an early stage. So far DLF portfolio performance is satisfactory. One bank (KICB) has joined the MCFE, with one sub-loan signed in late 2005, and another one having passed final approval. The signed operation is also performing satisfactorily.

The Bank's three operational public loans are sovereign guaranteed and are performing. Meanwhile, the Government continues to make payments for two sovereign guaranteed projects – the SME Credit Line I and the Kyrgyz Agricultural Corporation (KAC).

1.3.3 Mobilisation of Co-Financing

To date, the Bank has mobilised EUR 570 million in addition to the Bank's financing for a mobilisation ratio of 3.1. Much of this mobilisation is related to the KMC project.

1.3.4 Lessons Learned

A number of the Bank's projects have been reviewed by the Evaluation Department and the experience to date has produced numerous lessons relevant to the Bank's operations in a difficult business environment. The following provides results of published evaluations of the Bank's operations and also recommendations for expanding the Bank's activities going forward:

Project design

- The Bank should strictly separate private sector operations from public guarantees. If not prepared to assume private-sector risks, the Bank should not finance the project.³
- When creating a Greenfield bank, it is important to develop a realistic pipeline of potential projects and not to be too optimistic regarding the ability to develop the portfolio.⁴
- Complex projects depend on sponsors with sufficient experience to succeed in an adverse business climate. Experienced sponsors can support the Bank's transition impact objectives by ensuring full involvement of local co-sponsors.⁵

Skills transfer

- TC funded consultancy is important in assisting local banks to develop MSE lending. The Bank's impact is enhanced by its ability to bring different products to a single client; therefore cooperation between teams is vital.⁶
- Even when working with international sponsors, the Bank could use TC (for example for training) to ensure that skills are transferred to the wider sector.⁷

Policy dialogue

- Private sector investments can be complemented with specific sector reform components via expanded dialogue with the Government.

In light of the above recommendations and building on the Bank's operational experience, the following lessons can help to expand further operations in the Kyrgyz Republic.

- ETCI has proven to be a suitable approach to deal with poor, small economies like the Kyrgyz Republic. ETCI eases procedures for small investments via the DLF and MCFE mechanisms and ensures access to TC for due diligence,

³ KAC project, PE99-131

⁴ KICB project, PEX03-186

⁵ KCM project, PE98-098

⁶ DKIB, XMR

⁷ Hotel Kyrgyzstan (Hyatt Hotel), PE03-235

monitoring and implementation. In this way, the Bank is able to reach a wider business stratum. TC is particularly important for DIF investments which require even greater attention to corporate governance issues.

- Micro finance programmes provide strong tools to enhance grassroots businesses and to support rural and agricultural borrowers. Given the very high demand for micro finance, particularly amongst agribusiness clients, the Bank should continue to expand MSE lending by:
 - i. Adopting a pragmatic approach to its work with partner banks and better-run NBFIs, and expanding the list of partners, for example considering smaller banks or even those with less MSE lending experience;
 - ii. Seeking risk sharing arrangements with co-financiers and donors, including via structures such as the Central Asia Risk Sharing Facility (CARSSF);
 - iii. Expanding mechanisms to provide local currency financing (predominately using guarantee structures at the outset).
- The Bank will strengthen policy dialogue and implement selected TC activities to improve the business climate. The President and Prime Minister have supported the Bank's proposal to create an Investment Council to ensure high-level policy dialogue. ETC Fund resources will help ensure professional management of the Council, and the Bank will participate alongside domestic and foreign private businessmen. Other initiatives include judicial training and legal advice on laws which impact investors' legal protection.
- To help expand quality lending, the Bank has implemented TCs to help draft the Pledge Law, develop a credit bureau and provide advice on deposit insurance. Continued development of banking sector infrastructure supports the Bank's operations more generally.
- In order to have a wider impact on natural resources, the Bank can further expand its support to development of transparent licensing procedures. This will help attract higher quality entrants to the sector.
- Significant TC will be required if the Bank is to have a serious impact in the area of infrastructure reform. Moreover, the Bank will need access to co-financing grants, as the country's heavy debt burden makes financing traditional infrastructure difficult. The Bank can offer loans to state owned entities but without a sovereign guarantee if commercial structures are adopted and viable.

1.4 Portfolio Ratio

As at end 2006, 83 per cent of the portfolio was committed to private sector operations. Thus, the Bank achieved a key objective outlined in the previous Strategy, to bring the portfolio ratio above the 60 per cent target. This was achieved due to continuing investments with private partners while sovereign loans continued to repay. Existing sovereign guaranteed loans should be repaid by 2012.

2. Operational Environment

2.1 The General Reform Environment

2.1.1 Political Developments and Reform

The reform process was interrupted by the so-called Tulip Revolution in March 2005, followed by presidential elections, and only by summer 2006 was the Government formed. Although these events had limited direct impact, there was a worsened perception of the investment climate and an overall slowdown (GDP fell by 0.2 per cent).

Political opposition has remained outspoken, although disorganised. There are many political parties, including genuine opposition groups, but limited coordination as each party is associated with just one or two individuals. The country has a vibrant non-governmental organisation (NGO) network.

In November 2006 the country plunged into a political crisis, for the second time in less than two years. The Government and the “For Reforms” opposition coalition resolved their differences in a negotiated manner leading to the adoption of a new Constitution, which reduced the powers of the Kyrgyz President and gave Parliament more control over appointment of the Government. However, at the end of December 2006 the Constitution was amended again, reversing changes that had limited the President’s authority. In April 2007 a new wave of protest rallies pushing for an early presidential election and demanding constitutional reforms took place.

The problems facing the Government have not changed since two years ago. The Government must develop and implement a strategy to address widespread poverty, deep-seated corruption and unemployment (especially in rural areas).

2.1.2 Regional Issues

As a land-locked country, the Kyrgyz Republic strives to develop good relations with all its neighbours and to actively promote regional cooperation. Besides the Commonwealth of Independent States (CIS), the Kyrgyz Republic is an active member of various regional security and economic organisations, ranging from the Shanghai Cooperation Organisation (SCO), to regional economic groupings such as the Eurasian Economic Community. The country became a member of World Trade Organisation (WTO) in December 1998, the first country in the region, although benefits have been limited.

The country continues to balance its international relationships; the United States negotiated a new lease for the Manas airbase while the Russian airbase in Kant may be enlarged. In terms of economic ties, Russia and other CIS countries remain very important. There has been continuing rapprochement in relations with Kazakhstan, reflected in improved conditions for transit of Kyrgyz exports of agricultural and other products throughout Kazakhstan. Kazakhstan is a key foreign direct investor, especially in the banking sector. China, a WTO member since 2001, is a significant

trade partner, the third largest destination of exports (after United Arab Emirates and Russia) and the largest origin of imports in 2005. China is also an important source of bilateral financial support. Recently, it provided financing to complete a section of a road linking China to Uzbekistan through the Kyrgyz Republic. Relations with Uzbekistan remain difficult, although recently, there has been expanded cooperation, particularly with regard to security issues in the Fergana valley.

In the Soviet and post-Soviet periods, Kyrgyz Republic benefited from subsidised energy imports in exchange for timing and limiting the release of water from its large hydro power units. However, following a breakdown in the trilateral agreements on water and energy, Uzbekistan has now invested in additional storage and flow capacity to reduce the impact of excess water releases. Concerns remain in Kazakhstan about the impact of Kyrgyz Republic's seasonal releases. Due to its water resources, the Kyrgyz Republic has potential to play a more important role in regional power trade and in due course may be able to sell power to South Asia. Addressing the shortage of energy to meet domestic heating requirements in winter, however, remains a challenge and requires new investments in thermal heat and power generation as well as further structural reforms (see section 2.2.2).

2.1.3 Labour Issues

The Kyrgyz Republic has been a member of the International Labour Organisation (ILO) since 1992, and to date has ratified forty-nine ILO conventions (including the eight core conventions) out of a total 187 ILO conventions. The country has not provided updated reports to the ILO on application of ratified conventions. As the informal labour market is significant, the effective protection of workers' rights could fall below standards stipulated by national laws and ILO conventions.

The labour code, last amended in 2005, provides workers full rights to form and join labour unions. Forced or compulsory labour is illegal and children are protected from economic exploitation and working in hazardous environments. There are strong restrictions on overtime work (maximum 120 hours per year). The code also provides for maternity leave of one and a half years. The minimum wage was raised in October 2006, but remains very low at just KGS 340 (USD 9) per month.

Worker protection is limited, however, when considering employer commitments: the monetary costs of dismissal are low (one month's severance pay), the use of fixed-term contracts is allowed and the notice period required for contract termination is relatively short. Unemployment benefits exist but their levels are low and eligibility conditions restrictive. Although the Kyrgyz Republic is bound by international commitments under ratified core ILO conventions, according to reports from various NGOs, child labour is a problem and remains widespread, especially during cotton and tobacco harvest seasons.

According to a 2006 US State Department report, the Kyrgyz Republic is a source, transit, and growing destination country for men, women, and boys trafficked for the purposes of forced labour and sexual exploitation. The report qualifies the Kyrgyz Republic as a Tier 2 country, i.e. a country which does not fully comply with minimum standards for elimination of trafficking but is making efforts to bring itself into

compliance.

2.1.4 Social Conditions

In recent years, the development of social conditions in the country provides a mixed picture. Poverty incidence has improved with the poverty rate declining from 50 per cent in 2003 to 44 per cent in 2005. Nevertheless, poverty remains high in rural areas⁸ and in recent years, income inequality worsened with Gini coefficient⁹ (measured by per capita consumption) increasing from 0.30 in 2000 to 0.33 in 2004. The rising trend of unemployment (measured by labour force survey) since the survey began in 1998 has not reversed and the rate increased from 8.9 per cent in 2003 to 9.7 per cent in 2005. Other social indicators such as life expectancy and infant mortality per 1000 births remained unchanged between 2002 and 2004 at 68 years and 21, respectively.

In terms of regional disparities, social conditions vary to a larger extent in terms of per capita income, poverty incidence and access to health service but less in terms of employment rate and access to some of the infrastructure services as presented in Table 2.¹⁰

Table 2: Regional differences, 2004

	Average monthly per capita income (som)	Population living below poverty line (%)	Employment rate (%)	Doctors per 1000 population 1/ population 1/ (%)	Population with access to drinking water (%)	Population with access to electricity supply (%)	Population with access to gas supply (%)
Kyrgyz Republic	827.4	45.9	91.5	-	81.0	99.8	18.6
Batken region	624.3	77.8	84.1	1.38	64.0	99.9	4.1
Jalalabat region	653.1	50.1	93.3	1.52	74.2	99.5	5.5
Ysykkul region	618.6	54.1	92.3	1.97	85.2	99.9	-
Naryn region	673.7	66.3	92.8	1.79	77.8	100.0	-
Osh region	718.8	57.0	95.7	1.48	65.1	100.0	15.3
Talas region	659.0	51.3	95.9	1.76	97.3	100.0	-
Chui region	1091.0	21.7	86.1	1.90	100.0	99.5	12.0
Bishkek city	1277.2	16.5	90.4	3.34	100.0	100.0	74.7
Coefficient of variation 1/ 2005 data	0.32	0.42	0.05	0.33	0.18	0.00	-

Source: National Statistical Committee of the Kyrgyz Republic

Despite the fact that legislation provides for equal rights for men and women, the transition has been disproportionately hard for women in terms of political representation, employment opportunities and wage rates. Responsibility for family and

⁸ This figure is based on consumption per capita poverty line definition of KGS 9,605 (USD 234) in 2005 prices. The percentage of population living below USD 2 per day (in 1985 USD at purchasing power parity) was 21.4 per cent in 2003 (the latest survey year).

⁹ A value of 0 represents perfect equality, and a value of 1 perfect inequality.

¹⁰ The extent of variation is measured by the coefficient of variation, a statistical measure of variance defined as standard deviation divided by mean. Higher coefficient indicates a higher degree of variation.

child care has transferred back to women from the former state-run services. Considerable increases in the proportion of non-remunerated activities have resulted in difficulties for women in balancing paid and unpaid responsibilities. Many women have been forced into informal sector employment which involves long hours of work, low wages, and difficult conditions. Furthermore the absence of any form of social protection such as sick leave, maternity leave, or pension contributions for informal workers leaves them extremely vulnerable to poverty. Better access to micro-loans might be one way of bringing women back into the formal labour force, noting that higher numbers of trafficked women may be partly attributed to poverty and lack of other employment opportunities.

2.1.5 Legal Environment

The Kyrgyz Republic has continued to reform its commercial law framework during the last two years. Of note, in 2005, is the new Law on Counteracting Terrorism Financing and Legalisation of Criminal Profits which should help address concerns regarding money-laundering activities in the country. The general legal environment for business remains weak with the need for serious improvements to the legislation on concessions and securities markets. Laws on corporate governance and insolvency are more in compliance with international standards. However implementation remains questionable, due in particular to weaknesses in the court system. The 2005 Pledge Law, which was intended to promote out-of-court enforcement procedures, lacks appropriate implementation regulations and its application on that particular point has not yet taken root.

Lots of initiatives by the international community currently aim to improve the quality of legislation and legal institutions in the Kyrgyz Republic. Not least among these is the Bank's initiative to strengthen judicial capacity in the commercial law sector, with training courses offered to judges during 2006-2008. In the next period, the Kyrgyz Republic continues to face the challenges of strengthening its legal institutions, especially its court system, curbing corruption and generally promoting the rule of law.

2.1.6 Environmental Aspects

The National Environmental Action Plan (NEAP) adopted in 1995 remains the country's primary guiding policy. The NEAP defines key environmental issues: inefficient water resources management, land degradation, over-exploitation of forest resources, and the threat of a decline in biodiversity and inefficient mining and refining practices. Since the last Strategy, environment-related functions have been transferred from the Ministry of Environment and Emergency Situations to the State Agency on Environmental Protection and Forestry. Among the latest changes in the legislation are ratification of the Water Code in 2005, and the Ecological Code that is currently being developed to resolve existing contradictions in legislation, policies and institutional arrangements. The Government is also on a path of harmonising the existing environmental legislation with international commitments. The Mid Term Strategy for 2006-2010 is expected to include an emphasis on environmental sustainability to ensure that environmental considerations are taken into account as it relates to development objectives.

