DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR THE KYRGYZ REPUBLIC

As approved by the Board of Directors on 16 November 2004

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I. EXECUTIVE SUMMARY

The Kyrgyz Republic is committed to and is continuing to make progress towards implementation of the principles of Article 1 of the Agreement Establishing the Bank, although the last parliamentary and presidential elections did not fully conform to OSCE standards. A new round of parliamentary and presidential elections is to take place in 2005. A key issue is the succession to President Askar Akayev, as the Constitution limits the President's terms in office to two. There was a deterioration in the area of freedom of the media, although an independent printing house was allowed to begin operations. Albeit subject to Government pressure at times, civil society and the political opposition are generally able to voice their concerns about Government policy.

The macroeconomic environment has been stable in the last two years owing to continued fiscal consolidation and appropriate monetary policy. The economy grew by 6.7 per cent in 2003, up from zero growth in 2002 and 5.3 per cent in 2001. Volatile growth reflects a decline in production at the Kumtor gold mine due to an accident in 2002. There are signs of more broad-based growth and continued expansion of micro and small businesses in recent years, although the economy is still concentrated on agriculture, gold mining and electricity production.

The Kyrgyz Republic remains one of the lowest-income countries of the Bank's countries of operations, with a high incidence of poverty. Although the Paris Club rescheduling agreed in March 2002 eased the debt service burden, the country's external debt to GDP is over 100 per cent and is one of the highest in the region. As a result of high indebtedness, the Government has only borrowed sovereign loans on concessional terms in the past two years and this limitation is likely to remain in place during this strategy period.

There has been some progress in transition over the past two years; several important reform initiatives have been undertaken, although there is room for further improvement. Following a series of bank failures in the aftermath of the Russian crisis, banking sector supervision has been strengthened through improvement of the supervisory powers of the National Bank of the Kyrgyz Republic. Financial institutions are gradually gaining public confidence and credit to the private sector has been steadily increasing. Yet the sector is still underdeveloped and banks have concerns about their ability to defend their creditor rights through the court system. The new Joint Stock Company Law has been strengthened to improve corporate governance standards. Further amendments, in August 2004, should afford better protection to minority shareholders' rights and thereby encourage minority (including foreign) investment.

Although the authorities committed to reducing the quasi-fiscal deficit in the electricity sector, much-needed tariff increases to cost-recovery levels – a prerequisite for the sector to undertake investments to reduce network losses – are only being implemented slowly. There is a renewed effort to privatise Kyrgyz Telecom and negotiations continue between the Government and a strategic investor which could lead to finalisation of a contract in 2005. A new anti-corruption law has been adopted and the President has created and chairs a new Council on Good Governance in order to address the issue of endemic corruption. The effectiveness of these initiatives is yet to be proven. In mid-2004, Kumtor Mining Company, which accounts for around 10 per cent of GDP, was effectively privatised and the authorities committed to taking several measures to improve the governance of the mining sector, including the adoption of the Extractive Industries Transparency Initiative (EITI).

The Kyrgyz Republic has one of the most liberal trade regimes in the region; however its small size means that its own reform efforts alone will not be sufficient to create the conditions for sustainable trade development and economic growth. The country is highly dependent on access to trade routes from Central Asia and to the markets of neighbouring countries. There have been some improvements; for example, Kazakhstan recently signed a bilateral treaty on trade and commerce and China has financed road infrastructure improvements. However, the Kyrgyz Republic would benefit significantly from greater openness in neighbouring economies. The Kyrgyz Republic's vast hydropower resources can only be efficiently developed in a regional context, whilst improved transport also relies on complementary regional investments. The Bank will continue its attempts to forge a regional policy dialogue for overcoming some of these constraints by direct means and also through cooperating with IFIs and donors.

In the forthcoming strategy period, the key challenge will remain the fostering of the private sector as an engine for growth and economic diversification. In order to achieve this goal, the country should continue to focus on the following reform priorities: (i) further improvement of the investment climate through the adoption of more concrete and enforceable measures against corruption, improvements in the court system and the lessening of bureaucracy; (ii) increasing transparency and corporate governance of enterprises by further revisions to relevant laws; (iii) improving tariff structure and regulation, especially in the power sector, in order to attract private investments while addressing affordability constraints; (iv) promoting the consolidation of the banking sector and further improvements to the supervisory capacity of the regulator; and (v) enhancing regional cooperation in the areas of water, energy, transit and regional trade.

Over the coming strategy period, the Bank stands ready to provide further support to the Kyrgyz Republic as it addresses its transition challenges and to assist the authorities in the implementation of their immediate and mid-term priorities as identified in the National Poverty Reduction Strategy (NPRS) 2003-2005 and the Comprehensive Development Framework (CDF) until 2010. The Kyrgyz Republic is one of the Early Transition Countries (ETCs). Under its recently introduced ETC Initiative[1], which is of particular relevance to the Kyrgyz Republic, the Bank will adopt more innovative instruments, consider small-sized, more difficult and higher risk projects, and provide appropriate technical cooperation (TC) to support investment expansion. The Bank will also strengthen policy dialogue with the authorities in order to improve the investment climate.
The Bank's main operational objectives will focus on the following in this strategy period.

[1] This new approach has been formulated to help the Bank's seven poorest countries of operation in their efforts to overcome poverty.

Fostering the Private Sector

The development of private businesses will form one of the pillars of the Bank's operational strategy. The Bank will explore possibilities of direct financing for projects in various sectors, including natural resources, agribusiness, textile, property and services. The Bank will contribute to attract regional and international investors. Newly introduced tools under the ETC Initiative, including the Medium-Sized Co-Financing Facility, Direct Lending Facility (DLF), due diligence TC, as well as the team dedicated to the ETC Initiative, provide new opportunities to develop projects. Smaller equity investments will be targeted under the Direct Investment Facility (DIF), although the newly amended Joint Stock Company Law has yet to be tested and there remains a significant concern about predictability in the court system.

The Bank will also further enhance access to finance for micro and small businesses through local banks, by further expanding the Micro and Small Enterprise Finance Facility (MSEFF) in terms of volume, product range and geographical reach. The Bank will also promote enterprises engaged in foreign trade through the Trade Facilitation Programme (TFP).

The Bank will seek opportunities to participate in the privatisation of key state enterprises. The Bank has provided technical assistance to the telcoms regulator and also to support privatisation of Kyrgyz Telecom. The Bank will support further investments if the Government succeeds in attracting a qualified investor.

Strengthening the Financial Sector

The banking sector in the Kyrgyz Republic, although it has been developing steadily, still remains small and weak. The Bank will continue to facilitate the entry of new investors to the sector which is important for increasing capitalisation and quality of bank management. The Bank will expand the number of Partner Banks and the financial products offered. It also will encourage consolidation of the banking system where appropriate. The Bank will seek to strengthen the banking sector through TC activities, including targeted advice on issues such as banking supervision, deposit insurance and formation of an effective credit bureau.

Kyrgyz banks which are chosen as partner institutions under the MSE Finance Facility and TFP facilities benefit from the provision of substantial technical assistance to improve credit and financial management skills in general; in particular to develop MSE and TFP financing as core products. The Bank is also developing new products under the ETC Initiative. The new Medium-sized Co-Financing Facility (MCFF) will help banks which have the best corporate and lending procedures to meet funding requirements of their relatively larger clients.

The Bank is aware of the constraint placed on the expansion of its work in the financial sector by the high risk that many potential partner banks represent. However, the Bank also expects to share risk with donors through the Central Asia Risk Sharing Special Fund (CARSSF) and other schemes, including those from the

ETC Initiative, as a means to leverage its own resources and increase its exposure to the local financial sector.

Support for Essential Infrastructure

Investment needs in infrastructure are considerable in the Kyrgyz Republic. Given limited public resources, however, prioritisation is essential among sovereign-guaranteed publicly financed projects. Since the Bank does not provide concessional funds, it will consider financing non-sovereign infrastructure projects that would have cash flows sufficient to support debt, without recourse to sovereign guarantee. For other critical infrastructure projects, the Bank could, for example in the energy and municipal and regional infrastructure sectors, blend its resources with grants to achieve concessional terms if such funds, including those from the ETC Initiative, are available. The Bank will proceed selectively with such an approach and coordinate closely with donors, IFIs and the Kyrgyz Government on the overall investment priorities of the country in the context of the NPRS. The Bank will pay particular attention to project structures that combine Bank financing with other IFIs, as well as donor grant funds.