The Kyrgyz Republic has ratified nine international agreements on nature conservation/protection, including on issues of Biodiversity Conservation (1996), Climate Change (2000) and has ratified the Kyoto Protocol, Desertification (1997), and most recently the Stockholm Convention on Persistent Organic Pollutants (2006). The Government and the civil society are actively supporting various national and regional initiatives on environmental protection. The Kyrgyz Republic is a member of United Nations Division for Sustainable Development and signed the Issyk-Kul and Nukusky Declaration (1995), supporting sustainable development globally and specifically in the Central Asia region.

The Bank's approach to environmental issues in the Kyrgyz Republic complements its private sector activities. For example, the Bank monitors the environmental due diligence standards implemented by PBs utilising EBRD lending (MSEFF and MCFE). The Bank continues to ensure its partners, including KMC, implement the highest environmental standards. Moreover, the Bank has worked with the IFC and international and local NGOs to implement rural development and biodiversity conservation programmes around the KMC site. This was enhanced in August 2005 when the Bank initiated a programme to enhance monitoring of the Sary-Chat Ertash nature reserve there. Recent development of property projects on Lake Issyk Kul have also been appropriately designed to ensure protection of this Ramsar designated nature area.

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic Conditions for the Bank's Operations

Macroeconomic policies remained generally prudent and unaffected by the political events of March 2005. The IMF's Poverty Reduction and Growth Facility remained on track. Lack of economic diversification and high external debt make the economy vulnerable to shocks as evidenced by negative growth in 2005 after relative robust performance the preceding two years. Besides high debt service, long-term growth hinges on further improvement in the business environment, including the quality of public institutions. Productivity increase in the agriculture sector is also important as it still accounts for around one third of GDP and half of total employment.

Real economy: The economy contracted by 0.2 per cent in real terms in 2005 due to disruptions caused by the political events that year and a (scheduled) decline in production from the KMC (accounting for 6 per cent of GDP). This followed robust growth (7 per cent per annum) in 2003 and 2004. In 2006, the economy registered real growth of 2.7 per cent, which partly reflected stronger investment. The main driver of growth in 2000-2005 was the services sector that grew by 6.8 per cent per annum. The services sector's share in GDP (40 per cent in 2006) surpassed that of agriculture (around 30 per cent), which grew sluggishly in the past six years (2.7 per cent per annum).

Economic policies: Macroeconomic policies continued to focus on fiscal consolidation and maintaining price stability. The general government fiscal deficit narrowed from 5.3 per cent of GDP in 2003 to 4.1 and 4.0 per cent in 2004 and 2005, respectively.

This was achieved primarily as a result of increased tax revenues. In 2006, the deficit is estimated to have further narrowed to 2 per cent of GDP despite various tax cuts introduced during the course of the year as the country benefited from lower interest payments (due to the 2005 Paris Club debt rescheduling) and increased customs revenues (owing to surge in imported goods). Inflationary pressures rose at the end of 2005, mainly because of the shortfall in farm output and fuel price increases. A surge in money supply beginning in 2005, linked to sizable unsterilised intervention in the foreign exchange market by the NBKR, may also have been a factor. During 2006 the NBKR has adopted a more flexible exchange rate policy to allow the local currency to nominally appreciate against the US dollar and this has helped inflationary pressure to subside.

External sector: The current account deficit widened sharply to 18 per cent of GDP in 2006 from 3.4 per cent in 2004. These developments partly reflected one-off factors relating to KMC: a scheduled decline in gold exports (2005) and increased imports of gold mining equipment (2006). In recent years, remittances from workers who have emigrated (many to Russia and Kazakhstan) are an increasingly important source for narrowing the current account gap (as much as 16 per cent of GDP in 2006). After a record USD 131 million net FDI inflows in 2004, inflows dipped to USD 43 million in 2005 but back to USD 125 million during three quarters of 2006.

While Paris Club debt rescheduling (in 2002 and 2005) has eased the debt burden, total public external debt remains significant, amounting to 69 per cent of GDP at end 2006. The Authorities' decision in February 2007 not to seek debt relief under the HIPC initiative means the country's debt burden will remain high during the Strategy period with an annual debt service of 3.5 per cent of GDP (USD 100 million).¹¹

2.2.2 Transition Success and Transition Challenges

In the past two years, progress in key transition measures has been insufficient, primarily due to weak government implementation. In the forthcoming period, the key challenge remains to build a sustainable private sector which can contribute to growth and further poverty. Therefore, the Government should work to:

- Further improve the investment climate and avoid measures which threaten existing investments;
- Implement measures to tackle corruption, improve the court systems and lessen bureaucracy;
- Increase transparency and improve corporate governance of enterprises (particularly in the state sector);
- Improve tendering and licensing procedures in many sectors, but particularly in the awarding of natural resources licenses;
- Improve tariff regulation, especially in the power sector, in order to attract private investment in infrastructure;
- Facilitate the further deepening of the financial sector by withholding unnecessary interference while further strengthening the regulatory

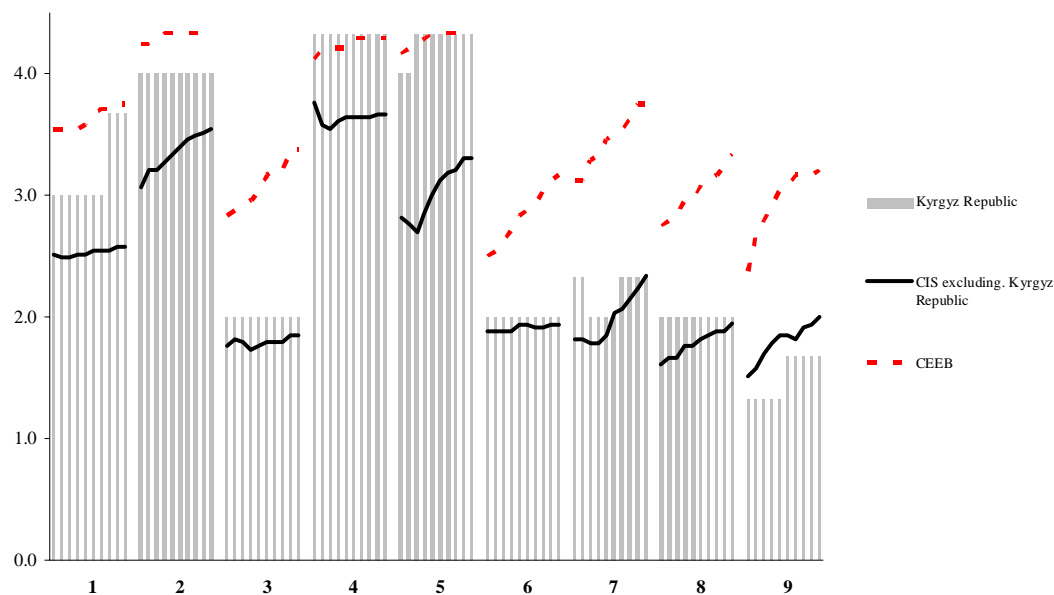
¹¹ The HIPC initiative could have reduced debt significantly – according to some estimates, by up to USD 947 million (39 per cent of GDP in 2005).

independence and remit of the regulator and by encouraging the non-bank microfinance institutions to become sustainable including through privatisation.

Progress in transition

The Kyrgyz Republic implemented price, trade and foreign exchange liberalisation and small scale privatisation in the early years of transition. Less progress was made in the implementation of more difficult reform areas such as large-scale privatisation, governance and enterprise restructuring, competition policy, banking reform, non-bank financial sector reform and infrastructure reforms (Table 3). In recent years there has been better progress in banking sector reform evidenced by increased level of banking intermediation, albeit from very low level, as well as large-scale privatisation through the de facto privatisation of KMC.

Table 3: Reform progress in the Kyrgyz Republic compared to CIS and CEEB, 1996-2006



- 1 = Large scale privatisation
- 2 = Small scale privatisation
- 3 = Enterprise restructuring
- 4 = Price liberalisation
- 5 = Trade and foreign exchange liberalisation
- 6 = Competition policy
- 7 = Banking sector reform and interest rate liberalisation
- 8 = Securities markets and non-bank financial institutions
- 9 = Infrastructure reform

Source: EBRD Transition Report 2006

Financial sector reforms: The regulatory and supervisory framework has strengthened in the past two years. A new pledge law was adopted in March 2005. In November

2005 further revisions to the law regulating the banking sector introduced better principles of corporate governance, and extended the regulator's authority over banking groups on a consolidated basis. A new AML law entered into force in August 2006 and has been implemented since 8 November. The Financial Intelligence Unit is gathering information on all large transactions, but at present has limited capability to analyse information provided and has no powers to enforce bank compliance.

Despite political uncertainty since March 2005, the banking sector grew rapidly, with total customer loans up around 60 per cent per annum in real terms in the last three years. Customer loans to GDP increased from 3 per cent in 2003 to 10 per cent in 2006. Competition has also strengthened as a number of Kazakh banks have established subsidiaries. The key challenge is to further strengthen the independence of the regulator (NBKR) and its supervisory capacity and prepare for the introduction of a deposit insurance system.

The non-bank financial sector is dominated by microfinance institutions and credit unions regulated by the NBKR. Credits extended by these institutions amounted to 4-5 per cent of GDP in 2006. However, since most do not have a deposit license, NBFIs activities rely on external financing (primarily from donors). These institutions must become sustainable, most likely by converting themselves into deposit taking institutions, with sufficient capital as well as strengthened corporate governance and risk management. The authorities are preparing for the privatisation of KAFC (now renamed Ayilbank) the largest NBFIs (in terms of assets) which specialises in micro-finance to the agricultural sector. Other non-bank financial sector activities, such as leasing, insurance and pension funds, remain small and further regulatory improvement is necessary.

Large scale privatisation, enterprise restructuring and competition policy: Little progress was achieved in enterprise sector reforms. While the share of state-owned companies in GDP has declined substantially as a result of *de facto* privatisation of KMC in 2004, the state still controls a number of enterprises in agriculture and mining sectors as well as in infrastructure. In the past two years, there was some progress in the sales of state assets in the tourism sector but the privatisation of other large companies has stalled. There are issues regarding the corporate governance of large state-owned companies including transparency of their financials. Whilst the Kyrgyz Republic is one of the first countries in the region to adopt the principles of Extractive Industries Transparency Initiative (EITI), it is important that more companies adopt EITI standards. Improving corporate governance of large companies, especially state-owned, is the key challenge in the strategy period.

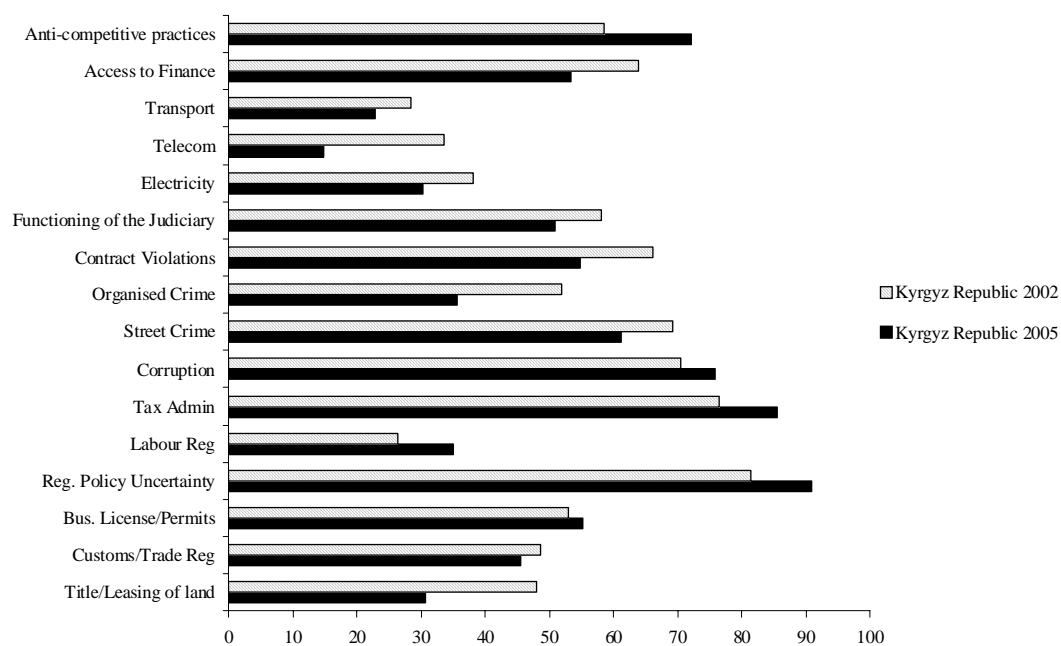
Infrastructure reforms: Infrastructure continues to be characterised by a generally low quality of services and inefficiency, and in need of extensive investment. Fiscal constraints and lack of implementation capacity have limited the public sector from undertaking required upgrades and maintenance. Tariff reforms have not been implemented except in the telecommunications sector which was liberalised in 2001. The country must strive to achieve cost-recovery of state/municipally-owned enterprises through improved corporate governance and tariff reforms (while addressing affordability constraints). Such reforms will make new investments, including by EBRD with private or public sector investors potentially viable.

The power sector continues to be a significant burden. Although generation and distribution were restructured in 2001 by unbundling the state-owned monopoly, KyrgyzEnergo, into seven companies, they are not operating commercially and losses remain high. The quasi-fiscal deficit (defined as the cost of production minus cash revenues) in the electricity sector is approximately 8 per cent of GDP. Electricity tariffs for households were unified in April 2006 at KGS 0.62 or 1.5 US cents per kWh, abolishing the lifeline tariff system that had been subject to billing abuses. However, the average tariff is just over half the cost recovery level of around KGS 1.1 or 2.7 US cents per kWh. The authorities are working on a tariff reform schedule to reach full-cost recovery levels. Donors are urging the authorities to enhance the financial transparency in order to improve financial performance across the sector.