Policy Dialogue

During the strategy period, the Bank will strengthen policy dialogue with the authorities, in order to improve the investment climate and support their reform efforts. The Bank will coordinate closely with other IFIs and the business community, including the International Business Council, which the Bank has helped to create and manage, to make such policy dialogue effective and consistent.

The Bank will actively seek co-financing opportunities with other IFIs and bilateral institutions to mobilise greater resources into the country, especially projects that could enhance regional cooperation. 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
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
CIDA	Canadian International Development Agency (Canadian Government)
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
DFID	Department For International Development (UK Government)
DIF	Direct Investment Facility
DKIB	Demir Kyrgyzstan International Bank
DLF	Direct Lending Facility
EAP	Environmental Action Plan
EH&S	Environment, Health & Safety
EITI	Extractive Industries Transparency Initiative
ETC	Early Transition Countries
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
JSC	Joint Stock Company
KA	Kyrgyz Altyn
KAC	Kyrgyz Agricultural Company
KGS	Kyrgyz Som
KICB	Kyrgyz Investment Credit Bank
KMC	Kumtor Mining Company
KR	Kyrgyz Republic
KT	Kyrgyz Telecom
MCFF	Medium-sized Co-Financing Facility
MEI	Municipal, Environment & Infrastructure team
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
PROMA	Project Management Agency
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
TAM	TurnAround Management
TC	Technical Cooperation
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

The Bank's current portfolio includes two large investments with foreign investors (Kumtor Gold Mine and Hyatt Hotel), sovereign guaranteed projects (telecoms and power/electricity sectors) as well as a number of small private investments and an array of products vis-à-vis the financial sector. Due to coordinated agreement between the Government and other IFIs, the Bank has refrained from new sovereign projects since the mid 1990s. Portfolio development also has been constrained by limited foreign investment. These two factors are partly responsible for the smaller volume of signings and an overall net reduction in the Kyrgyz portfolio (as repayments outweighed new signings).

The Bank has signed 26 projects (including restructurings) for a gross commitment of EUR 147 million.[2] The above compares to an end-2001 committed portfolio of EUR 171.1 million. The reduction since 2001 is mainly due to cancellation of the SME II Credit Line (EUR 20.9 million) in 2002, repayments on other loans and EUR/USD exchange rate movements. Annexes 2 and 3 provide full details of signed Bank operations and the current portfolio. Annex 4 provides details of TC operations undertaken.

Table 1. Kyrgyz Republic: Overview of the Bank's Activities to Date, September 2004

	No. of Projects	Total Project Value (€ million)	EBRD Finance (€ million)	Debt (€ million)	Equity (€ million)	Current Outstanding	% Share of Commitments
Private	9.9	592	85	51	34	33.4	57%
State	5	96	62	62	0	26.1	43%
Bank Equity	2.5	12	3	2	2	3.5	2%
Bank Lending	2	10	10	10	0	5.9	7%
Small Business Finance	0.3	6	3	3	0	2.8	2%
General Industry	0.1	4	3	0	3	1.8	2%
Agribusiness	4	22	12	12	0	3.0	8%
Power & Energy	2	51	49	49	0	20.1	34%
Natural Resources	2	521	52	24	28	14.5	36%
Telecoms	1	40	8	8	0	3.4	5%
Property & Tourism	1	20	7	6	1	4.5	5%
Totals	**14.9**[3]	**687**	**147**	**114**	**34**	**59.5**	**100%**

[2] This does not include EUR 8.9 million approved but not committed under the MSEFF.
[3] In the case of framework arrangements for projects, the Bank calculates the number of projects by dividing the committed amount by the framework amount approved.

1.2 Implementation of the Previous Country Strategy

The Bank's last Strategy, approved in September 2002, noted the difficult investment environment, and focused on private sector development. Strategic priorities included:

- **Privatisation and Enterprise** – Supporting private enterprise, including small businesses, though MSE and DIF facilities and assisting in the privatisation of remaining major state enterprises.
- **Financial Sector** – Supporting the FI sector by increasing capitalisation and investment.
- **Natural Resources** – Helping attract investment, particularly if gold prices should stabilise; thereby attracting strong and reputable international sponsors.
- Through **policy dialogue**, help develop and improve transparency, governance and the investment climate.

Despite signing less than EUR 8 million (including TFP) during the Strategy period, the Bank made progress implementing this Strategy, especially in the financial sector and enterprise development:

1.2.1 Privatisation and Enterprise

Improvements in the banking sector – both in bank supervision and in individual institutions – allowed the EBRD to expand the TFP and Micro and Small Enterprise Finance Facility (MSEFF) and thereby provide greater support to small businesses. For example, by end June 2004, the MSEFF had disbursed nearly 6,500 loans to approximately 5,500 Kyrgyz SMEs for a total of USD 11.5 million. The outstanding portfolio was USD 6.6 million with 4,500 clients. Following rapid regional expansion the MSEFF now finances more than 1,000 SMEs per month.

Significant work was devoted to monitoring the Direct Investment Facility (DIF) portfolio; although the Bank did not expand upon its existing portfolio. In 2003 and 2004, the Kyrgyz Republic provided the Bank's first two successful exits from DIF investments.

In the power and telecoms sectors, the Bank leveraged its operations in order to maintain an open dialogue with Government about reform and privatisation.

1.2.2 Financial Sector

The Kyrgyz banking system is relatively immature and was significantly impacted by the Russian crisis and its associated foreign exchange devaluation. As a result of the crisis (and poor corporate governance), three of four banks participating in EBRD's SME I Credit Line were placed into administration.

However, the past two years have seen many positive developments, highlighted by the entry of Kazakh strategic investors into the banking system. In response to the need for local banks to strengthen and diversify operations, EBRD set up the MSEFF, with a long term commitment and clear focus on institution building and training. The availability of the Central Asia Risk Sharing Special Fund (CARSSF) and donor-funded TC allowed the Bank to expand financing on a non-sovereign basis. The Bank also extended the TFP to four Kyrgyz banks (again with support of the CARSSF).

The Bank made an equity investment in Ineximbank alongside a Kazakh strategic partner – one of the first examples of regional cooperation between Kyrgyz and Kazakh financial institutions. The Bank also contributed to the capital increase of Demir Kyrgyzstan International Bank (DKIB) to bring it in line with the NBKR capital requirements and continued to support Kyrgyz Investment Credit Bank (KICB).

Bank staff provided guidance to the NBKR and other government bodies on issues such as Deposit Insurance, amendment of the Pledge Law and establishment of an effective Credit Bureau.

1.2.3 Natural Resources

Kumtor Mining Company (KMC) remains a positive example of a natural resource project in the region. Following a restructuring, the Sponsor has committed to the company for the foreseeable future, which will result in an extension of the mine's lifespan by another 5 years, with potential to undertake further projects for development of the Kumtor satellite gold deposits.

Via support for the restructuring, the Bank and IFC helped achieve an incremental privatisation of the gold sector. Kumtor is now included within Centerra, which has been listed on the Toronto Stock Exchange, and Kyrgyz Government ownership has been reduced to around 29 per cent, down from 66 per cent previously. Moreover, Government commitment to the Extractive Industries Transparency Initiative (EITI) will impact the entire sector, beyond Kumtor. The Bank expects to initiate a dialogue with KA about its long-term restructuring as a profitable, commercial entity.

Despite the downturn in the gold market at the beginning of the decade, the Bank continued to discuss natural resource projects with other investors, in hopes of finding appropriate partners for the other (smaller) Kyrgyz gold mines.

1.2.4 Policy Dialogue

The Bank retains a strong policy dialogue with the Government, including involvement in President Akayev's Consultative Council on Investment. The Bank was instrumental in ensuring effective development of the International Business Council (the Bishkek Head of RO served as IBC Chairman). The Bishkek RO has been a regular participant in consultative meetings with the Government regarding the investment environment and the Bank has supported the Government in implementing key objectives within its programme to improve the investment climate.[4]

[4] The Government's Investment Matrix was developed jointly with IFIs in an effort to address key obstacles in the investment climate. The Government is now implementing the fourth version of the Investment Matrix.

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

The transition impact of the Bank's projects has been satisfactory. Although two sovereign projects – the SME Credit Line I and the Kyrgyz Agriculture Company – have been unsuccessful, loans to KMC and the Hyatt Hotel Bishkek helped ensure implementation of high quality foreign investments, while loans to Kyrgyz Telecom (KT) and Kyrgyz Electric Grid helped advance corporate and commercial governance in both state-owned enterprises, bringing them closer to eventual privatisation.