Investment climate

Developments regarding the investment climate in recent years also are mixed. Table 4 is based on EBRD/World Bank BEEPS and shows the percentage of firms reporting minor, moderate or major problems in 2002 and 2005. Perception of obstacles to business improved on average in infrastructure and crime but worsened for business regulation, taxation and corruption.¹²

Table 4: Problems in the Business Environment



Source: EBRD/WB BEEPS 2002 & 2005

Qualitative interviews with firms in early 2006 explored the business environment in five key areas: business regulation, courts and dispute resolution, corruption and crime,

¹² As the BEEPS were carried out in spring 2005, it may not reflect subsequent changes in the investment climate following the political events in March/April 2005. However, qualitative survey undertaken in early 2006 indicates that the overall picture has not changed significantly.

access to finance and infrastructure. The interviews confirmed that regulatory uncertainty remains a significant problem. Many managers felt that laws were not clear and were open to interpretation:

“Every law can be interpreted differently. If 2 men gather there will be 2 variants of law, if 4 then 4 variants.”

The main problem identified by SMEs (estimated to employ around 60 per cent of the population and produce over 40 per cent of GDP) related to uneven application of legislation. They note the existence of “favoured” companies, usually with powerful state connections. SMEs’ priorities for reform include reduction in income tax, VAT and contributions to the Social Fund, especially in the first years of operations. Measures to simplify the tax system, broaden the tax base and reduce corruption that came into effect from January 2006 could have a positive impact on the business environment particularly for SMEs.¹³

The World Bank’s “Doing Business” report published in summer 2006 also produces a mixed picture. The overall ranking of the country improved from 104th place among 175 economies in 2005 to 90th in 2006 as the process for property registration improved and access to credit eased. On the other hand, the environment regarding licensing, paying taxes, trading across borders and business closure remained problematic and worsened in some cases.

The corruption perceptions index (CPI) score of the Kyrgyz Republic published by Transparency International (on a scale ranging from 10 to 0, 0 being highly corrupt) declined from 2.3 in 2005 to 2.2 in 2006. According to quantitative questions within BEEPS, corruption has declined in terms of level but increased in terms of frequency. Between 2002 and 2005 the bribe tax fell from 3.70 per cent to 2.46 per cent of firms’ sales, and kickback tax decreased (albeit modestly) from 2.41 per cent to 2.16 per cent. Bribe frequency, on the other hand, rose from 43.70 per cent to 52.85 per cent, the highest in the region. The Kyrgyz Republic has ratified the UN Convention against Corruption in September 2005. The current government has kept the fight against corruption as a top priority and formed the National Agency for Prevention of Corruption on 21 October 2005.¹⁴ Their impact is too early to assess and further concrete measures may be needed to tackle deteriorating environment as indicated by the CPI.

¹³ Income tax was set at a uniform rate of 10 per cent, profit tax was reduced from 20 per cent to 10 per cent, value added tax (VAT) on farm output was temporarily suspended, and payroll tax was reduced from 31 per cent to 29 per cent.

¹⁴ For information see Russian language pages of NAPC website at www.napc.kg.

2.3 Access to Capital and Investment Requirements

Access to medium and long-term finance continues to be severely limited. Deposits in the banking system grew from 3.5 per cent of GDP at the end of 2001 to 15 per cent at the end of 2006, reflecting increasing confidence, but are still too low to support an expanding private sector. Total loans by commercial banks reached around 10 per cent of GDP, with 27 per cent over 1 year maturity. Interest rates on loans have gradually been declining but average interest rates as reported by the NBKR continue at relatively high rates (24 per cent in local and 17.5 per cent in foreign currency).

FDI net flows are now positive, after the outflows experienced in 2000 and 2001. This is largely due to increased investments from neighbouring countries and further investments at KMC. FDI net flows of USD 100 million per annum in the past three years accounted for around one quarter of annual gross investment and roughly equalled annual capital expenditures by Government. Given likely continued limitations on public sector finance, a top government priority remains to remove investment obstacles.

3. Strategic Orientations

3.1 The Bank's Priorities for the Strategy Period

The Bank will remain focused on its core areas of expertise: financing private investors, supporting banking sector development and supporting reforms in key infrastructure. The ETC Initiative will allow the Bank to further expand the range of its potential clients to include smaller enterprises operating in the regions. This is very important as there are few sectors where large investment is present. The size of individual investments tends to be quite small in key sectors such as agribusiness, textiles, and property and tourism.

3.1.1 Fostering the Private Sector

Development of private businesses remains the Bank's key operational objective. Direct financing will be targeted to agribusiness, textile, property and tourism, consumer services, as well as natural resources should there be opportunities with credible investors. This should contribute to diversifying the economy, expanding external trade and employment. The Bank will also contribute to the improvement of energy efficiency in the private sector enterprises.

Given the importance of agriculture (30 per cent of GDP), the Bank will strengthen efforts to reach this sector and ETCI products should help widen opportunities with smaller foreign and local investors. For example, the Bank has financed smaller agribusiness companies via the MSEFF as well as the new Direct Lending Facility and Medium-sized Co-Financing Facility.

The Bank will continue to expand its successful programme to finance micro and small

enterprises through financial intermediaries. In the past two years, the Bank increased its focus on facilitating financial access to rural borrowers, and in 2006 began working with Aiyl Bank, the country's largest provider of agricultural finance. The Bank has increased the number of commercial bank partners. From a sector perspective, by working with an array of financial institutions, the Bank would like to increase competition, which will increase lending volume, reduce interest rates and lengthen tenors for borrowers.

The Bank has financed regional cross-border investments involving investors from Russia, Kazakhstan and the Kyrgyz Republic. Given rapid growth in the region, the Bank expects to be able to support other regional investors coming to the Kyrgyz market from CIS countries, as well as from countries such as Turkey, Korea and China.

3.1.2 Strengthening the Financial Sector

The Bank's impact on the financial system is significant with exposures to nine financial institutions accompanied by substantial technical assistance. Overall, the sector has strengthened due to continuing capital increases, growing depositor confidence and increased competition. The Bank has supported the sector by developing a stronger pledge law and enhancing the operation of the credit bureau. Moreover, the Kyrgyz Republic has been at the forefront of the Bank's efforts to work with non-bank microfinance institutions.

The Bank will be focusing on strengthening (in terms of capital, corporate governance and general competitiveness) its partner financial institutions. In the forthcoming period, the Bank could participate in capital increases and where appropriate support consolidations between banks and non-bank institutions. The Bank also considers supporting conversion of NBMFIs into deposit taking institutions.

As the Government intends to privatise Aiyl Bank and the Savings and Settlement Company, which would further strengthen the overall quality of the financial sector, the Bank will seek how best support this initiative. Also the Bank will seek ways to develop new products which reduce financial institutions' foreign exchange risks. As a first step, the Bank has developed a guarantee facility product which enables NBMFIs to raise local currency funding more competitively.

As the Bank is at or near prudent lending levels with a number of partners, it will work with donors to share risks as a means of leveraging Bank financing. At the same time, the Bank will work with the NBKR on bank supervision issues to strengthen the sector and hope to find additional partners. The Bank will maintain a close dialogue with other donors to ensure targeted assistance for the sector more generally. Such assistance in the coming period could include further support on bank supervision, development of deposit insurance system, implementation of the new anti-money laundering law and further support for the credit bureau.

3.1.3 Support for Critical Infrastructure

The Bank's direct financing of infrastructure has been limited due to the country's restricted capacity for external borrowing and also due to inability to proceed with key

reforms. For example, efforts to finance the energy sector are most likely possible only after tariff reforms and willingness to allow commercial (private) management. In light of its high debt burden, the Government must continue to avoid significant new state borrowings, and it is expected that new sovereign loans will continue to be limited to those with 45 per cent grant element.

Therefore, the Bank will continue to seek non-sovereign infrastructure projects, which could include financing for privatisations (telecoms) or concessions (power, roads, gas pipelines). Where possible, projects may be regional in nature. Considering the level of the country's sovereign indebtedness, the Bank's ability to finance sovereign guaranteed projects in the strategy period will be limited, particularly if there is not access to a stable and predictable source of co-financing grants.

3.1.4 Policy Dialogue

The Bank is a key counterpart to Government and provides advice on private sector development and the investment climate. Following the 2005 political changes, the Bank has retained its dialogue with the new authorities as well as civil society. Building on success of the International Business Council, the Bank has helped to create a new advisory council, with the participation of both the President and the Prime Minister, where business representatives can bring attention to key barriers to private sector development. By supporting the Council Secretariat, the Bank will ensure follow-up of the Council's decisions and recommendations. Considering recent discussions of potential nationalisation of some existing high-profile investments, it is important to maintain quality dialogue between investors and government. Other key TC projects include ongoing training for judges and a legal reform programme to address obstacles to investment.

The Bank worked with other donors to harmonise approaches to improve the business environment, this included support for the first joint country strategy developed by the World Bank, Asian Development Bank, United Nations Development Programme and key bilateral donors. The Bank will continue its coordination with other IFIs and the business community. The Bank's Environmental Policy and Public Information Policy will apply to all projects developed in the Kyrgyz Republic.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 General Industry

Although private sector development is hampered by uncertain political developments, there have been some important (albeit relatively small) investments in the past year in manufacturing, processing and services. Development of private business will be the Bank's key objective during the strategy period, which will contribute to diversify the economy, expand the country's external trade and generate growth and employment.

Positive developments in external trade are vital for a small, landlocked country in transition like the Kyrgyz Republic. Currently, the country's external trade remains very limited and insufficiently diversified as Kyrgyz exports are concentrated in a few low value added commodities. The Bank will therefore seek to support an increase and

diversification in the Kyrgyz Republic's trade.

Through financing private sector enterprises, the Bank will seek opportunities to improve energy efficiency of the enterprises. Given the average investment size, ETCI instruments are vital to the Bank's operations.

In the Strategy period, the Bank will focus on the following areas:

- Seek successful investments with foreign and local partners. The Bank will continue marketing to regional investors, including from countries such as Russia, Kazakhstan, Turkey and China. Such investments require a sufficiently pragmatic approach to new clients and may require TC resources to streamline due diligence.
- Utilise ETCI to reach smaller Kyrgyz-owned companies via an expansion of MCFF, DLF and DIF products. It is hoped to add at least one more bank as an MCFF partner. All three products are supported by TC, which is vital during due diligence stage and implementation.
- Continue to support MSE lending. KMSEFF partner banks are disbursing more than USD 5 million per month to MSE borrowers. The Bank has initiated activities with three non-bank institutions, offering a new outlet for MSE lending, and expanded its MSE financing to reach rural areas more fully. Continued expansion of MSE activities requires the partner institutions to continue to grow their capital, expand operations and adopt appropriate corporate governance reforms.
- The Bank also seeks opportunities to finance projects which enhance energy efficiency and consider effective use of CDM financing. At present, the Bank is implementing its energy efficiency objectives on a case by case basis. The first financing was for EUR 500,000 to the Interglass glassworks. The Bank is ready to support the same type of projects and has conducted energy efficiency audits for smaller sites which could benefit from energy efficiency investments and would consider a credit line specifically for this purpose. However, the Bank's ability to finance energy saving projects is undermined by very low electricity prices (only 50% cost recovery levels), as well as non-payments, which means many companies have no incentive to reduce energy usage.
- Expand TC available to smaller companies to ensure skills and knowledge transfer. The BAS programme plans to undertake 60 projects per year, focussing in rural areas through its regional office in Osh and an anticipated second regional office in Issyk Kul. After supporting 4 projects in the past two years, TAM intends to support a minimum of 3 projects annually. Further expansion depends on TC support and the needs of potential investee companies.
- Continue to pay close attention to governance standards by government and investors. The Bank will work to ensure higher levels of transparency of ownership, particularly involving political figures.

3.2.2 Agribusiness

As agriculture forms the backbone of the economy and is the main source of employment, the Bank will enhance agribusiness projects in order to increase value-added in the sector, to increase export earnings, and to contribute the diversification of

the economy. Although the Bank has been active in the agribusiness sector since its early days of operation, the number of projects and success rate has dramatically increased since the introduction of ETCI in 2004. Some improvements in the business climate should help the Bank identify viable investment opportunities, either directly for large enterprises or, through financial intermediaries, for SMEs.

- The Bank will strive to expand use of ETCI products to support local agribusiness companies displaying high growth potential.
- Increased interest from agribusiness companies in the CIS may also provide opportunities for Bank financing. Such CIS connections would enhance Kyrgyz agribusiness companies' access to regional markets.

KMSEFF has expanded its activities to offer specialised loan products and support banks in acquiring the necessary know-how and capacity to provide finance to rural agricultural SMEs.

3.2.3 Property and Tourism

The property and tourism sector has been an important source of economic growth for the country in recent years. The Bank has financed high quality projects resort, residential and hotel facilities on Lake Issyk Kul and high standard hotels and residential facility in Bishkek. There is increasing interest in retail, commercial and residential real estate, especially offices in the capital and tourist accommodation.

- The Bank will seek to build upon experience gained in the successful DIF and DLF as well as the Hyatt Hotel financing. Most projects are likely to be small and should be channelled through DIF and DLF in the coming years.
- The Bank will consider equity investments alongside local and foreign sponsors especially when working with known clients and those which have demonstrated strong corporate governance, quality of construction and management.
- The Bank also will seek larger projects suitable for direct financing.
- Financing regional infrastructure projects, such as regional roads and aviation that facilitate easier access to the country and thus promote property and tourism development also will be considered.

3.2.4 Natural Resources

Mining is one of the key industries in the country. The Bank financed KMC and participated in its restructuring into Centerra. Recent developments include:

- extension of the life span of the mine from 2007 to at least 2012 and possibly longer;
- doubling of an exploration budget for new satellite gold deposits;
- provision of support to the Kyrgyz Government implementation of principles of EITI, and support on publication of the first two (unaudited) reports in 2004 and 2005.

Continuing involvement as a minority shareholder allows the Bank to monitor KMC's corporate standards and retain a policy dialogue with Government. In addition, the

Bank is continuing to assist development of KMC, and may offer additional financing for the adjacent developments, assuming that current legal uncertainties (including threats of re-nationalisation) are resolved. The Government and KMC are working to remove outstanding uncertainties regarding development of the KMC site and should ensure continued application of the highest environmental standards.

Further large-scale investments in the extractive sector are limited by non-transparent licensing procedures, which resulted in non-transparent ownership of large undeveloped gold mines such as Jerooy and Taldy Bulak. The Bank is exploring how best to support the introduction of better licensing procedures so as to attract higher quality entrants in the sector, and will continue to engage the Government to this end.

The Bank will continue to assist the development of a market-based oil and gas sector, both upstream and downstream, with focus on potential for increased regional integration and improved EH&S management. The Bank is reviewing all its investments to seek out energy efficiency components, in particular through carbon emissions reduction and carbon credit potential. However, energy efficiency depends on sectoral reforms; customers do not see savings from reducing energy usage.

The Bank will continue to work with its private sector partners to help implement EITI. It is hoped that greater transparency in licensing procedures and in tracking revenue streams will help level the playing field for all natural resources investors, thus increasing overall investment in the sector.

3.2.5 Financial Institutions

The Bank's key goal is to increase financing for the private sector via financial institutions, while also strengthening and improving the institutions themselves and the financial sector more generally. Thus, the Bank will seek opportunities to facilitate entry of new investors or encourage consolidation. The Bank will work with existing clients to provide new products and increase limits under existing programmes. As noted elsewhere, in light of capital constraints, the Bank will work with IFIs and other donors to share risk, which would allow an overall increase in portfolio for these PBs. Moreover, the MCFE will allow the Bank to support its Kyrgyz partner banks to meet the needs of their relatively larger clients. Going forward, key initiatives include:

- Further equity investments, where the Bank's role can improve corporate practices and encourage further consolidation. Significant TC may be required to enhance quality within Kyrgyz banks.
- Entrance of Kazakh institutions in the past few years boosted the sector, bringing new technologies and enhancing competition. Concerns about transparency of Kazakh sponsors limited the Bank's cooperation in 2005-2006; however, it is important that the Bank finds ways to work with Kyrgyz subsidiaries of Kazakh institutions.
- Support financial institutions which have been or will be privatised such as Kairat (now Halyk Kyrgyz Republic), SSC and Aiy Bank. Again, TC requirements need to be assessed and funding arranged.

- Introduction of new products, such as mortgage finance and leasing. The Bank could provide targeted TC for the legal and institutional development of these products.
- Financing energy efficiency investments through a credit line for local banks teamed with technical assistance targeting both lenders and borrowers.
- Provision of targeted assistance, at the request of Kyrgyz authorities, to strengthen the legal framework including: improvement of the Pledge Law (streamline collateral procedures), further support of the Credit Information Bureau, support to develop a deposit insurance scheme and provide training to banks and regulators on AML legal and regulatory implementation.

3.2.6 MSE Financing

The Bank supports development of small businesses and recognises that access to financing continues to be one of the largest obstacles to the growth of small businesses in Kyrgyz Republic. Therefore, the Bank will continue to support banks with tailored technical assistance and credit lines once the existing KMSEFF programme is complete in late 2007. The current general technical assistance will be replaced by more targeted support as partner banks graduate from the programme. These partner commercial banks will be encouraged to improve their own internal training capabilities and as the commercial banks graduate from the general KMSEFF assistance, this support will be replaced by more tailored support to improve the MSE operations of the individual banks. Specifically, the Bank will seek to improve efficiencies of commercial banks lending particularly with respect to rural finance.

Further, the Bank will continue to deepen its support to the smallest entrepreneurs by expanding its support to sustainable non-bank organisations and assist the strongest of them to transform into deposit-taking entities. Finally, the Bank will encourage programmes to increase financial support to the smallest rural and agricultural businesses. Specific initiatives include:

- Supporting new commercial bank partners to introduce microfinance lending;
- Working with existing partner banks to expand rural and agricultural lending;
- Participate in capital increases and where appropriate support consolidations between banks and NBMFIs;
- Support the creation of a greenfield, dedicated microfinance bank;
- Working with commercial banks and non-banks to introduce better technologies and methodologies such as credit scoring to improve efficiencies and lower the cost of lending to this sector;
- Supporting the ongoing privatisation of Aiyl Bank;
- Supporting the commercialisation (“transformation”) of non-bank microfinance institutions into deposit taking institutions;
- Seeking sources of local currency funding for non-bank microfinance institutions;
- Continued support of the Kyrgyz Credit Bureau.

3.2.7 Telecoms

While some progress has been made on regulatory and legal reform in the sector, work remains. Though the sector is formally fully liberalised and competition exists in the mobile, internet, paging and related segments appropriate legal and regulatory mechanisms need to be established. Similarly, international best practice of independent regulation should be formalised by the Government. The Bank has exposure to Kyrgyz Telecom through a USD 9.4 million 15-year sovereign guaranteed loan (November 1994). KT has been converted to an open JSC and partially privatised through the voucher programme. The Bank is prepared to support KT privatisation to a strategic investor and is hopeful this process will be completed in 2007/ 2008.

- If privatisation is not successful, the Bank could work to improve KT's operating performance including, potentially, by supporting a tender for a private management contract.
- The Bank continues to seek opportunities to support alternative private sector operators. There is growing interest in the Kyrgyz mobile sector from Russian and Kazakh operators.
- The Bank has been providing assistance to the National Telecommunications Agency on issues such as universal access, tariffs and inter-company access. Continuation of the assistance depends on the commitment to implement the recommendations.

3.2.8 Infrastructure

The country's infrastructure continues to deteriorate due to insufficient investment, including in key areas: generation and distribution of electricity and gas, urban and national transport systems, municipal waste, water and heating. The Bank's direct financing of infrastructure has been limited due to the country's restricted capacity for external borrowing and also due to inability to proceed with key reforms. In light of its high debt burden, the Government must continue to avoid significant new state borrowings, and it is expected that new sovereign loans will continue to be limited to those with a 45 per cent grant element.

Therefore, the Bank will continue to seek non-sovereign infrastructure projects. Where possible, projects may be regional in nature. Considering the level of the country's sovereign indebtedness, the Bank's ability to finance sovereign guaranteed projects in the strategy period will be limited, particularly if there is not access to a stable and predictable source of co-financing grants.

Policy dialogue with the Government and other IFIs and donors has focused on the need to further improve the Law on Concessions and to seek opportunities to develop pilot commercial operations (including a potential PPP), particularly in the power sector, and potentially in the aviation sector. Close cooperation with IFIs and donors will be needed over the Strategy period as the Bank seeks to finance one or two infrastructure projects.

- Political uncertainty and absence of reform blocked progress on projects such as a concession for SeveroElectric (northern power) company. The Bank remains prepared to support this or other power sector investments, including hydro power projects which would be coordinated with other IFIs.

- The Bank conducted due diligence on municipal projects, such as Bishkek Vodokanal. As municipal entities are restricted from assuming direct loans, the Bank is seeking an appropriate structure for such projects. Donor support, in the form of grant co-financing, will be needed to proceed. It is desirable to establish more stable and predictable source of grant co-financing.
- The Bank also seeks opportunities to finance projects which enhance energy efficiency and improve environment and is seeking to effectively use CDM financing.
 - At present the Bank is considering the rehabilitation of a gas pipeline which will significantly reduce gas emissions to the environment;
 - Unfortunately, the ability to finance energy saving projects is undermined by very low electricity prices (only 50 per cent cost recovery levels), as well as non-payments, which means many companies have no incentive to reduce energy usage.

4. IFIs and Multilateral Donors

4.1 IMF

The Poverty Reduction and Growth Facility (PRGF) was approved in February 2005 with a total access equivalent to SDR 8.88 million (approximately USD 13.6 million). The Executive Board of the IMF completed the second review of the Kyrgyz Republic's arrangements under the three-year PRGF in May 2006. Completion of the review enabled the Kyrgyz Republic to draw an amount equivalent to SDR 1.27 million (about USD 1.86 million). The total disbursement under the PRGF amounted to SDR 3.79 million (approximately USD 5.59 million).

With the breakdown in discussions with regard to HIPC debt restructuring, the IMF is monitoring the PRGF which is scheduled to end in 2007.

4.2 World Bank and MIGA

To date, the World Bank has approved 29 projects for a total commitment of USD 673 million. This includes eight adjustment credits for USD 346 million and 21 investment projects for USD 328 million. Following repayments, the current portfolio comprises 15 active projects for USD 273 million. The on-going projects include Agricultural Support Services; Land and Real Estate Registration; Rural Finance II; Irrigation and Irrigation Rehabilitation; Village Investment Project; Health Sector Reform II; Payments and Banking System Modernisation; Urban Transport; Power and District Heating; Rural Water Supply and Sanitation.

Multilateral Investment Guarantee Agency (MIGA) provided a USD 5.3 million political risk guarantee for the investment of an Austrian investor in Kyrgyz Air. MIGA has provided a USD 885,000 guarantee to investors for their investment in the Manas Management Company. The foreign investors in both projects are currently engaged in disputes with their Government counterparts. The Kyrgyz Air matter is in arbitration at the London Court of International Arbitration. The investors have filed claims with MIGA in respect of both projects.

4.3 IFC

International Finance Corporation's (IFC's) current portfolio in the Kyrgyz Republic has grown to USD 15.2 million as of 1 August 2006 and the amount of total investments made in the Kyrgyz economy since 1996 reached USD 57 million. The largest investments were made to gold mine, KMC, with additional investments in a packaging plant "Altyn-Ajydar", milling plant "Akun" and four financial sector projects: Demirbank, KICB, FINCA and MCA "Bai-Tushum". In the framework of the MSEFF joint project with the Bank, IFC provided the credit lines to AKB Kyrgyz Republic, Ineximbank and Kazkommertsbank.

In 2005, IFC launched a technical assistance project to improve legal, regulatory and tax framework for Housing Finance Development. In the same year IFC launched a second stage of the Leasing development project, aimed at improving the legislative framework, legal and taxation areas for leasing activities and providing practical assistance to local banks who will be taking part in IFC Leasing Facility in future.

4.4 ADB

To date, ADB has approved 26 projects, all on concessional or grant terms, totalling USD 604 million, of which 11 projects for USD 216 million are ongoing. ADB has also provided 64 TA projects amounting to USD 38 million and 5 grants from the Japan Fund for Poverty Reduction amounting to USD 4 million. The two largest ADB sectors are transport (which received USD 178 million) and the social sectors, including education, health, nutrition, and social protection (which received about USD 150 million).

The overall objective is to reduce poverty, primarily by promoting economic growth and selectively supporting human development. ADB's assistance focuses on: (i) agriculture; (ii) connections with regional markets; (iii) human development, particularly childhood development; and (iv) reforming the financial sector.

4.5 IDB

The Islamic Development Bank (IDB) has co-financed with other IFIs on the Bishkek-Osh Road (ADB), a 220 kW Transmission line (Kuwait Fund), and the Osh Airport (Kuwait Fund). The Islamic Corporation for the Development of Private Sector (ICD, the private sector arm of IDB) had its first mission in July 2006 to Kazakhstan, Kyrgyz Republic and Tajikistan, but has yet to invest in the Kyrgyz Republic.

4.6 UNDP

The UNDP Country Programme supports the Government to meet the Millennium Development Goals and implement its Comprehensive Development Framework (CDF). The following priority needs are identified for 2005-2010:

- 1) Poverty reduction through sustainable development
- 2) Promoting good governance
- 3) Strengthening human security
- 4) Enhancing regional cooperation

Continued attention is being paid to gender equality and application of information and communication technology as cross-cutting themes within all UNDP programmes.

National execution of UNDP programmes at the country level remains at the core of UNDP's mission to enhance the national ownership programme and build national capacities for its implementation. Strengthening partnerships with other UN and development agencies operating in the country, as well as civil society and volunteer organisations, is another area which UNDP Kyrgyz Republic considers itself to be a key to the success of development initiatives in the country.

4.7 EU

The EUs support for the Kyrgyz Republic through technical assistance to the CIS (TACIS) programme is based on its Strategy Paper 2002-2006 and Indicative Programme 2005-2006 for Central Strategy. The overall objective is to promote stability and security and assist sustainable economic development and poverty reduction. The TACIS programme focuses on: (1) support for institutional, legal and administrative reform, (2) support in addressing social consequences of transition, and (3) development of infrastructure networks. The budget for the Kyrgyz Republic is EUR 15 million which is complementary to other instruments, notably the Food Security Programme, the TACIS Regional Programme, the ECHO programme and the European Initiative for Democracy and Human Rights.

From 2007 onwards, when the Kyrgyz Republic will benefit from the Development Cooperation Instrument, EU assistance will be based on the Strategy Paper 2007-2013 and the Indicative Programme 2007-2010. The areas of priority at the national level are anticipated to be i) promotion of Central Asia regional cooperation and good neighbourly relations, ii) poverty reduction and increased living standards and iii) support for good governance and economic reform. The Kyrgyz Batken Oblast in the Ferghana valley will benefit from poverty alleviation activities under TACIS worth EUR 3 million each year. The EU has made available approximately EUR 250 million in assistance to the Kyrgyz Republic during the period of 1991 – 2005.

At the regional level, the projects will focus on i) energy, transport networks and market integration, ii) environment, iii) border and migration management: the fight against organised crime and customs and iv) education, science and people to people activities.

III. ANNEXES

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Annex 1 Political Assessment

Compliance with Article 1

The Kyrgyz Republic is committed to and is making progress towards implementation of the principles of multi-party democracy, pluralism and market economics referred to in Article 1 of the Agreement Establishing the Bank.

The political upheaval in March 2005 resulted in a change of power in the country. The presidential elections, which took place after the March events, marked tangible progress towards meeting international standards for democratic elections. In terms of political pluralism, the Kyrgyz Republic with its many functioning political parties, its relatively free media and its network of active civil society organisations, continues to feature well in the regional context.

Nevertheless serious problems remain. Poverty, unemployment, deep-seated corruption and nepotism, which were major driving factors behind last year's "Tulip Revolution", are still there. Local entrepreneurs still complain of bribery, bureaucracy and burdensome taxes, while foreign investors are concerned with political instability. Organised crime is a problem, including instances of criminal elements which attempt to exert undue influence on the Government. Democratic institutions remain fragile, pending constitutional, electoral and judicial reform.