On balance, the Bank has been successful in financing small enterprises. The Kyrgyz Republic was one of the first countries to develop a DIF portfolio. Although the portfolio has at times faced significant difficulties, lessons learned in the Kyrgyz Republic have helped develop DIF approaches across the region. The Bank's recent successful projects in the financial sector – particularly equity participations and MSEFF – are also notable, raising corporate standards, know how, asset quality, and expanding products.

1.3.1 Influence on the Transition Process

Enterprise Sector

The Bank has had a positive impact through working with key foreign investors. The Kumtor gold mine is considered one of the highest standard natural resource projects in the region. The Hyatt Hotel also raised standards in the property and tourism sectors.

The Bank has also had a positive impact on small investors. The MSEFF has helped bring small and medium sized enterprises (SMEs) into the formal financial sector and out of the shadow economy, therefore its impact goes beyond transition at the financial institution level. More than 90 per cent of the clients financed under the MSEFF are first time borrowers in any bank. A high repayment performance as well as an increasing ratio of repeat borrowers is a clear indicator of the growth dynamics and potential of SMEs in the Kyrgyz Republic. DIF experience has been mixed: two projects have had high demonstration impact involving training and new technologies, while others faced significant difficulties with local partners. However, even when faced with corporate governance concerns about its partners, the DIF portfolio has opened opportunities for dialogue, for example concerning the JSC Law and general legal/court system reform. Improvements in legal reform could reinvigorate equity financing. Other small investments unfortunately also raised significant concerns about the legal system, particularly in one case when the Bank was not able to defend itself against perceived illegal actions of a hostile majority shareholder.

On privatisation, the Bank's experience also is mixed. The Bank maintains an active dialogue with the Government, with regard to KT and SeveroElectric for example, where the Bank could support strong appropriate investors.

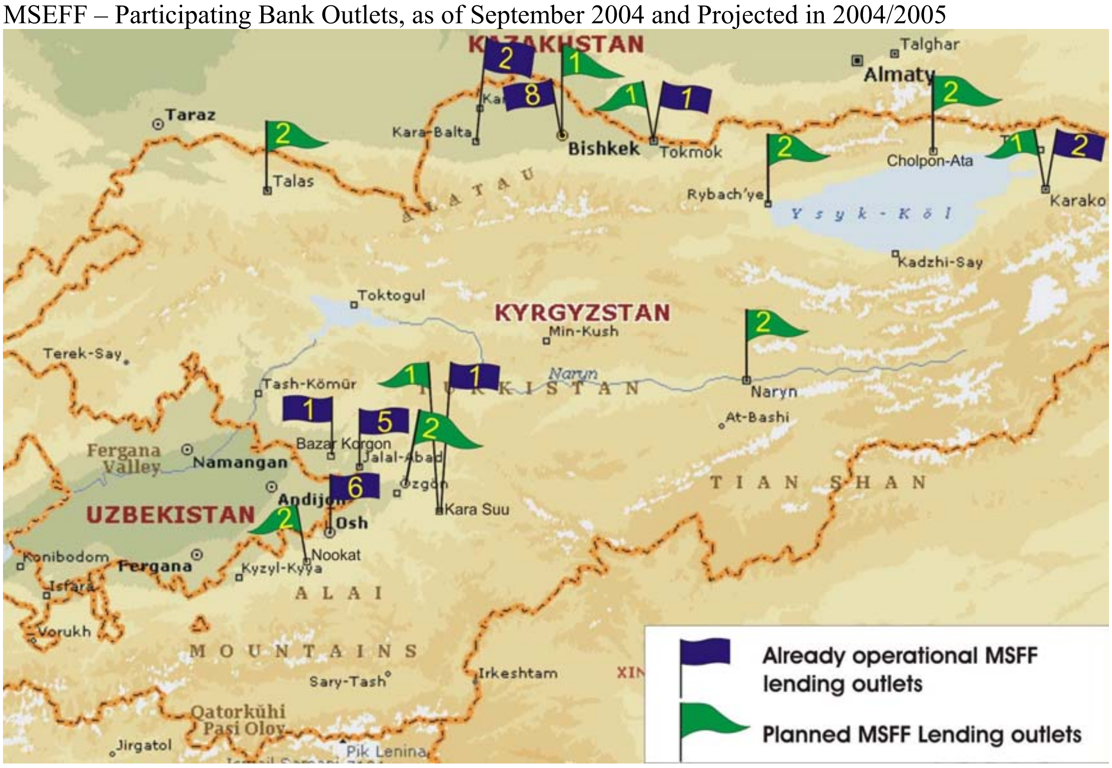
Financial Sector

The Bank has had a significant impact on the financial sector. Equity investments in three banks have helped raise capitalisation, as well as corporate standards. Most notable was the Bank's ability to support a cross-border investment by a Kazakh bank.

The MSE and TFP facilities not only provided vital financing for the enterprise sector, but also have been backed by TC programmes to help banks develop key credit skills. The MSEFF provides powerful demonstration benefits at corporate, loan officer and borrower levels.

The Bank's recent interventions with the Government have mainly related to the Pledge Law. Parliament passed a revised version in June 2004, but this version was vetoed by the President as it did not address issues which had been highlighted by Government, banks and donors (it failed to introduce streamlined registration or out of court repossession procedures). An improved Law would help banks to expand lending. The Bank also participated in the creation of an independent Credit Bureau, which, with further improvement, could be an important factor to support SME and retail lending. Finally, the Bank provided advice on deposit insurance; further advice could be provided to move this forward in the Strategy period.

MSEFF – Participating Bank Outlets, as of September 2004 and Projected in 2004/2005



Infrastructure

The existing projects with the Government – in Telecoms and Power – continue to perform satisfactorily. The Bank's conditionalities have helped move both companies towards stronger corporate management. In telecoms, the Bank also provided significant assistance in the regulatory area; and, in fact, the Kyrgyz Republic is widely considered an advanced reformer in this area.

The transmission network improvement project in Issyk Kul region was particularly creative in directly linking repayments to tariff payments from Kumtor. Such structures could benefit other natural resource investments; including at the Jerooey gold mine.

1.3.2 Financial Performance of Existing Portfolio

The current portfolio in the Kyrgyz Republic has a weighted project risk rating of 6.22, compared with the average for Central Asia of 5.56, and 5.42 for the Bank as a whole. The overall portfolio is impacted by Kyrgyz country risk rating, given that more than 50 per cent of the portfolio is sovereign guaranteed.

Public loans are sovereign guaranteed and are repaying on time. Two sovereign guaranteed projects (approved nearly 10 years ago) – the SME I Credit Line and the Kyrgyz Agricultural Company (KAC) – faced significant difficulties, forcing the Government to take on direct budgetary repayment responsibility. The loan to the Kyrgyz Electric Grid is supported by direct payments from KMC covering about 50 per cent of the total exposure. KT is making regular payments, and its repayment strength is likely to increase with completion of privatisation.

KMC repaid its USD 30 million senior exposure in 2002 and the remaining subordinate exposure was transferred to equity in July 2004. The restructuring led to an increase of the assets under management of approximately EUR 10 million. The Bank's exposure to the Hyatt Hotel is performing satisfactorily, with the company's financial performance improving.

A successful exit from one of the DIF investments last year earned a 24 per cent compounded return. A second exit earned a small return (approximately 4 per cent p.a). The Bank envisages exits from the current portfolio of DIF investments over the next two years. Growth of the DIF portfolio has been hampered by concerns about the legal regime and corporate governance within the existing and potential investee companies.

In the financial sector, two banks are utilising funds under the MSEFF (with others benefiting from TC only at this stage). Available TFP lines are being actively utilised. Equity investments in three banks are still in their early stages. KICB earned its first profit in 2003 and will turn a profit in 2004. In 2003 the Bank provided additional capital to DKIB; the past 18 months have seen increasing profitability. Ineximbank is developing rapidly and seeks to become a top three bank in the Kyrgyz Republic.

1.3.3 Mobilisation of Co-Financing

The Bank has been successful in mobilising co-financing. In total, the cost of projects financed by the Bank amounts to EUR 697 million, with a ratio to EBRD financing of 5.7:1.

1.3.4 Lessons Learned

Private Sector

The Bank's interventions in the private sector have produced numerous lessons. In the first place, financing private sector projects which rely on support of a sovereign guarantee has not been successful (KAC and SME I Credit Line). On the other hand, investments with large foreign investors (Hyatt and Kumtor) demonstrated benefits of working with partners who can provide additional support when unexpected problems arise. The impact of these projects on the local economy is greater than the specific project financed.