In November 2006 those problems triggered a political crisis, for the second time in less than two years. A week of massive demonstrations ended in a compromise, reflected in a new Constitution, which curbed presidential powers in favour of parliament. It is commendable that both the Government and the opposition forces displayed a constructive approach to end the crisis threatening the fragile stability of the country. It is now time to concentrate on important challenges facing the country and its people.

However, on 30 December 2006 the lawmakers approved the newest changes to the Constitution effectively returning to the Kyrgyz President much of the authority that was taken away from the presidency amid public protests in November. The December reversal led to protest rallies in April 2007 demanding resignation of the President and constitutional reforms.

Political environment

The key event in the two years since the adoption of the last country strategy was the upheaval in March 2005, sometimes referred to as the "Tulip Revolution". The March revolt ended President Askar Akayev's 14-year rule. President Akayev was first elected unopposed in 1991 and then re-elected in 1995 and 2000. According to the Constitution, the President was not allowed to run for a third successive term in office. He was due to step down in the autumn of 2005 but the March events accelerated the process of the change of power.

The Kyrgyz Republic has been at the forefront of democratic transformation in the post-Soviet area. President Akayev contributed to the country's openness, reform orientation and democratic image. However, Akayev's popularity faded as he moved in a more

authoritarian direction. He allowed increased domination of the economy by his immediate family and a small group of supporters. Fraudulent parliamentary elections in February 2005, in which Akayev's son and daughter won seats in parliament, added to popular discontent. In the aftermath of widespread protests that followed the parliamentary elections, Akayev's regime collapsed very quickly, reflecting both weakness of the state and lack of support for the regime.

According to the OSCE/ODIHR observation mission, the parliamentary elections of 2005 fell short of OSCE commitments and other international standards for democratic elections. These were the first parliamentary elections since the 2003 amendments of the Constitution which substantially altered the structure and the method of election of Jogorku Kenesh (parliament). In place of a two-chamber legislature with a total of 105 deputies, the new unicameral parliament consists of 75 seats. In previous parliamentary elections, a quarter of the seats were determined on the basis of party lists and the rest were single-mandate constituencies. Under the new rules, party lists were abolished and all the elections took place in single-mandate constituencies. This significantly weakened the role of political parties in the electoral process.

As is the case in many CIS countries, political parties in Kyrgyz Republic are centred round a single individual rather than a party programme. The two major pro-government parties together nominated 65 per cent of the total number of candidates put forward by the political parties. Most opposition parties agreed to cooperate during the elections but, nevertheless, their candidates were predominantly self- rather than party-nominated.

For a short period of time after the elections, the outgoing and the newly elected parliament operated in parallel. At the end of March 2005 the outgoing parliament dissolved itself and the newly elected parliament was legitimised. In April the new parliament accepted President Akayev's resignation and scheduled the presidential election for 10 July 2005.

In contrast to the parliamentary elections, the presidential ones in July were an improvement over all previous elections and marked a tangible progress towards meeting international standards for democratic elections. According to the OSCE, fundamental civil and political rights, such as freedom of expression and freedom of assembly, were generally respected throughout the election process. Six candidates contested the election, offering voters a degree of choice. The candidacy of the incumbent President Kurmanbek Bakiev was dominant and an agreement between Kurmanbek Bakiev and Feliks Kulov was generally perceived as a stabilising factor in the political process. The agreement between the two leading politicians envisaged that Kulov would withdraw from the electoral race and be appointed as Prime Minister if Kurmanbek Bakiev was elected president. As expected, Kurmanbek Bakiev comfortably won the election with 88.7 per cent of the votes and appointed Feliks Kulov as Prime Minister.

In the past two years since the "Tulip Revolution", the record of the new authorities is mixed. Although media freedom and civil liberties have improved since March, there are questions about the Government's reform effort. Since March the country has witnessed numerous demonstrations and protests, storming and blockading of

government buildings, land seizures, violent redistribution of property and related killings, attempts by organised crime groups to unduly influence the Government and instability in various parts of the country (mostly in the south). The southern regions of the country have been a traditional hotbed of instability fuelled by poverty, unemployment in a predominantly agricultural area and ethnic tensions. All of these factors contribute to an environment conducive to encouragement of the ideas of radical extremism. In recent years the influence of such organisations as Hizb-ut-Tahrir and Islamic Movement of Uzbekistan (IMU) in the south of the country has visibly increased. The country appears to be more fragmented and potentially unstable than before the March revolt.

Lack of progress in improving the situation on the ground combined with delayed promises to accelerate constitutional reforms, triggered a political crisis in early November 2006. A week-long pro test demonstration, organised by the opposition “For Reforms” coalition, demanded resignation of the country’s President unless he agreed to introduce parliamentary checks on executive authority. The increase of parliamentary control over the Government was one of the opposition’s key demands. Political tension was diffused when President Bakiev and the opposition agreed on 9 November, in an unprecedented short period of time, the text of a new Constitution. The new Constitution envisages a shift of responsibilities from the President to the Parliament and the Government, effectively creating a parliamentary-presidential form of governance. The Parliament will consist of 90 members, at least 50 per cent of which would be elected on party lists. The party that gains more than 50 per cent of seats in Parliament will name the Prime Minister and oversee ministerial appointments, subject to Presidential confirmation. It was agreed that President Bakiev, as well as the Parliament, should stay in office until their current term expires in 2010.

The difficult consensus, reached in November did not last long. On 30 December the Constitution was amended again, reversing the changes that had limited the President’s authority. The December reversal, combined with termination of Bakiev’s alliance with Feliks Kulov and the latter’s joining the opposition, led to a new wave of protests in April 2007 with protesters demanding early presidential elections and constitutional reforms. The April rallies went ahead despite significant concessions from Bakiev, including nomination of an opposition leader, Almazbek Atambayev, as the Prime Minister and proposing to again amend the constitution in order to restore the main provisions of the November Constitution.

Rule of law and human rights

The overthrow of the Akayev regime in March resulted in an improvement in the Government’s commitment to the rule of law and respect for human rights. The Government generally respects the human rights of its citizens, but problems remain. As in previous years, corruption remains a serious problem as does trafficking in persons, child labour and discrimination against ethnic minorities. The Kyrgyz Republic has always been active in undertaking international human rights commitments. The real problem however, is the implementation of the adopted recommendations, laws and regulations in practice.

Since March 2005 harassment of opposition groups and independent media has

decreased and the Government has allowed peaceful meetings and demonstrations. At the same time, the “Tulip Revolution” has unleashed forces that threaten the social order and stability in the country. The new authorities are engaged in a constant struggle for bringing the situation under control amid prison revolts, property disputes and disruption of public order resulting from land seizures and storming of Government buildings.

In the area of labour rights, the Kyrgyz Republic is bound by international commitments under the ratified core ILO conventions. As in previous years, according to reports from various NGOs, child labour is a problem and remains widespread, especially during cotton and tobacco harvest seasons.

According to a 2006 US State Department report, the Kyrgyz Republic is a source, transit, and growing destination country for men, women, and boys trafficked for the purposes of forced labour and sexual exploitation. The report qualifies the Kyrgyz Republic as a Tier 2 country, i.e. a country which does not fully comply with minimum standards for elimination of trafficking but is making efforts to bring itself into compliance. Although the Government continued to strengthen overall efforts to combat human trafficking, more remains to be done. The Government has demonstrated good prevention efforts but has made limited progress in protection and law enforcement.

Despite the fact that legislation provides for equal rights for men and women, the transition has been disproportionately hard for women in terms of political representation, employment opportunities and wage rates. Responsibility for family and childcare has transferred back to women from the former state-run services. Considerable increases in the proportion of non-remunerated activities have resulted in difficulties for women in balancing paid and unpaid responsibilities. Many women have been forced into informal sector employment which involves long hours of work, low wages, and difficult conditions. Furthermore the absence of any form of social protection such as sick leave, maternity leave, or pension contributions for informal workers leaves them extremely vulnerable to poverty. Better access to micro-loans might be one way of bringing women back into the formal labour force, noting that higher numbers of trafficked women may be partly attributed to poverty and lack of other employment opportunities.

Although the Kyrgyz authorities facilitated the resettlement of more than 400 Uzbek refugees who had fled to the Kyrgyz Republic following the massacre in Andijan in May 2005, the human rights groups have raised serious concerns over the fate of some of the remaining refugees. The Kyrgyz Republic is party to the 1951 Refugee Convention which bans forced return of refugees and in particular the return of any asylum seeker to a place where they face torture or persecution.

External relations

The land-locked Kyrgyz Republic is bound to be an active proponent of regional cooperation as an effective means of contributing to the country’s economic development. Regional cooperation is also crucial from the security point of view. A member of the CIS and a party to its Collective Security Treaty, the country has

membership in various regional security and economic organisations. Increasingly important among them is the SCO, which includes Russia and China, two large regional powers, as well as Kyrgyz Republic's immediate neighbours Kazakhstan, Uzbekistan and Tajikistan. Kyrgyz Republic will be hosting next year's Council of the Heads of States of SCO as it assumes the organisation's rotating presidency.

On a bi-lateral level, the country maintains economic ties with many countries of the CIS, and particularly strong ones with Russia and Kazakhstan, both countries being large trading partners and investors of the Kyrgyz Republic. Russia also maintains its permanent military base in Kant.

The Kyrgyz Republic is in the process of enhancing its relations with the EU, including in the area of trade and economic cooperation. For the time being EU-Kyrgyz Republic bilateral trade remains very low and insufficiently diversified. EU investments in the Kyrgyz Republic are also very limited, notably due to the overall unfavourable investment climate and political instability in the country. The EU provides the Kyrgyz Republic with technical assistance, inter alia to support developments of its trade and economy, and intends to enhance its engagement.

Relations with the United States have been strained since unprecedented expulsion of two US diplomats, reciprocated in a similar measure by the United States, and the Kyrgyz demands for a ten-fold increase of rent for the use of the Manas Air Base. In July 2006 the parties reached a deal on continued coalition use of the airbase to support the ongoing war on terrorism in Afghanistan. It was announced that the United States expects to provide more than USD 150 million in total assistance and compensation over the next year.

The European Union has committed to increase cooperation with Central Asia in the coming years, in line with the new Strategy for Central Asia which is due to be approved in June 2007. Trade is increasing between the Kyrgyz Republic and EU member states.

Relations with Uzbekistan reached a low point in connection with the refugee crisis following the massacre in Andijan in May last year. Recently there was a rapprochement between the two countries. Its declared purpose is strengthened bi-lateral cooperation in fighting terrorism and religious extremism. Stable relations with Uzbekistan are also important for the Kyrgyz Republic considering the substantial Uzbek minority in the southern regions of the country bordering Uzbekistan.

Annex 2 Signed Projects

As at December 2006

Investment	Signing Date	Total project cost EUR million	EBRD finance EUR million	Stage
Kyrgyz Telecommunications	16/11/94	40.3	7.4	Repaying
Kyrgyzstan Credit Line	16/02/95	8.3	8.3	Repaying
Kumtor	04/05/95	491.3	31.5	Completed
Transmission Network Improvement Project	22/05/95	29.4	29.4	Repaying
Kyrgyz Agribusiness Company	29/08/95	15.6	5.8	Completed
Kyrgyz Agribusiness Company : Divestment	17/10/95	0.7	0.7	Completed
Demirbank Kyrgyzstan (portage equity)	07/11/96	2.5	0.5	Disbursing
Joint Venture Italkyr CJSC	27/11/97	18.6	6.3	Repaying
Talas Transmission Network Improvement Project	18/12/97	19.5	18.5	Repaying
Kyrgyzstan - SME Line of Credit II	28/07/98	0.1	0.1	Completed
BiStyle (formerly Investment in New Kadam)	30/12/98	0.6	0.6	Completed
KAC Revised Investment	04/06/99	4.7	4.7	Repaying
KAC Revised Investment	20/07/00	0.6	0.6	Repaying
Regional TFP: Ineximbank (formerly Eridan Bank)	18/12/00	1.5	1.5	Disbursing
Kyrgyz Investment and Credit Bank (KICB) (debt & equity)	04/05/01	12.3	3.6	Disbursing
DIF - BDC-Vytas	11/05/01	1.3	0.7	Completed
DIF - Kalipso	19/05/01	1.1	0.6	Completed
DIF - Issyk-Ata Hydro Power Station Rehabilitation	30/05/01	0.8	0.4	Completed
Regional TFP: Kyrgyz Investment and Commercial Bank (KICB)	08/06/01	0.3	0.3	Signed
DIF - Besser Kyrgyzstan	28/09/01	1.2	0.6	Completed
DIF - Ala-Archa	07/12/01	1.5	0.8	Completed
Kyrgyz MSE - Inexim Bank	08/07/02	1.4	0.7	Disbursing
Kyrgyz MSE - AKB Kyrgyzstan	16/09/03	2.4	0.9	Disbursing
Kyrgyz Republic - Inexim Bank - equity participation	31/10/03	4.1	2.1	Disbursing
Kyrgyz MSEFF - Inexim Bank, Tranche 2	25/03/04	2.4	1.1	Disbursing
Centerra	30/05/04	20.3	20.3	Repaying
DIF-Karven Club	01/08/06	0.2	0.2	Disbursing
DLF-Cotton Corporate Limatex WC Facility	11/07/05	0.8	0.8	Completed
DLF - Karven Village	10/04/06	0.9	0.9	Disbursing
DLF - Sheen-Line	27/07/06	2.0	2.0	Signed
DLF - Shnos Petrol Filling Station Network Upgrade & Exp	31/07/06	2.4	2.4	Signed
ETC - Non-Bank MFI BW - Bai-Tushum	12/09/05	1.6	1.3	Disbursing
ETC - Non-Bank MFI Fw - Finca Micro Credit Company	22/12/05	1.6	1.2	Disbursing
First NIS Regional Fund	21/11/94	0.5	0.3	Repaying
Interglass LLC	09/12/04	14.4	5.5	Repaying

Kyrgyz Agricultural Finance Corporation (KAFC) – Debt	15/06/06	1.5	1.6	Disbursing
Kyrgyz MSE – AKB Kyrgyzstan	09/12/04	3.6	1.1	Disbursing
Kyrgyz MSE – AKB Kyrgyzstan	16/09/03	2.4	0.9	Disbursing
Kyrgyz MSE – Inexim Bank	31/03/05	3.4	1.8	Disbursing
Kyrgyz MSEFF II – ECO Bank	22/05/06	2.0	2.0	Disbursing
Kyrgyz MSEFF II – KICB MSE	31/07/06	2.4	2.4	Signed
Kyrgyz MSEFF II – KKB	15/07/05	4.0	1.8	Disbursing
Kyrgyz Republic – Inexim Bank – equity increase	18/11/05	3.9	3.9	Disbursing
MCFE – KICB Abdysh-Ata Sub-Loan (NRP)	26/12/05	0.9	0.5	Repaying
Raduga-II	11/04/05	12.6	4.7	Completed
Regional TFP: Demir Kyrgyz International Bank	22/08/00	0.2	0.2	Disbursing
DLF – Karven Four Seasons	06/12/06	6.0	2.9	Disbursing
DLF – Orion Hotels	08/11/06	4.0	1.5	Signed
ETC Nonbank MFI Framework	08/11/06	0.8	0.8	Signed
Country Total		754.9	185.1	

Annex 3 Current Portfolio Stock

As at December 2006

Sector	Portfolio EUR million	Undrawn Commitment EUR million	Operating Assets EUR million
Energy	19.3	2.3	17.1
Natural Resources	12.4	2.3	10.2
Power & Energy	6.9	0.0	6.9
Financial Institutions	25.7	4.6	21.1
Bank Equity	4.7	0.0	4.7
Bank Lending	5.9	0.6	5.3
Small Business Finance	15.1	4.0	11.1
General Industry	5.0	0.9	4.1
Specialized Industries	14.0	5.6	8.3
Agribusiness	4.2	2.0	2.2
Property & Tourism	7.9	3.6	4.3
Telecoms, Informatics & Media	1.8	0.0	1.8
Country Total	64	13.4	50.6

Annex 4 TC Projects in the Kyrgyz Republic

as at December 2006

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved Date	Sector
Roundtable on the Kyrgyz Deposit Protection System	6,969	6,969	05/04/04	Finance, Business
Kyrgyz Republic: Telecom Regs Universal Access	199,845	71,963	03/06/05	Community/Social Services
BAS Programmes in the Kyrgyz Republic 2004-2007 - Framework	1,137,512	496,609	24/03/05	Manufacturing
Kyrgyz MSEFF - Micro and Small Credit Advisors	770,239	770,239	17/11/03	Finance, Business
Kyrgyz MSEFF - Micro and Small Credit Advisors	198,559	198,559	17/11/03	Finance, Business
Expansion of the Kyrgyz MSE Finance Facility	600,000	572,502	21/07/05	Finance, Business
Expansion of the Kyrgyz MSE Finance Facility	500,000	454,766	21/07/05	Finance, Business
Community TMG Programme for Information and Communications technology (ICT) Development in Low Transition Region in the Kyrgyz Republic	104,899	78,498	03/12/04	Manufacturing
Judicial Training Programme / Phase I (Action Plan)	100,000	100,000	03/12/04	Community/Social Services
Expansion of the Kyrgyz MSE Finance Facility (KMSEFF) MSE Credit Advisors	400,000	87,325	28/04/05	Finance, Business
Kyrgyz Republic: Reform of Investors' Protection Legislation (Phase I)	70,900	35,323	14/10/05	Community/Social Services
Judicial Capacity Building - Phase II	700,000	105,000	16/11/05	Community/Social Services
Kyrgyz Agricultural Finance Corporation Institution Building Adviser: Preparation for Privatisation and Transformation	243,000	0	08/02/06	Finance, Business
MSE Lending Credit Scoring Feasibility Study - Kyrgyz Republic	46,000	41,848	21/03/06	Finance, Business
Interconnect & Costing (Kyrgyzstan II)	450,000	19,991	09/05/06	Community/Social Services
TAM - Sheen Line	85,500	18,116	15/06/06	Manufacturing
TAM ICT Incubator Project	94,601	5,843	08/11/06	Manufacturing

Japan-EBRD Central Asia MSE PBs Strengthening Facility - Assistance to the Credit Information Bureau, Bishkek, Kyrgyz Republic	16,000	16,000	22/03/05	Finance, Business
Japan-EBRD Central Asia MSE PBs Strengthening Facility	32,195	32,195	22/03/05	Finance, Business
Judicial Capacity Building - Phase II	700,000	105,000	16/11/05	Community/Social Services
Japan-EBRD Central Asia MSE PBs Strengthening Facility - AKB MIS Spftware	56,956	0	27/02/06	Finance, Business
Japan-EBRD Central Asia MSE PBs Strengthening Facility -- AKB Hardware	56,956	0	27/02/06	Finance, Business
Japan-EBRD Central Asia MSE PBs Strengthening Facility - Ecobank Institution Building	182,260	0	17/03/06	Finance, Business
Japan-EBRD Central Asia MSE PBs Strengthening Facility - Ecobank Institutional Building Advisor on Strategic Development	5,923	0	16/10/06	Finance, Business
Community TAM Programme - Pokrova - Kyrgyz Rep	162,800	87,413	09/06/04	Manufacturing
TAM - Pokrovka Community	35,270	6,191	28/03/06	Manufacturing
TAM Feasibility Study in the Kyrgyz Republic	13,600	12,791	10/12/02	Manufacturing
Calypso & Vytas Audit 2003	25,000	25,000	07/04/03	Finance, Business
Kyrgyz Republic - Deposit Insurance	28,000	28,000	23/09/03	Finance, Business
TAM - BIK	85,500	53,770	24/09/03	Manufacturing
TAM - Strategic Plan for the Walnut Timber Industry	22,281	21,933	24/09/03	Manufacturing
TAM - Sadus	80,638	80,638	24/09/03	Manufacturing
Kyrgyzstan Credit Line for Micro Enterprises - Start Up	20,000	20,000	16/12/03	Finance, Business
Extention to Kyrgyz Deposit Insurance project	2,400	2,400	17/03/04	Finance, Business
International Banking Conference	33,542	33,542	07/06/04	Finance, Business
Market, Technical and Financial Due Diligence for Residential Property Development	39,480	34,615	15/09/04	Construction
Kyrgyzstan: Limatex Gauze: Market Study	32,000	32,000	22/10/04	Manufacturing

Raduga II Legal Due Diligence	5,000	5,000	10/02/05	Construction
KyrceI and Munai Myrza Petrol Station Networks	40,000	39,888	29/07/05	Extractive Industries
Munai Myrza - Technical Commercial and Environmental Due Diligence	50,000	49,770	29/07/05	Extractive Industries
TAM -Massive	31,500	21,082	04/11/05	Manufacturing
TAM - Strategic Plan for the Walnut Timber Industry	3,724	0	28/02/06	Manufacturing
TAM - Sadus	4,862	3,862	09/05/06	Manufacturing
Judicial Capacity Building - Phase II	161,000	0	07/06/06	Community/Social Services
TAM - Taiwan Funded ICT Incubator	74,440	0	29/09/06	Manufacturing
Institutional Capacity Building - Biodiversity Conservation	100,000	20,000	26/01/05	CEALs,CoFinancing Lines & RVF's
Kyrgyz Republic - MSE Credit Advisors - regional expansion	398,437	398,437	03/06/03	Finance, Business
Kyrgyz Republic - MSE Credit Advisors - regional expansion	400,981	400,981	03/06/03	Finance, Business
Kyrgyz Republic - MSE Credit Advisors - regional expansion	417,543	417,543	18/05/04	Finance, Business
Kyrgyz Republic - MSE Credit Advisors - regional expansion	453,958	453,958	08/09/04	Finance, Business
Assistance to the Kyrgyz Credit Information Bureau	5,784	5,784	27/09/05	Finance, Business
Assistance to the Kyrgyz Credit Information Bureau	12,983	12,983	07/11/05	Finance, Business
Expansion of the Kyrgyz MSE Finance Facility	1,069,069	300,826	31/03/06	Finance, Business
Assistance to the Kyrgyz Credit Information Bureau - International Advisor	10,283	0	14/06/06	Finance, Business
Assistance to the Kyrgyz Credit Information Bureau	25,737	0	14/06/06	Finance, Business
	10,604,125	5,785,150		

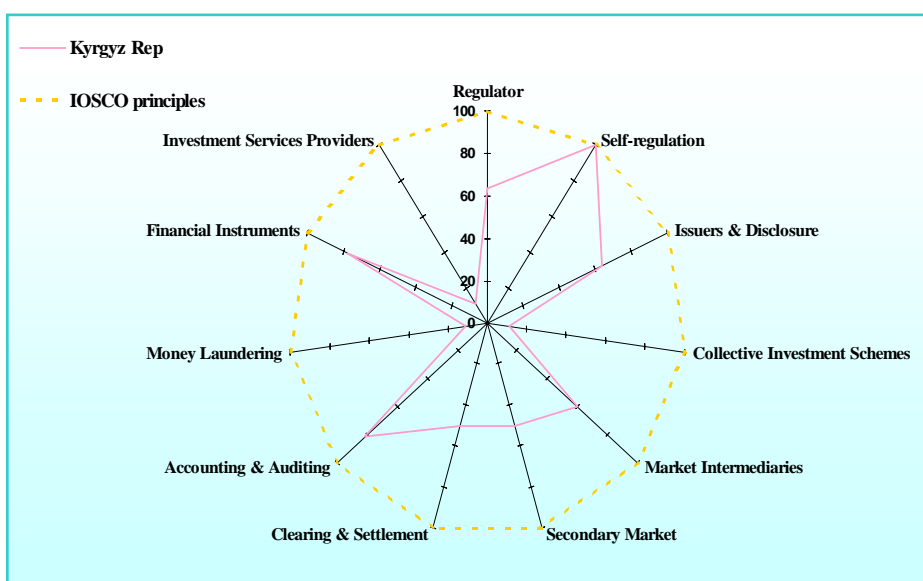
Annex 5 Assessment of the Kyrgyz Republic's Commercial Laws

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of such laws (also referred to as “effectiveness”). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for the Kyrgyz Republic, accompanied by critical comments of the Bank’s legal experts who have conducted the assessments.

Capital Markets

The primary legislation governing securities markets includes the Law on Securities Market (1998), the Law on Investments (2003, amended in 2004) and the Law on Investment Funds (1999, amended in 2003). The Law on Securities Market establishes statutory requirements for issuing and trading securities in the Kyrgyz Republic. It establishes a foundation for the regulation of the activities of securities market professionals and certain disclosure and transparency requirements for issuers. Pursuant to this law, all offerings of securities, whether private or public, must be registered with the Kyrgyz market regulator: the State Agency for Financial Supervision and Reporting under the Government of the Kyrgyz Republic. The Law on Investment establishes general principles of investor protection, aimed at improving the investment climate and promoting local and foreign investment. The Law on Investment Funds sets forth requirements for the establishment, operation, reorganisation and liquidation of investment funds. Investment funds can be established in the form of joint stock companies or non-corporate entities, such as unit investment funds.

Quality of securities market legislation - Kyrgyz Republic (2005)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2005

In the EBRD's 2004 Securities Market Legislation Assessment which benchmarked securities market legislation (i.e. the law on the books) in its countries of operations against the IOSCO's Objectives and Principles for Securities Regulators, the Kyrgyz Republic was rated as being in "low compliance" with international standards, indicating insufficient legislation in a securities market at an early stage of development. The assessment was updated in 2005 and the results confirmed the 2004 results. As shown in the chart above, among the many shortcomings reported, the assessment revealed insufficient legislation on collective investment schemes, money laundering and investment service providers. With specific reference to money laundering, the recent Law "On Counteracting Terrorism Financing and Legalisation of Criminal Profits" which came into force in November 2006 will possibly improve the current limited framework on this issue. The EBRD is currently implementing a legal reform project in the country to enhance the quality of legislation on investors' protection.

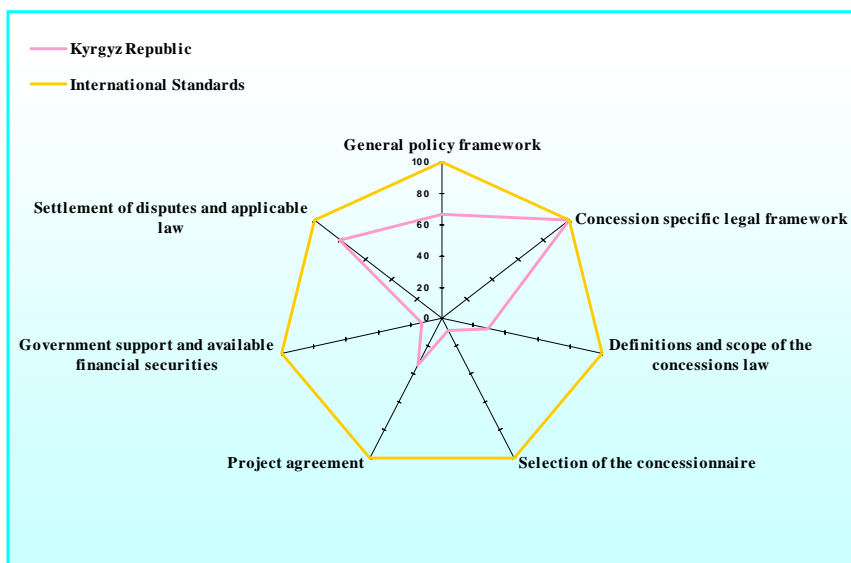
Concessions

The 1992 Law on Concessions and Foreign Concessionaire Entities in the Kyrgyz Republic, as amended (the "Concessions Law") is the main act regulating concessions. Besides the Concessions Law, a number of other acts should be taken into account in respect of the concession legal framework. These are the general application laws "On Foreign Investments", "On Property", "On Lease and Lease relations", "On Fundamentals of Deregulation, Privatisation and Entrepreneurship" referred to in the Concessions Law. In addition, sector specific laws (e.g. the Water Act and the Mineral Resources Act) introducing the licensing system may be applicable. This co-existence of a large number of pieces of legislation creates uncertainties as to the exact application field of each of the laws and leads to a risk of inconsistencies among the various acts.