The Bank should continue to expand the range of products available to smaller companies. The MSEFF and TFP have been effective in financing such companies through the banking system, with close to 100 per cent repayment performance. The MSEFF, in conjunction with comprehensive institution building and training, has been an effective model for improving banks' capacity to provide access to finance for SMEs. The bank will expand the MSEFF further to bring lending and training activities to rural regions. On the other hand, difficulties with the Bank's DIF investments demonstrates the continuing need to seek suitable mechanisms for financing this target group.

Given the above, the ETC Initiative promises well in that it should allow flexible implementation of DIF procedures and development of new products, such as the Direct Lending and Co-Financing Facilities. For larger companies, the Bank will proactively seek non-traditional foreign investors, for example from Kazakhstan, Russia, China and Turkey. ETC support is necessary in developing this target market as well.

Finally, the Bank must continue to work with the Government to address obstacles to private sector investment and development. Key interventions on such issues as the Law on Pledge and the Joint Stock Company Law continue. Targeted Legal Transition Team interventions are also planned.

Financial Sector

The Kyrgyz banking system is relatively immature. Banks have limited capitalisation and more significantly, limited management experience. Thus, there remains a strong need for Bank intervention, both through support for management improvement in Partner Banks and also by banding the mainstream products such as equity, MSE and TFP. The Bank has demonstrated that targeted TC support can be vital to improving bank performance, with the high quality of the MSEFF loan portfolio serving as a key indicator.

The sovereign SME facility will not be repeated, but a new Co-Financing Facility under the ETC Initiative should help local banks target larger clients. Targeted TC could be devoted to strengthening individual banks, but also to developing banking sector infrastructure, such as deposit insurance and credit bureau programmes.

Infrastructure

While refraining from sovereign lending, the Bank can seek to finance innovative infrastructure projects. Key products which the Bank can promote include concession finance (eg, for SeveroElectric) and municipal enterprise finance (eg, for Bishkek or Osh Vodokanal). For both targets, however, strong Government support remains imperative and significant TC funds will be required.

Policy Dialogue

The Bank has a very open dialogue with Government officials, including the President, key ministers and the NBKR. The Bank receives much support, in particular due to its focus on the private sector. The Government firmly supports the new ETC Initiative, and hopes that it will enable (i) innovative infrastructure financing; (ii) increased SME and MSE investments; and (iii) targeted policy interventions. The Bank has addressed key legislation and regulation and should continue to do so, in particular as it impedes banking sector development and investment.

1.4 Portfolio Ratio

As of 30 September 2004, the private to state sector portfolio ratio stood at 57:43, based on an active portfolio of EUR 60.7 million. The target 60:40 ratio has nearly been achieved this year due to the increase in the investment in Centerra/Kumtor Mining Company, following the restructuring of the Bank's exposure. Until 2004, the ratio was negatively impacted by significant prepayments from Kumtor. The 60:40 target will be achieved, as early as end 2004, by concentrating on private sector projects. In fact, at the present time the Bank is not financing any sovereign projects in the Kyrgyz Republic. Moreover, the country continues to work on privatisation of Kyrgyz Telecom and, should negotiations with a strategic investor prove successful, the Bank's exposure to KT could potentially be re-structured or re-classified to the private sector portfolio in 2005.

2. *Operational Environment*

2.1 The General Reform Environment

2.1.1 Political Developments and Reform

The Kyrgyz Republic continues to make progress towards implementation of the principles of multi-party democracy, pluralism and market economy as envisaged in Article 1 of the Agreement Establishing the Bank.

The forthcoming presidential and parliamentary elections are driving the domestic political agenda. The main question is succession to Askar Akayev, who has been President since independence.

Besides presidential polls, there are parliamentary elections in February 2005. The last Jogorku Kenesh (the country's two-chamber parliament) was elected for five years in 2000. In accordance with amendments in 2003, the upcoming parliamentary elections will change the structure of parliament by creating a one-chamber legislature with a reduced number of deputies.

The Government's human rights record remains poor, although there were improvements in some areas. Attempts to suppress media freedoms in 2002 and 2003 raised concerns. In addition to the closure of some newspapers, there are reports of attacks on journalists. Human Rights Watch (HRW) have documented human rights violations, particularly in the areas of political participation, freedom of assembly and expression (see Addendum 1). On the other hand, Government eased control over print media in 2004 by allowing the establishment of an independent printing house, effectively breaking the monopoly of the state-controlled publishing house. Mass media benefits from unhindered access to the internet.

Political opposition is relatively well-established and outspoken. There are many political parties, including genuine opposition groups, a relatively strong and active civil society and, notwithstanding challenges and setbacks in democratic transition, the country continues to feature well in the regional context.

2.1.2 Regional Issues

As a land-locked country, the Kyrgyz Republic is keen to develop good relations with all its neighbours and to actively promote regional cooperation. The country has good relations with its large neighbours such as Russia and China and also the United States.

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, to regional economic groupings such as the Central Asian Cooperation Organisation (CACO) and the Eurasian Economic Community.

In an effort to open the Kyrgyz Republic to international trade, the country became a member of World Trade Organisation (WTO) in December 1998, the first in the region. However, benefits to the Kyrgyz Republic so far have been limited as its main trading partners and neighbours have not yet joined the WTO.

On the bilateral level, the country maintains strong economic ties with Russia and other CIS countries. There was a visible rapprochement in relations with Kazakhstan, reflected in the improved conditions for transit of Kyrgyz goods. Kazakh domestic rail tariffs now apply to Kyrgyz goods transported through the Kazakh rail system. Kyrgyz trucks crossing Kazakh territory no longer require permits. The practices of deposit payments at the border and customs escorts for transiting trucks were also abolished. These measures are expected to facilitate Kyrgyz exports of agricultural and other products to Russia through Kazakhstan. Trade relations with China, a WTO member country since December 2001, are also improving due to customs harmonisation. Relations with Uzbekistan remain difficult over the issue of border demarcation and border crossing, which significantly reduce cross-border economic activities.

There has been less tangible progress in addressing the issue of water-energy trade. Under the 1998 Long Term Framework Agreement, the Kyrgyz Republic is required to release the majority of the water from reservoirs along the Naryn river during the summer months to meet the irrigation requirements of down-stream countries (Kazakhstan and Uzbekistan). In return, the Kyrgyz Republic should be compensated with fossil fuels to meet winter demand for electricity and heat. The effectiveness of this agreement has been undermined by the down-stream countries' varying water requirements, depending on weather conditions, and the Kyrgyz Republic's requirement to release water during winter to meet its peak electricity demand, causing flooding in down-stream countries. In recent years, Uzbekistan has invested in additional storage to re-regulate winter flows and to increase the flow capacity of the river, enabling it to handle higher flows during winter, thus reducing its dependence on water release from the Kyrgyz Republic for irrigation. Reflecting this development, WB with the support of EBRD, other IFIs and the donor community who have initially supported the idea of a new multi-party agreement on water and energy trade, are now encouraging the Kyrgyz Republic to enter a bilateral agreement with Kazakhstan which would be acceptable to both countries. The proposal involves facilitating electricity trade between the Kyrgyz Republic and Russia through Kazakhstan, while reducing the amount of winter release from the Kyrgyz Republic by increasing generation capacity from a new thermal plant.[5]

2.1.3 Labour Issues

The Kyrgyz Republic has a relatively liberal labour code (September 1997, further amended in 1998, 2001, 2002 and 2004) that provides rights for all workers to form and join labour unions. Forced or compulsory labour is illegal and children are protected from economic exploitation and working in a hazardous environment. Monetary costs of dismissal are not high (one month's severance pay), the use of fixed-term contracts is allowed and the notice period required for contract termination is relatively short.[6] There is a minimum wage, but at a very low level KGS 100 (USD 2.4) per month. Unemployment benefits also exist but they are rather low and

[5] The proposal is being considered in the Water-Energy Consortium (WEC) of CACO and also in the Working Group on Energy and Water Resources under the Central Asia Regional Economic Cooperation (CAREC), a regional forum coordinated by the ADB. The members of CAREC are Azerbaijan, China, Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan and Uzbekistan.

[6] Notice periods are two months for employees with open-ended and fixed-term contracts and three days for those on a probationary period or under short-term contracts.

eligibility conditions are restrictive.[7] There are strong restrictions on the use of overtime work (maximum 120 hours per year). The code also provides for maternity leave of one and a half years.

The registered unemployment rate of just 2.9 per cent at end 2003 is considered to be well below the real figure (using ILO definitions).[8] However, it is important to note that the labour market is characterised by a large incidence of informal employment. It was estimated that in 1998 around 45 per cent of the working age population was working in the informal market.[9] Despite some formalisation of labour since 1998, it is likely that the size of the informal market is still significant. Given the significance of informal labour, workers' protection may fall well below standards stipulated by the law.