Whilst the Concessions Law contains a number of positive elements such as clear reference to compensation in case of unilateral termination (including lost profit) and to compensation for "inseparable improvements" of concession object and to international arbitration, it does not overall constitute a sufficiently solid legal basis for the development of private sector participation in infrastructure and utility services in the Kyrgyz Republic. Amongst its shortcomings, the Concessions Law is too vague and unclear as far as the majority of its basic elements are concerned. Its scope of application and definitions require significant improvement. Whilst the Concessions Law provides for the adoption of a list of objects that can or cannot be subject to concessions, not only is such list unavailable, but it is unclear whether this is a general list or a particular one for every concession. The sectors and/or types of infrastructure and/or services in respect of which concessions may or may not be granted are not

clearly specified either. The tender procedure is left by the Concessions Law to be defined by the Government. Unfortunately, there is no reference in the Concessions Law to any possibility of awarding concessions without competitive procedures. Even though the Concession Law contains provisions on project agreement, these are not flexible enough (e.g. limitation of concession transfer, possibility for the government to withdraw the decision on the objects included in the list of concessionable objects "due to provisions of the concession agreement which run counter to the Kyrgyz Republic interests"). Although the Law includes a reference to possible tax benefits, it is mostly silent as far as possible government support and financial securities are concerned. The above provisions make the Concessions Law too rigid and this lack of flexibility may deter potential investors.

Quality of concession legislation – Kyrgyz Republic (2005)



Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the ‘web’, the more closely concessions laws of the country approximate these standards.

Source: EBRD Concessions Sector Assessment 2005

The EBRD’s 2005 Concession Laws Assessment undertaken to evaluate applicable regimes throughout its countries of operations (i.e. the laws on the books only rather than how they work in practice), revealed that Kyrgyz laws were in “low compliance” with internationally accepted standards in this sector. As can be seen from the chart above, rules governing most dimensions, and in particular, definitions and the scope of application, selection of a concessionaire, availability of financial instruments and state support need to be dramatically improved in order to meet the requirements of a modern legal framework facilitating private sector participation.

Corporate Governance

The Law on Joint Stock Companies (the “JSC Law”) enacted in 2003 and amended in

December 2004 is the principal legislation on corporate governance in the Kyrgyz Republic.

In 2004, the EBRD benchmarked the relevant Kyrgyz corporate governance legislation with the Principles of Corporate Governance published by the OECD and the results demonstrated that the national legislation is in “medium compliance” with international standards. The JSC Law was amended after the assessment and the new regulation improved the Kyrgyz legal framework. In particular, the role of the board of directors was clarified, the independence of the Auditing Committee was strengthened and stricter reporting obligations and disclosure requirements and new rules for protection of minority shareholders were introduced.

In 2005, the EBRD launched a survey for testing the effectiveness of corporate governance (i.e. how the law works in practice). A case study dealing with related-party transactions was designed. The case study investigated the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction was indeed entered into by the company and on how it was possible to obtain compensation in case damage was suffered. Effectiveness of legislation was then measured according to four principal variables: complexity, speed, enforceability and institutional environment.

The survey revealed that the major shortcomings which might undermine the effectiveness of corporate governance in the country are the speed of proceedings, which can last over two years and the weak institutional environment: company books are not considered of good quality, competence and experience of courts, prosecutor and the securities commission should be improved, while corruption and partiality in judgements are still considered as major problems. As a result, the effectiveness of corporate governance legislation in the country is generally low.

Insolvency

The main law governing bankruptcy and insolvency in the Kyrgyz Republic is the Law on Bankruptcy (Insolvency) (the “Insolvency Law”) of 1998, as amended, which provides for both liquidation and restructuring and applies to all commercial enterprises other than certain types of state-owned business. The Insolvency Law was rated as “medium compliance” in the EBRD Insolvency Sector Assessment of 2003, which measured the extensiveness of laws against international standards.

There are a number of positive attributes to the law: a relative easy and quick (on paper) process for initiating proceedings by both creditors and debtors; a well-defined threshold test for insolvency (unwilling or unable to make a payment of a certain minimum amount to a creditor when due); allowance for anticipatory filings by debtors who expect to become insolvent; and a stay of proceedings which prevents the debtor from unlawfully disposing of its assets and which prevents all but secured creditors from taking enforcement actions to “strip” the debtor.

The Insolvency Law could be improved in a number of ways: require specific notice to known creditors of the commencement of proceedings; add detail to the process for avoiding pre-bankruptcy transactions to make it effective; require debtors to deliver up

assets and provide relevant information to the administrator; enforce the stay of proceedings against all creditors while providing a means by which parties may obtain relief from the stay; and, provide a set of qualifications for insolvency administrators.

The Insolvency Law's most significant failings can be found in the restructuring arena. The law provides insufficient scope for court involvement and supervision of the process or approval of the final plan. The failure to stay the rights of secured creditors may encourage them to seize assets before a debtor can propose a proper restructuring plan. Also, the law makes operation of a restructuring debtor difficult by being unclear on who retains management functions during a restructuring and by failing to prevent suppliers from refusing to supply essential services (such as electricity and natural gas). Finally, failure to allow reorganisation financing to be provided on a priority basis will, inevitably, make restructuring difficult.

These flaws were demonstrated when the Insolvency Law was reviewed as part of the 2003-2004 EBRD Legal Indicator Survey (LIS). The LIS, which examined the effectiveness of the law in practice, indicated that the law generally lacks speed, predictability, and efficiency with creditor initiated processes suffering the most.

Secured Transactions

Although the Kyrgyz Republic had a comprehensive legal framework for charges since the 1997 reform, it was not a functioning system and the business community increasingly expressed frustration about it. A number of initiatives for reform were undertaken in the last couple of years, led by international investors and foreign advisers, in particular EBRD and USAID.

In January 2005, the Parliament adopted the new Law on Pledge and Mortgage. The most notable feature of this new law, and the one which created most resistance in the parliamentary process, was the introduction of out-of court enforcement foreclosure. The USAID Commercial Law Project in particular noted that "the chief barrier to the development of a vibrant mortgage market in Kyrgyz Republic is the extremely high cost, in terms of expenditures of both time (more than two years through the courts), and money (on average 140 per cent of the value of a claim), necessary to liquidate collateral in the event of default. These circumstances result in credit rationing (typically mortgage amounts are capped at half the value of the mortgaged property), which is necessary to reduce risk, combined with very high interest rates (average 22 per cent), which are necessary to recoup costs. The new law circumvents this barrier by providing for speedy, neutrally administered and fair liquidation procedures, which should result in increased access to, and lower costs for, credit."

The EBRD's own assessment, which dates from 2003, concurred: according to a regional survey on enforcement, the process in the Kyrgyz Republic could take from 9 to 15 months. The main problems arose from the debtor's obstruction to enforcement, whether the enforcement was directly led by the creditor or led by court. Since in both cases, the creditor must give notice to the debtor and wait 30 days before starting enforcement or filing a petition to the court, the debtor has ample opportunity to create obstructions, which it was reported was almost always the case.

There is not yet clear information on how the new system now operates in practice. In any event, the law is still in state of flux since, only a few months after the adoption of the new law, the International Business Council's Financial Committee in Bishkek undertook to prepare new amendments to the law, related to problems with registration and realisation in particular. Other amendments related to land law and housing code were put forward with the aim of strengthening the mortgage market.

One area which would certainly benefit from improvement is the registration of pledges. The Kyrgyz Republic has a centralised, electronic pledges register where pledges over movable assets, including future assets and intellectual property rights, can be recorded. The central register is located in the capital city of Bishkek, with regional offices located in Osh, Jalalabat, Karakol, Naryn, and Talas. The registry has been operating since 1998 since which time a number of areas for improvement have emerged:

- The register is not directly searchable by users, for example via the Internet;
- The number of documents which must be produced at registration could be reduced, thus making the registration process easier and more user-friendly;
- Different asset registries should be connected so that a third party can find out all pledges registered against a chargor in a single search.

Telecommunications

The communications sector (the "Sector") in the Kyrgyz Republic is currently regulated by the National Communications Agency ("NCA") and is governed by the Telecommunications Law of 1998 (the "Law") and various supplementary legislation. The Law reflects many modern principles in communications regulation, creating NCA as an independent regulator with the power to implement the regulatory framework, enforcing competition, monitoring licensing conditions and administering tariff and interconnection control. The Sector policy maker is the Ministry for Transport and Communications.

In the past decade, the Government of the Kyrgyz Republic (the "Government") has made much progress improving the Sector environment. In accordance with WTO commitments, the market was formally liberalised in January 2003. While a number of operators compete with majority state-owned KyrgyzTelecom (KT), it still dominates the marketplace in the fixed segment. Several efforts have been made to privatise varying shareholdings in KT, the most advanced of which was halted by parliament following the March 2005 change in Government. A new tender for a majority stake in KT was announced in 2006; however privatisation has yet to move forward. Difficult terrain outside Bishkek and a dearth of investment in the fixed network has left teledensity at approximately 9 per cent.

While liberalisation has started to take hold in the Kyrgyz Republic, much work remains to ensure that maximum benefit can be yielded in terms of the attraction of private investment and development of the sector. Many challenges lie ahead for the authorities in their efforts to ensure the regulatory framework is fully implemented. To capitalise on the benefits to be yielded from a competitive marketplace, the authorities must move, without delay, to implement all necessary mechanisms to support the liberalised marketplace ensuring appropriate regulatory controls are imposed upon

dominant operators (e.g. tariff rebalancing, workable interconnection and a mechanism for securing appropriate universal access). Further, sector institutional arrangements, which reflect international best practice of independent regulation, should be re-affirmed and formalised by government. Additionally, while the 1998 Telecommunications Law provided a firm basis for the reform of the Sector at that time, the overall legal framework now needs revising to address the challenges within the sector today.

Further, to allow KT access to the capital and expertise necessary develop network infrastructure and participate in a competitive environment, Government should ensure privatisation moves forward in an appropriate and timely manner.

The EBRD has been providing technical cooperation assistance to the authorities for a number of years. Direct TC assistance began in 1998 supporting the elaboration of strategic policy for the sector; assistance with drafting the 1998 telecoms law; and, assistance with the establishment of NCA. The EBRD continues to assist the sector authorities and is currently providing substantial TC assistance to the authorities in the areas of universal access, interconnection, tariffing and regulatory capacity building. Going forward, subject to satisfactory implementation of output of the assistance, the EBRD will continue to support the sector authorities to implement and apply the sector regulatory framework.

Annex 6 Bilateral Assistance

Canada

Canada has funded development projects in the Kyrgyz Republic through the Canadian International Development Agency (CIDA). CIDA continues to provide support to the Kyrgyz Republic through its contributions to multilateral organizations. Within Central Asia, CIDA is concentrating its assistance in Tajikistan. Given this focus, existing bilateral programmes in the Kyrgyz Republic are being concluded and only limited new programming, i.e. small projects carried out through Embassy-managed funds, will be considered.

France

France has a small technical assistance budget which is devoted mainly to cultural development and exchanges. This includes grants for students to study French and in French universities. France, working with the OSCE, provides training for police and other emergency response agencies. In 2007, France will initiate a training programme for the Kyrgyz civil service authority.

Germany

Germany commenced bilateral assistance to the Kyrgyz Republic in 1992 and has since committed more than EUR 180 million for Technical and Financial Cooperation in the form of grants and loans.

In 2001, Germany and the Kyrgyz Republic agreed on focusing bilateral cooperation on the sector of sustainable economic development with the aim of supporting the transition to a market-oriented economy. Accordingly, German bilateral support focuses on private sector and microfinance development and establishment of credit unions, as well as vocational training and adult-training.

Furthermore, Germany also supports programmes in the realm of basic social needs first and foremost the reform of the health sector through a joint sector wide approach with the World Bank and other donors, but also the national medical emergency programme.

Finally, the Kyrgyz Republic also benefits from regional programmes that include vocational training, support for commercial law and judicial reform and the fight against tuberculosis and desertification.

Japan

Japan commenced bilateral assistance to the Kyrgyz Republic in 1991. By the end of 2005, total disbursements under loans were USD 236.7 million, grants assistance was USD85.2 million and technical cooperation was USD 75.1 million.

Based on policy dialogue with the Kyrgyz authority, currently Japanese official aid focuses on the following four priority areas: (i) transition to a market-oriented economy, (ii) basic human needs (primary health care and education etc), (iii) economic infrastructure, and (iv) agriculture sector.

Loans denominated in Yen are provided by the Japan Bank for International

Cooperation (JBIC) mainly for the transport sector (airports and roads). Grants are continuing in key areas such as health sector and food production. TC for human resources development is ongoing in areas related to the market economy, public administration as well as environment. This is provided through Japan International Cooperation Agency (JICA). JICA also have provided funding for studies on key development issues such as agricultural management system and rural development planning for the Issyk-Kul State Region. The Japan Overseas Cooperation Volunteer programme (JOCV) has been active in the Kyrgyz Republic since 2000 and provides grass roots development assistance.

Looking just at 2005, disbursements of grant aid to the Kyrgyz Republic were USD 9 million and technical cooperation was USD 11 million.

Switzerland

The Kyrgyz Republic is a priority country for the Swiss economic cooperation, focusing on the fight against poverty, security and stability. Moreover, in the context of the Bretton Woods institutions, Switzerland plays an active role as a facilitator and bilateral partner for members of the Swiss-led constituency.

The future Secrétariat d'Etat à l'économie (SECO) programme will be fully consistent with the priorities and objectives set by the Government in its CDS and NPRS (2003). Main lines of intervention include:

- establishment of reliable and adequate infrastructure,
- improvement of macroeconomic framework, and
- development of the private sector, focusing on SME.

SECO bilateral cooperation programme will focus on:

- coordination with donors and an active participation in policy dialogue with government;
- supporting efforts to improve public finance through capacity building and technical assistance;
- infrastructure financing, with a focus on water and electricity;
- improvement of the business environment, promotion of SME, and diversification of exports;
- decentralisation of authorities.