2.1.4 Social Conditions

Stable economic growth combined with a gradual reduction in inequality have contributed to poverty reduction. The number of people living below the nationally defined poverty line (which is expenditure per capita of KGS 7491 in 2001 prices) has declined from 52 per cent in 2000 to an estimated 40.8 per cent in 2003. Poverty has been declining based on other poverty measurements such as consumption per capita poverty line definition of KGS 6975 in 2001 prices.[10] The "depth" of poverty – the gap between the observed consumption levels of poor households and the poverty line has also declined from 17.7 per cent in 2000 to 9.0 per cent in 2003. According to the most recently available data, income inequality is declining, with the Gini coefficient falling from 0.45 in 2000 to 0.42 in 2002.[11] Life expectancy has increased from 67 years in 1999 to 68 years in 2002. Infant mortality per 1000 births declined from 22.7 to 20.9 and basic school enrolment increased from 90 per cent to 97 per cent during the same period.

The extent of poverty reduction has been more notable in rural areas with the percentage of the rural population living below the poverty line declining from 60 per cent in 1999 to 47 per cent in 2002. However, most of the poor still live in rural areas (70 per cent of the total number of poor) and regional differences remain, with a lack of visible improvement particularly in the Naryn region, the oblast with highest incidence of poverty.

2.1.5 Legal Environment

The Kyrgyz Republic has continued to reform its commercial law framework during the last two years. Of note, in 2003, the Government adopted a new Law on Joint Stock Companies (JSC) (amended most recently in August 2004), the new Law on

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[7] Those who have worked more than ten years receive two and a half times the stipulated minimum level of KGS 250 per month. The eligibility period is six months within a calendar year, but no more than twelve months within three years.

[8] Registered unemployment rate has been constant at around 3 per cent since 1997. However, the unemployment rate under ILO definitions was 8.7 per cent in 2003.

[9] 'Informal market' is defined as including those employees without a written contract, those who are employed outside agriculture, with a total of 1-5 employees including the owner, and those self-employed in agriculture on land plots smaller than 50 per cent of the median.

[10] Using this definition, the nationwide rate of absolute poverty declined from 62.5 per cent in 2000 to 56.4 per cent in 2001.

[11] The Gini index measures inequality over the entire distribution of income or consumption. A value of 0 represents perfect equality, and a value of 1 perfect inequality.

Investments in the Kyrgyz Republic, and the amendments to the Law on Investment Funds. Parliament has been asked to re-review the Pledge Law (the version passed in June was vetoed by President Akaev); if properly implemented it should improve the secured transactions regime. These legislative developments are positive steps in the country's legal transition process, even though there is still room for improvement in order to bring laws in line with international standards, especially in the insolvency and concessions sectors.

A remaining area of concern is the country's ability to develop functioning legal institutions and procedures that can support foreign investment. As in the past, the main issue is the lack of public confidence that contractual rights will be upheld by the courts. There has been very limited progress in this area, and doubts continue to be expressed by investors about the ability of local courts to make sound decisions in a fair and impartial manner. More than ever, the Kyrgyz Republic faces with the challenges of building adequate legal institutions, especially a sound court system, fighting corruption and generally strengthening the rule of law.

2.1.6 Environmental Aspects

The Kyrgyz Republic is endowed with a diverse mountain eco-system as well as rich water resources. The economy is largely agricultural, and thus land productivity is critical for the population's wellbeing, in particular for the rural poor. Insufficient management of land and water resources due to the past heritage of extensive agricultural practice and collective land ownership, as well as poorly maintained irrigation systems, are key environmental issues. Salinisation reportedly affects 11.5 per cent of the country's irrigated area. The most recent analysis carried out by the ADB in 2003 identifies the following environmental priorities: (i) land resources management; (ii) efficiency improvement in hydropower and irrigation for water use; (iii) attention to industrial and urban pollution; (iv) addressing natural disasters; and (v) regional cooperation on energy, water and biodiversity conservation. Managing transboundary water courses is an urgent issue for Kyrgyz Republic, Uzbekistan and Kazakhstan. The Kyrgyz Republic lies at the centre of the Central Asian biodiversity hotspot which is under threat, due largely to deforestation induced by uncontrolled logging, fuel wood collection, fire and conversion to agricultural land.

The Government formulated its environmental policy and supporting legal framework during the 1990s. The National Environmental Action Plan (NEAP) adopted in 1995 remains the prime policy document. A comprehensive framework law requires the adoption of specific regulations for implementation and enforcement. Most of the environmental standards in force are based on those of the former Soviet Union. These are stringent, however, the ability to monitor or inspect emissions, and hence enforce them, is very limited.

The WB has addressed deficiencies in the irrigation systems in its technical cooperation work: Irrigation in Central Asia – Social, Economic and Environmental Issues (2003). The WB and ADB are planning a number of projects in the agricultural and rural water supply sectors and continue to address land and water management issues.

The Bank's approach, given its focus on the private sector, is complementary to that of other organisations. The Bank will continue to monitor and provide training to local banks, to ensure that they are capable of conducting environmental due diligence and thus support environmentally sound development within the SME sector. The Bank will also continue its support and guidance to private sector projects, such as Kumtor/Centerra. With respect to the latter, the Bank is exploring with IFC and Fauna and Flora International, the possibility of further technical assistance on rural development and biodiversity conservation. All projects are subject to the Bank's Environmental Procedures and incorporate, as appropriate, Environmental Action Plans (EAPs), in line with the Bank's mandate to support environmentally sound and sustainable development through its investment projects.

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic Conditions for the Bank's Operations

The macroeconomic environment has been stable during the last two years owing to continued fiscal consolidation and appropriate monetary policy. Nevertheless the country's high indebtedness remains a key concern. In this respect, preserving macroeconomic stability through prudent fiscal and monetary policies is of utmost importance during the strategy period.

Output

In recent years, growth has been more broadly based, but remains concentrated on agriculture, gold mining and electricity production. The economy grew by 6.7 per cent in 2003, up from flat growth in 2002 and 5.3 per cent in 2001, with robust growth continuing in the first half of 2004, which Government figures give as 9.2 per cent. The volatility reflects a decline in production at Kumtor which accounts for 10 per cent of GDP, due to an accident in 2002. In 2003, agriculture, which accounts for over 35 per cent of GDP, grew by an estimated 3.8 per cent, and the industrial sector, excluding Kumtor, by 8.5 per cent. Lower electricity exports were counterbalanced by higher domestic demand. Growth was primarily driven by a strong increase in private consumption and the rebound of exports, while capital investments continued to decline. This raises concerns on growth sustainability in the medium-term. Growth is projected to decelerate slightly to 6 per cent in 2004, although many sectors will remain buoyant due to the positive external environment. Medium-term economic performance will hinge on more broadly based private sector investment, given the limited capacity of the public sector to undertake capital investments. This highlights the importance of improved investment climate.

Monetary policy and the exchange rate

The NBKR has been generally successful in maintaining relative price stability in the past two years. A small rise in CPI inflation (to 5.6 per cent) occurred in 2003 due to supply disruption of wheat and gasoline, however pressure abated and prices remained stable at 3.9 per cent during the first half of 2004. Remonetisation of the economy continued and was helped by improved confidence in the banking system. Broad money grew strongly by 34.5 per cent (in nominal terms) in 2003 accompanied by an increase in broad money to GDP ratio, from 14.6 per cent in 2002 to 17.6 per cent in 2003. The currency appreciated by 8.5 per cent in real terms against the dollar in 2003, on the back of stronger net inflows. Real interest rates measured by treasury bills declined from 5.2 per cent in December 2002 to 1.8 per cent by April 2004, reflecting the easing of monetary conditions. Monetary policy will focus on maintaining inflation within the 4-5 per cent range, primarily through active open market operations to keep the growth of base money under control.

Fiscal policy

The Government remains committed to tight fiscal and monetary policies. Macroeconomic performance is monitored by the IMF under a Poverty Reduction and Growth Facility (PRGF). The main focus is to broaden the tax base, improve tax collection and maintain a tight control over expenditure, while accommodating increases in social spending in line with the poverty reduction strategy. Fiscal deficit (cash basis) narrowed from 9.2 per cent of GDP in 2000 to 5.2 per cent in 2003. This was achieved by reduction of the public investment programme (PIP) by more than 3 percentage points of GDP and a 2.7 percentage point increase in tax revenues. Expenditures on education, health, social security, welfare, and pension funds have increased from 12.2 per cent of GDP in 2000 to 14 per cent in 2003.

In 2003 the law extending value added tax (VAT) to large-scale agricultural producers was adopted against strong opposition from farmers. Historically, the agricultural sector has contributed just 3 per cent of total tax revenues (through land tax). Unfortunately, collection of VAT from the agricultural sector has been difficult to date. A new property tax also experienced implementation difficulties; nonetheless, targets for 2003 under the PRGF have broadly been achieved through improved collection of existing taxes.

The focus of the fiscal programme in 2004 is to further strengthen tax collection including the full implementation of agricultural VAT and the property tax. Fiscal expenditure will be capped except for wage increases for teachers, nurses and doctors. Fiscal deficit is expected to narrow further to 4.3 per cent of GDP.

Balance of payments

The current account deficit narrowed from 6.6 per cent of GDP in 2000 to 2.8 per cent in 2003, due to reduced PIP-related imports and a sharp rise in service revenues from Manas airport and the nearby international military base. Gold exports in US dollar terms have been volatile, due to fluctuations in world prices and output, while exports of electricity to neighbouring countries declined. There have been small net FDI inflows in both 2002 and 2003 and annual medium- and long-term loan disbursements of USD 70-80 million. Overall balance was positive in both 2002 and 2003 and international reserves were boosted by debt rescheduling agreed at the Paris Club in 2002, as well as financing from WB and the ADB. At the end of 2003, gross international reserves reached USD 359 million or, 5.3 months' imports of goods and services.

In 2004, the current account deficit is likely to widen, due to continued strength in domestic demand which will stimulate import demand. The international reserves position will be helped by revenues from the sale of Centerra shares in June (estimated to be around USD 80 million) in addition to the final scheduled exceptional financing related to the Paris Club agreement.

Foreign debt and debt service

The Kyrgyz Republic's foreign debt remains high at around 103 per cent (total public and private) and 94 per cent (public long-term) of GDP at the end of 2003. Most of the external debt is owed to multilateral and bilateral creditors – 60 per cent and 28 per cent, respectively. The Paris Club – an informal group of official creditors whose role is to find co-ordinated and sustainable solutions to the payment difficulties experienced by debtor nations – granted a flow rescheduling of foreign debt in March 2002, easing the debt service burden by USD 111 million (current value terms) between 2002 and 2004, with the possibility of considering stock rescheduling (write-off) in early 2005. Debt service was nearly 25 per cent of exports of goods and services in 2000, which was scheduled to decline to 17 per cent in 2003. Due to rescheduling, debt service paid in 2003 was only 11 per cent of exports of goods and services. Yet, in 2005, without further rescheduling, debt service will increase to 14 per cent. According to the IMF, without a debt write-off by the Paris Club, the Republic's external debt would remain at unsustainable levels beyond 2010.[12] A Paris Club decision will depend on the country's track record under the PRGF arrangement. If stock rescheduling under the Naples terms (write-off of debt owed to bilateral creditors by two-thirds) is provided, the country could achieve debt sustainability by 2010.[13]

2.2.2 Transition Success and Transition Challenges

There has been some progress in transition with several important initiatives.

Recent achievements include adoption of a new anti-corruption law and establishment of a Presidential Council on Good Governance, strengthening of bank supervision, some progress on privatisation – although KT and SeveroElectric remain in state control – efforts to reduce the quasi-fiscal deficit in the power sector, the effective privatisation of KMC and support for the EITI.

However, compared to some other CIS countries, fewer advances have been made in building institutions for a market-based economy.

[12] IMF (May 2003), *Kyrgyz Republic Debt Sustainability Analysis*, IMF mimeo.

[13] Debt is generally regarded as unsustainable if the ratio present value (PV) of debt (total public debt outstanding discounted by 5.7 per cent) to exports is above 150 per cent or PV of debt-to-revenues ratio is above 250 per cent. It should be noted that debt-sustainability estimates are sensitive to applied discount and exchange rates.

Table 2: Transition Indicators of Commonwealth of Independent States (CIS), 2003

Countries	Price liberalisation	Trade & foreign exchange system	Competition policy	Large-scale privatisation	Small-scale privatisation	Governance & enterprise restructuring	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Infrastructure reform
Azerbaijan	4	3.7	2	2	3.7	2.3	2.3	1.7	1.7
Belarus	2.7	2.3	2	1	2.3	1	1.7	2	1.3
Georgia	4.3	4.3	2	3.3	4	2	2.3	1.7	2.3
Kazakhstan	4	3.3	2	3	4	2	3	2.3	2.3
Kyrgyz Republic	***4.3***	***4.3***	***2***	***3***	***4***	***2***	***2.3***	***2***	***1.3***
Moldova	3.7	4.3	2	3	3.3	1.7	2.3	2	2
Russia	4	3.3	2.3	3.3	4	2.3	2	2.7	2.3
Tajikistan	3.7	3.3	1.7	2.3	3.7	1.7	1.7	1	1.3
Turkmenistan	2.7	1	1	1	2	1	1	1	1
Ukraine	4	3	2.3	3	4	2	2.3	2	2
Uzbekistan	2.7	1.7	1.7	2.7	3	1.7	1.7	2	1.7

1 indicates little or no progress. 4.3 indicates standards similar to advanced economies
Source: EBRD Transition Report, 2003

The Kyrgyz Republic has developed a long-term National Poverty Reduction Strategy (NPRS) to implement its Comprehensive Development Framework to 2010 (CDF). NPRS 2003-2005 outlines strategic priorities in order to enhance effectiveness of state administration, improve social equality and ensure sustainable growth through structural reforms.

The key challenge for the country during this Strategy period remains to foster the private sector as an engine for growth and economic diversification. More specifically, challenges for the Strategy period are:

Investment Climate
Key challenges: improve tax administration, adopt concrete measures against corruption, enhance effectiveness of courts and reduce bureaucracy.

Enterprise surveys suggest that the business environment has been improving. According to the EBRD/WB Business Environment and Enterprise Performance Survey (BEEPS), firms perceived the overall business environment to have improved in the period 1999-2002.[14] The National Business Opinion Survey, conducted by the Project Management Agency (PROMA, an EU-funded NGO) also suggests that business confidence improved between August 2002 and June 2003.[15] However, both surveys suggest that tax policy and administration, bureaucratic red tape (permits, licensing, reporting and inspections), and corruption of officials and courts continue to be serious obstacles to business.

On tax administration and policy, according to the BEEPS, companies increasingly hide income from tax inspectors. Businesses also believe state regulation has imposed an increasing burden. According to the PROMA survey, 42 per cent stated that permit requirements increased over the last 12 months. Both the BEEPS and PROMA survey indicate that corruption continues to be a concern. According to

[14] BEEPS data are available on http://info.worldbank.org/governance/beeps/
[15] National Business Opinion Survey results are available on www.ibc.kg

BEEPS, both the level and frequency of bribes increased. Similarly, 55 per cent of respondents to the PROMA survey stated that corruption in Government had increased, 65 per cent stated that courts are corrupt and 61 per cent thought tax inspectors abused their powers.

The authorities have begun to take measures to address these issues. As a first step, they publicly recognised the need to overcome these issues to make the Kyrgyz Republic more attractive to investment. In order to increase transparency and openness in state governance, a decree "Concept of State Policy in Regulation of Business Activities of Entrepreneurial Entities" was adopted on 5 February 2004, that requires Government to engage in 60-day public consultation to receive comments on draft legislation. In January 2004, a task force was appointed to revise the Tax Code, to remove inconsistencies, simplify taxation, and cut tax rates if fiscally justified. The process has so far been transparent, with opportunities for the public and business community to comment.

A Commission on Deregulation was established in September 2003. It has prepared laws on licensing and inspections that aim to establish clear rules for introducing new licensing and set out principles for carrying out business inspections.

Following the passage of an anti-corruption law in March 2003, the President established a Presidential Council on Good Governance in February 2004. The Council should develop concrete measures to improve policy and enhance implementation. In December 2003, the country joined the UN Convention against Corruption and the document was ratified by Parliament in June 2004. Parliament also has adopted a law requiring Government officials to declare their incomes and wealth.

The effectiveness of these measures depends on whether there are accompanying reforms of the judiciary and law enforcement institutions. The Government needs to fully implement its stated policies in all of these areas. Encouragingly, the Corruption Perceptions Index score of the Kyrgyz Republic, published by Transparency International in October (on a scale ranging from 0 to 10, 0 being highly corrupt) improved from 2.1 in 2003 to 2.2 in 2004. Nevertheless, the level of perceived corruption is still high and the country is ranked 122nd among 146 countries along with Kazakhstan.