United Kingdom

The Kyrgyz Republic is a key target country for Department for International Development (DfID) assistance. Total UK aid is around GBP 6 million per annum and will rise to GBP 10 million by 2010. There is a focus on governance, including large commitments in Public Financial Management, rural water, health, and village-level service delivery. DfID also supports significant regional work on HIV and AIDS.

The UK is strongly committed to harmonisation and working closely with donor partners to support country-led development. We are currently developing a Joint Country Support Strategy with the WB, ADB, Swiss and UN to align our support more

closely to the Country Development Strategy. Together with the WB and other partners, we provide sector budget support to the health sector and will continue to progress towards an increasing share of our programme being channelled through national systems, as fiduciary risk allows.

We work closely with the Bank country office, sharing analysis, discussing political and policy issues and working together on our respective programmes including the ETC initiative.

United States of America

U.S. assistance to the Kyrgyz Republic aims to foster private sector development, higher quality health care, and support to anti-trafficking programmes, improve primary education, and promote rational and effective management of water and energy. Total US assistance budgeted in FY06 is USD 30 million in the following areas:

Economic Reform: SME development through business advisory services, accounting training and other business and economics education. Support to banks and multilateral financial institutions to facilitate access to credit. Reducing investment constraints and modernising customs, reforming commercial law and economic policy and developing a land market.

Energy and Water: Assist in developing a regional electricity market and support the Kyrgyz Republic in reforming the electricity sector to establish a transparent, competitive market.

Health and Population: Increase utilisation and quality of primary health care services through implementation of the National Health Reform Programme. This programme provides continuing medical education for doctors, nurses, and paramedics.

Education: Training and resource development for 11 pilot schools and 84 cluster schools. By supporting the Kyrgyz National Scholarship Test, provide fair opportunity for school graduates to receive state grants for higher education.

Democracy and Media: Strengthen 1) political processes and institutions, 2) civic organisations, 3) sources of independent information; election administration; and 4) political party assistance and voter education. Support for human rights defenders, civic education, anti-trafficking activities, commercial law and judicial training, legal education, and local governance.

Conflict Mitigation: Foster cross-border collaboration on infrastructure and social projects. Increase economic opportunities, improve service delivery, and promote citizen participation in addressing issues at the core of potential conflicts.

Annex 7 Selected Economic Indicators

Kyrgyz Republic

	2001	2002	2003	2004	2005	2006 <i>Estimate</i>	2007 <i>Projection</i>
Output and expenditure <i>(Percentage change in real terms)</i>							
GDP	5.3	0.0	7.0	7.0	-0.2	2.7	5.7
Private consumption	1.6	4.2	22.1	7.5	3.2	na	na
Public consumption	0.0	-0.2	-2.0	2.5	-1.0	na	na
Gross fixed capital formation	-3.2	-7.4	-6.4	7.4	10.2	na	na
Exports of goods and services	-3.2	8.1	5.3	12.8	-9.8	na	na
Imports of goods and services	-13.8	13.1	16.0	16.3	1.0	na	na
Industrial gross output	5.4	-10.9	17.0	3.7	-12.1	-10.2	na
Agricultural gross output	7.3	3.1	3.2	4.1	-4.2	1.5	na
Employment <i>(Percentage change)</i>							
Labour force (end-year) ¹	1.4	1.2	2.3	1.9	na	na	na
Employment (end-year)	1.1	1.1	1.7	2.3	na	na	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	7.8	8.6	8.9	9.0	9.7	na	na
Prices and wages <i>(Percentage change)</i>							
Consumer prices (annual average)	6.9	2.0	3.1	4.1	4.3	5.6	5.0
Consumer prices (end-year)	3.7	2.3	5.6	2.8	4.9	5.1	5.5
Producer prices (annual average)	12.0	4.8	4.6	9.0	2.6	15.3	na
Producer prices (end-year)	11.2	7.5	13.5	4.3	6.0	10.4	na
Gross average monthly earnings in economy (annual average)	18.6	15.8	13.7	16.9	14.5	14.4	na
Government sector² <i>(In per cent of GDP)</i>							
General government balance	-5.6	-5.3	-5.2	-4.0	-3.3	-2.0	-2.7
General government expenditure	26.0	28.1	27.4	27.4	28.0	28.5	na
General government debt	107.3	107.3	104.9	93.8	85.3	71.7	na
Monetary sector <i>(Percentage change)</i>							
Broad money (M2, end-year)	11.3	33.9	33.4	32.1	10.0	38.6	na
Domestic credit (end-year)	-8.1	21.6	11.3	-18.8	19.6	22.7	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	11.1	14.6	17.5	20.6	21.2	26.2	na
Interest and exchange rates <i>(In per cent per annum, end-year)</i>							
Official rate	10.7	4.4	4.0	4.0	4.1	3.2	na
Money market rate ³	19.1	7.0	4.0	4.0	4.3	4.2	na
Deposit rate ⁴	12.5	5.9	5.0	6.7	5.8	5.1	na
Lending rate ⁴	37.3	24.8	21.7	29.3	26.6	27.6	na
	<i>(Soms per US dollar)</i>						
Exchange rate (end-year)	47.7	46.1	44.2	41.6	41.3	38.1	na
Exchange rate (annual average)	48.3	46.9	43.7	42.6	41.0	40.2	na
External sector <i>(In millions of US dollars)</i>							
Current account	-24	-49	-81	-75	-198	-507	-163
Trade balance	31	-74	-133	-171	-419	-845	-480
Merchandise exports	480	498	590	733	687	824	881
Merchandise imports	450	572	724	904	1,106	1,669	1,361
Foreign direct investment, net	-1	5	46	131	43	250	92
Gross reserves, excluding gold (end-year)	230	289	365	549	570	764	na
External debt stock	1,678	1,785	1,978	2,104	2,020	2,061	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	4.8	4.8	5.0	5.8	4.9	4.5	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service ⁵	30.8	21.0	22.3	19.1	14.8	9.9	na
Memorandum items <i>(Denominations as indicated)</i>							
Population (end-year, million)	4.9	5.0	5.0	5.1	5.1	5.1	na
GDP (in millions of soms)	73,883	75,367	83,872	94,351	100,899	113,176	126,000
GDP per capita (in US dollar)	309	322	381	435	480	549	na
Share of industry in GDP (in per cent)	26.8	21.3	20.2	21.7	20.0	17.6	na
Share of agriculture in GDP (in per cent)	34.5	34.4	33.6	29.9	28.5	28.9	na
Current account/GDP (in per cent)	-1.6	-3.1	-4.2	-3.4	-8.1	-18.0	-5.2
External debt - reserves (in US\$ million)	1,448	1,496	1,614	1,555	1,450	1,297	na
External debt/GDP (in per cent)	109.6	111.1	103.0	95.1	82.1	73.2	na
External debt/exports of goods and services (in per cent)	299.3	278.8	265.5	223.3	211.9	185.8	na

¹ Based on labour force data from World Bank World Development Indicators.

² General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign-financed public investment programme and net lending.

³ Weighted average rate on interbank loans in soms with 1-90 days maturity, from International Financial Statistics.

⁴ Weighted average over all maturities from International Financial Statistics.

⁵ Debt service scheduled and excludes US\$ 111 million debt rescheduling granted by the Paris Club of official creditors for 2002-04.

Annex 8 Environmental Issues

The Kyrgyz Republic is a land of great natural beauty, has a diverse mountain ecosystem, and is rich in water resources. The country's economy is dependent on agriculture and livestock (which together account for 30 of GDP and 50 per cent of employment). Productivity and sustainability of the sector is undermined by poor historical practices of land and water management and poorly maintained irrigation. Agricultural land is being lost due to erosion, and salinization is a concern in over 10 per cent of irrigated areas.

Intensive use of natural resources has led to large-scale land degradation and loss of biodiversity. The Kyrgyz Republic lies at the centre of a biodiversity hotspot. Its forests are threatened by uncontrolled logging, fire and conversion to agriculture. The environment also is impacted by human economic activity that endangers protected animal species such as the snow leopard.

Municipal waste is one of the most urgent problems in Kyrgyz Republic resulting from limited government budgets, and weak legislative basis. Industrial pollution is high, although the last 10 years have been marked by the decline in emissions due to industrial slowdown. Pollution from transport is becoming a major contributor to air pollution. The mining industry creates 620 million m³ of hazardous toxic wastes annually (radioactive, heavy metals, cyanides, acids, etc.).

Given the above issues, the priority areas for environmental action include:

- Land resource management;
- Efficiency improvement in hydropower and irrigation uses for water use;
- Attention to industrial and urban pollution as these sectors recover; and
- Regional co-operation on energy, water and biodiversity conservation.

The environmental enforcement authorities need a substantially improved regulatory framework and institutional capacity if they are to fulfil their mission (OECD 2005). Most environmental standards are still based on those of the Soviet Union. Although the environmental legislation and associated government regulations for implementation and enforcement are stringent, ability to monitor, inspect and enforce regulations is very limited.

The National Environmental Action Plan (NEAP) adopted by the Government in 1995 remains the prime guiding policy document. It defines key environmental issues of concern: inefficient water resources management, land degradation, over-exploitation of forest resources, potential loss of biodiversity, and inefficient mining and refining practices. A number of institutional changes occurred in the Kyrgyz Republic since 2005. Environment-related functions have been transferred from the Ministry of Environment and Emergency Situations to the State Agency on Environmental Protection and Forestry of the Kyrgyz Republic. The latest changes in the legislation are ratification of the Water Code in 2005. The country has been discussing a new Ecological Code which should resolve existing contradictions in the current legislation and harmonise legislation with international commitments. The country's current draft CDS includes an environmental sustainability section which should help streamline

environmental considerations through all areas of economic development.

The Kyrgyz Republic has ratified 9 international agreements on nature conservation/protection, including on issues of Biodiversity Conservation (1996), Climate Change (2000) and has ratified the Kyoto Protocol, Desertification (1997), and most recently the Stockholm Convention on Persistent Organic Pollutants (June 2006). The Government and the civil society are actively supporting various national and regional initiatives on environmental protection. The Kyrgyz Republic is the member of UN CSD and signed the Issyk-Kul and Nukussky Declaration (1995), supporting a sustainable development globally and specifically in the Central Asia region.

Activities of other international organisations:

A number of international institutions are active. A Joint Country Support Strategy (JCSS) is being developed by the WB, UNDP, Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) of Germany, ADB and DfID with support of other IFIs and donors. UNDP's programmes include management and protection of environment and natural resources to ensure sustainable development. Specific projects include capacity building in municipal wastes management system, community-based rangeland management, CARNet (a digital information network on environment and sustainable development in Central Asia and Russia) and small grants to support civil society in conservation.

The WB/IDA is currently active in 6 projects including activities on rehabilitation of irrigation systems, improvement of management of water resources, disaster hazard mitigation project, including rehabilitation of the uranium storage and system of prediction and prevention of landslides, registration of property, and biodiversity in western Tian Shan.

The Global Environment Facility is implementing projects in biodiversity, climate change, land degradation and persistent organic pollutants with funding through 6 projects for USD 2.23 million.

Bank's Activities

The Bank's environmental approach is complementary to that of other organisations, particularly in light of the Bank's emphasis on the private sector. All projects in the Kyrgyz Republic will continue to be subject to the EBRD's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans (EAPs) into the legal documentation in order to address issues raised during due diligence.

The Bank continues to address insufficient institutional capacities through its projects and in cooperation with other international institutions. The EBRD continues to monitor and provide environmental due diligence training to local banks to ensure that they are capable of implementing environmental due diligence procedures and thus support environmentally sound development within the SME sector. The Bank also continues to provide support/guidance to other private sector projects, particularly KMC. Together with IFC and Fauna and Flora International, the Bank is providing technical assistance for rural development and biodiversity conservation given the

specific environmental implications of the mining activities.

TAM/BAS environmental programme

TAM Environmental Programme will assist Kyrgyz SMEs to implement environmentally-friendly technologies to reduce pollution and increase energy efficiency. TAM also is assisting the development of eco-tourism in the Issyk-Kul region.

BAS has introduced ISO 14001 environmental standards to the Kyrgyz SMEs, and is funding local energy efficiency efforts through support for consultants in the sector.

"Kyrgyz Republic: Institutional Capacity Building for Biodiversity Conservation"

EBRD, IFC and Kumtor Operating Company (KOC) are currently implementing a project to protect the endangered snow leopard. The two-year project begun in August 2005 should help improve management and monitoring of the Sary-Chat Ertash zapovednik (nature reserve), located near to the KMC. The project is jointly funded by EBRD with funds from the United Kingdom and IFC. KOC is providing additional financing. The programme will be managed by the Fauna & Flora International consultancy and the Kyrgyz Community and Business Forum in partnership with the International Snow Leopard Trust.

This TC builds on results achieved through previous activities supported with TC funds from EBRD which helped to create the Community and Business Forum (a local NGO working for sustainable development). The Forum was instrumental in facilitating dialogue between local communities and other stakeholders of KOC. Today, the Forum supports a wide range of NGOs, businesses and protected areas.

The Sary-Chat Ertash initiative is part of EBRD's on-going work to ensure KMC operations meet long-term sustainable development objectives. The proximity between the gold mining operations and the nature reserve is an example of how the Kyrgyz Republic has to balance business, community and environmental interests. In order to raise support of the local community the initiative also provides a Small Grants Programme, which focuses on development of local livelihoods such as crafts, sustainable forestry and agriculture.

Financial Intermediaries

In July 2006, the Bank provided environmental and social risk management training to Kyrgyz financial institutions (AKB Kyrgyz Republic, Bai-Tushum, Demir Kyrgyz International Bank, Inexim Bank, KICB, ECO Bank, Energobank, Kazkommertsbank, FINCA, and KAFC) to ensure they are implementing EBRD's environmental due diligence procedures, particularly within the SME/MSE sector and trade facilitation transactions.

Property

The Bank's investment in tourist sites on Lak Issyk Kul (Raduga II and DLF Karven) are located in an environmentally significant location, a designated Ramsar site (wetlands of international importance) subject to international protection due to its importance to migratory birds. Due diligence included a site visit as well as communications with local regulators, NGOs and the Ramsar Convention Secretariat. The Bank conducted a monitoring visit to the Raduga site in 2005 and 2006 to ensure implementation of the EAP and the Bank will continue to monitor these projects.