Enterprise Reform

Key challenges: to promote transparency and corporate governance, attract external sources of funding and implement privatisation plans.

Capital investments declined by more than 10 per cent between 2000 and 2003. This decline is largely attributed to lower investments by the public sector. Yet, capital investments by private enterprises are recovering only slowly. In spite of improvement in the banking sector, credit to the private sector is limited. According to the PROMA survey, only 15 per cent of respondents had received financing from financial institutions in the past 3 years. While this is a reflection of weakness of the financial system it also indicates lack of transparency and governance practices in enterprises.

A new law on joint stock companies, effective from April 2003, strengthened the rights of shareholders. The new law prohibits members of parliament, Government officials and public servants to serve on the board of directors, the executive body or the audit committee of joint-stock companies. Further amendments, in August 2004, should afford better protection to minority shareholders' rights and thereby encourage minority (including foreign) investment.

There are still a number of state-owned enterprises including utilities, agribusiness and mining, as well as numerous state-owned assets in the tourism industry. Following adoption of a new privatisation law in early 2002, renewed efforts have been made to privatise remaining enterprises, particularly in the tourism sector. There also has been a further attempt to sell KT. In September 2004, the State Property Agency signed a contract to sell 51 per cent of KT to a consortium of German investors, AREXTECH/Detecom. Approval from the Government could occur by the end of 2004. Finally, the authorities are attempting to introduce private concessions in the electricity distribution sector (see Infrastructure Reforms below).

In the mining sector, privatisation of state-owned companies such as KA has not been considered. However, important steps were taken: by converting KA's 66 per cent stake in KMC into a stake in Centerra, a newly created holding company listed on the Toronto Stock Exchange, the Government has effectively privatised KMC which accounts for around 10 per cent of GDP. The authorities agreed to implement EITI and to undertake risk assurance and control audit of KA, which should help the company to attract financing for future investments.

Small and Medium Sized Enterprises Development

Key challenges: improve investment climate and remove obstacles to investment.

SMEs are estimated to employ around 60 per cent of the population and produce over 40 per cent of GDP.[16] The number of registered SMEs fell from 8,734 enterprises in 2001 to 7,759 in 2002, indicating problems for SMEs moving into the formal sector, even though anecdotal evidence indicates strong SME growth. The PROMA survey indicates that SMEs continue to face more difficulties than larger enterprises. Issues of particular concern were (i) availability of financing and (ii) reduction of number of permits and inspections. Ongoing Government efforts should take these concerns into account and also should address the areas of tax and tax administration.

Financial Sector Reform

Key challenges: further enhance supervisory capacity and develop legal framework.

The banking sector was seriously impacted by the Russia crisis and devaluation of local currency in 1999. Banks' capital base has been eroded, non-performing loans increased, licenses were revoked and liquidation procedures were initiated for a number of banks. In the past two years, the health of the system has been recovering

[16] In the Kyrgyz Republic, SME definition differs by sector. In agriculture, industry and construction sectors, small enterprises are defined as those with up to 50 employees and turn-over of up to KGS 500,000 (USD 12,500) and medium enterprises as those with 51-200 employees and turn-over of KGS 500,000-2,000,000 (USD 12,500-50,000). In the services sector, small enterprises are defined as those with up to 15 employees and turn-over of up to KGS 500,000 (USD 12,500) and medium enterprises as those with 16-50 employees and turn-over of KGS 500,000-2,000,000 (USD 12,500-50,000).

and domestic credit grew strongly by 27 per cent in 2003. The sector also attracted direct investments from Kazakh banks – Kazcommerts Bank, Temir Bank and Halyk Bank, which recently won a tender for privatisation of state-owned Kairat Bank. However, the sector remains characterised by a low level of financial intermediation, weak capital base, a high level of non-performing loans and high real interest rates.

Table 3: Banking sector indicators in selected CIS, end-2002

	Armenia	Azerbaijan	Georgia	Kazakhstan	***Kyrgyz Republic***	Moldova	Russia	Tajikistan	Turkmenistan
Number of banks 1/	20 (8)	46 (4)	25 (5)	38 (n.a.)	**20 (6)**	16 (10)	1,329 (37)	17 (2)	13 (4)
Non-performing loans 2/	4.9	19.7	7.9	n.a.	**13.3**	7.6	11.4	n.a.	0.3
Domestic credit to the private sector 3/	4.8	n.a.	7.7	18.6	**4.2**	18.7	17.3	11.5	2.2

Sources: EBRD *Transition Report 2003* and IMF, *International Financial Statistics*.
1/ Brackets refer to the number of foreign owned banks
2/ In per cent of total loans
3/ In per cent of GDP

The supervisory powers of the NBKR have improved under the amended Law on Banks and Banking Activity, which came into effect in March 2003. The NBKR is now the sole institution authorised to issue and revoke licences and is solely responsible for bank supervision (authorised to take preventative actions). Minimum capital was increased to KGS 30 million (USD 750,000) in July 2003 and should be further increased to KGS 60 million (USD 1.5 million) by 2006. Banks are required to produce audited financial statements in accordance with international accounting standards and the NBKR is taking a greater role in supervising the quality of bank audits.

Worryingly, in mid-2004, Parliament passed a bill which, if signed into law, would remove NBKR's authority to establish minimum capital requirements for existing banks. Such political interference risks undermining the health of the overall system.

Despite further work by Parliament on the Pledge Law, the version approved (and subsequently vetoed by the President) did not allow for streamlined registration or out-of-court settlement between borrowers and banks. Lowering legal risks should lead to a reduction in the relatively high interest charged on commercial loans[17] and to more rapid development of leasing and mortgage loans (as has been the case in neighbouring countries).

Infrastructure Reform

Key challenges: improve tariff structure and regulation, especially in the power sector, to attract private investments while addressing affordability constraints

Infrastructure is characterised by a generally low quality of services and inefficiency, requiring extensive investment. In the past two years, the public sector has been unable to undertake upgrades and maintenance due to fiscal constraints.[18]

[17] At end 2003, the average interest rate on local currency loans weighted by maturity was 25 per cent, over 18 per cent in real terms.
[18] It should be noted that a substantial part of the external debt of the Republic is connected to infrastructure investments.

Implementation of reforms to enable infrastructure service companies to recover both operating and investment costs have been slow in most sectors. The exception was the telecommunications sector, which was liberalised in 2003 (see Table 4). The country needs to advance commercialisation of infrastructure services while simultaneously addressing the requirements of the poorest segment of the population.

*Table 4: EBRD index of infrastructure reforms 2003 and key infrastructure indicators in selected CIS*1/

	Armenia	Azerbaijan	Georgia	Kazakhstan	***Kyrgyz Republic***	Moldova	Russia	Tajikistan	Turkmenistan	Uzbekistan
POWER & ENERGY										
Electric power (EBRD index)	3.3	2.3	3.0	3.0	**2.3**	3.0	3.0	1.0	1.0	2.0
Electricity tariffs 2/	4.5 (98)	2.3 (45)	6.5 (90)	2.7 (92)	**1.32 (41)**	5.6 (91)	2.4 (102)	1.7 (65)	0.5 (63)	1.4 (72)
GDP per unit of energy use 3/	3.3	1.7	4.2	1.7	**3.2**	1.7	1.6	1.7	1.3	0.7
RAILWAYS										
Railways (EBRD index)_	2.0	2.3	3.0	2.7	**1.0**	2.0	2.3	1.0	1.0	3.0
Railway labour productivity 4/	20.6	29.4	71.9	51.0	**16.2**	27.5	90.1	50.3	32.7	51.1
ROADS										
Roads (EBRD index)	2.3	2.3	2.0	2.0	**1.0**	2.0	2.3	1.0	1.0	1.0
Paved roads 5/	96.2	92.3	93.4	89.7	**91.1**	87.0	67.4	.n.a.	81.2	87.3
TELECOMMUNICATIONS										
Telecommunications (EBRD index)	2.3	1.0	2.3	2.3	**2.7**	2.3	3.0	2.3	1.0	2.0
Fixed-line (mobile) penetration rate 6/	14.0 (1.2)	12.1 (10.7)	13.1 (10.2)	12.1 (3.6)	**7.8 (1.0)**	14.6 (5.1)	24.2 (12.1)	3.7 (0.2)	8.0 (0.2)	6.7 (0.7)
Internet penetration rate 7/	9.4	1.4	5.7	11.5	**12.3**	4.9	28.4	0.5	3.5	0.1
WATER & WASTE WATER										
Water and waste water (EBRD index)	2.0	2.0	2.0	1.7	**1.0**	2.0	2.3	1.7	1.0	1.7
Access to safe water by urban population 8/	n.a.	93 (58)	90 (61)	98 (82)	**98 (66)**	97 (88)	100 (96)	93 (47)	n.a.	94 (79)

Source: *EBRD Transition Report 2003* and World Bank, *World Development Indicators.*
1/ All indices are assessment as of mid-2003 and all indicators refer to 2002 unless otherwise stated
2/ US cents per kilowatt hour; collection rate in per cent in bracket
3/ PPP in US dollars per kgoe; 2001 estimate
4/ 1996=100
5/ As per cent of total roads; 1999
6/ Per 100 inhabitants
7/ Per 10,000 inhabitants
8/ Per cent of population; access to safe water by rural population in brackets; 2000

Power generation and distribution were restructured in 2001 by unbundling the vertically integrated state-owned monopoly, KyrgyzEnergo, into seven companies: two generation companies; one transmission company; and four distribution companies. The restructuring has not led to improved performance of the new entities. According to a study by the UK Government's Department for International Development (DFID), the sector is still characterised by high technical and commercial losses. Of the total domestically generated and imported electricity, 25 per cent is lost through obsolete equipment in transmission and distribution (technical losses) and 29 per cent through under-billing (due to insufficient metering) and poor collection (commercial losses).[19] This is extremely high given that total technical

[19] DFID, *Discussion Note 40, Non-Technical Losses in the Electricity Sector,* July 2003. The note can

losses in a well maintained system would be around 10 per cent and "acceptable" commercial losses would be around 2-3 per cent.

In order to address this problem, aggregate quantitative targets for reducing the so-called "quasi-fiscal deficit" (QFD) were established under the PRGF.[20] The QFD target for 2004 is 9.4 per cent of GDP (or, KGS 8.65 billion).[21] At sector level, the WB is advocating further increases in the average electricity tariff to reach 2.3 US cents per kilowatt hour by 2006 under the Consolidation Structural Adjustment Credit (CSAC) programme in order to provide better incentives for consumers to use energy efficiently while improving electricity companies' revenues.

The authorities are also being encouraged to consider a concession contract for electricity distribution at Severelectro, the distribution company covering Bishkek. The concession should be awarded via open international tender supported by financing from IFIs (EBRD, IDA and IFC) and bilateral donors. Part of the donor funding will be used to compensate socially vulnerable groups.[22] Meanwhile further reforms would grant the regulator, the State Energy Agency, greater independence and ensure adoption of internationally accepted tariff formulae.

The municipal water and waste water sector is also characterised by inadequate billing and collection combined with obsolete infrastructure. Due to lack of adequate funding, maintenance of the network has been delayed, leading to excess water losses. Improved metering and collection and elimination of cross-subsidies could improve the municipal water companies' finances. The current "cost-plus" tariff method could be supplemented by a "price-cap" methodology to provide incentives to water companies to improve efficiency.

2.3 Access to Capital and Investment Requirements

Access to medium- to 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 5.8 per cent at the end of 2003, reflecting increasing confidence, but are still too low to support an expanding private sector. Total loans by commercial banks reached just 3.4 per cent of GDP, of which just over 20 per cent were over 1 year maturity. Interest rates on loans have gradually been declining but the average interest rate weighted by loan maturity was still relatively high.

FDI net flows are now positive, after the country experienced net outflows in 2001. This is largely owing to increased investments by enterprises from neighbouring

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be accessed at www.kyrgyztariff.org

[20] As unbundled electricity companies are state-owned, these losses can be considered as indirect ways of providing state subsidy or the Government accruing lost revenues hence, the term "quasi-fiscal deficit".

[21] The QFD is defined as cost of production (at marginal cost equating to 2.3 US cents per kilowatt hour) minus cash revenues. QFD was reduced from 12 per cent of GDP in 2002 to 11 per cent of GDP largely because of appreciation of the som against the US dollar.

[22] Households in the lowest income decile spent 5 per cent of their income on electricity bills in 2003. The affordability threshold of electricity consumption is generally regarded as 10 per cent of income. If residential tariffs were to be increased to 2.3 US cents by 2006, it is estimated that the lowest income decile would spend around 6 per cent of its income on electricity bills.

countries. However, at just 1 per cent of GDP (in net terms) in 2003, FDI is not a significant source of financing. A top Government priority is to promote investment, particularly by addressing investment obstacles.

3. Strategic Orientations

3.1 The Bank's Priorities for the Strategy Period

In view of the transition challenges and macroeconomic environment, the Bank is well-placed to support the Kyrgyz Republic in its transition; in particular to support a reinvigorated private sector. The Bank will continue its efforts to improve the investment climate. This can be achieved through the Bank's active dialogue with the Government (for example, in the Presidential Consultative Council on Foreign Investment). Also, the Bank can utilise targeted TC to address specific investment obstacles and concerns, including privatisation implementation, tariff reform, legislative reform (such as JSC Law or Pledge Law) and institution building (such as Credit Bureau and Deposit Insurance).

The Bank's main priorities are (i) to foster private sector enterprise (including agriculture, tourism and natural resources); (ii) to support further consolidation and strengthening of the financial sector; (iii) to support infrastructure where possible, in light of sovereign debt constraints, by utilising innovative funding mechanisms. The ETC Initiative – including access to TC resources and grant funds – will be vital across all core activities, to enable the Bank to increase its pipeline of loans and investments.

3.1.1 Fostering the Private Sector

The development of private businesses remains the main pillar of the Bank's Strategy. The Bank will explore possibilities of direct financing in a number of key sectors, including natural resources, agribusiness, textiles, property and services. The Bank will seek to attract regional and international investors, from Russia, Kazakhstan, China and Turkey, amongst others.

Newly introduced tools within the ETC Initiative, including the Medium-Sized Co-Financing Facility and Direct Lending Facility (DLF), TC for due diligence and post-investment support, as well as a team dedicated to the ETC Initiative, will enhance opportunities to develop local and smaller projects. Smaller equity investments will still be targeted within DIF, noting the need for further improvements in both the Joint Stock Company Law and court system.

The Bank will continue to focus on micro and small businesses, by further developing the MSE Finance Facility through local banks, both in terms of geographical outreach and financial sector deepening. To this end it is planned to implement MSEFF II, which will provide additional loan funds and TC funds to the partner institutions with a special focus on the rural and agriculture sector. The Bank also will promote enterprises engaged in foreign trade by expanding TFP.

3.1.2 Strengthening the Financial Sector

Although improving, the banking sector still has a limited impact on the economy. The Bank will continue to facilitate the entry of new investors who can support increased capitalisation and quality of bank management. The Bank will consider equity participation in additional Kyrgyz banks, both with foreign and domestic partners, and is likely to promote consolidation of the sector over the coming period. The Bank will seek to strengthen the banking sector through TC, including seminars on banking supervision, advice on sound deposit insurance and development of an effective credit bureau.

Those local banks chosen as partner institutions under the MSE and TFP facilities will also benefit from substantial TC to improve credit and financial management skills. Special focus will be given to strengthening and developing the branch network in order to foster financial intermediation in the regions.

Expansion of the Bank's activities is constrained by the size and strength of partner banks. The Bank will therefore continue to benefit from co-financing and risk mitigation facilities to increase its activities in the financial sector. The ETC Initiative will also allow the Bank to leverage its resources, for example, the Medium-sized Co-Financing Facility (MCFF) will allow the Bank to support its most experienced partner banks to meet the financing requirements of their relatively larger clients. Once the Bank is satisfied with its partner banks' credit policies and procedures, the MCFF will allow the Bank to take up to 50 per cent of the risk of larger client exposures.

3.1.3 Support for Critical Infrastructure

The investment needs in infrastructure are considerable, but constrained by limited public resources and limits on sovereign borrowing. Given the Bank's inability to provide concessional loans, the Bank will consider financing non-sovereign infrastructure that produces cash flows to meet debt repayments without recourse to sovereign guarantees. In the energy and municipal infrastructure sectors, the Bank will seek to blend its loans with grants, to achieve more concessional terms, taking into account user affordability. The Bank will coordinate closely with other donors, IFIs and the Kyrgyz Government on the overall investment priorities of the country in the context of the National Poverty Reduction Strategy (NPRS).

The Bank will seek opportunities to support privatisation of key infrastructure. For example, having provided TC to the telecoms regulator over the past few years, the Bank would seek to finance KT's investment needs, should ongoing contract negotiations result in a successful sale to a qualified investor. The Bank is working with other IFIs on potential concession projects, most notably SeveroElectric.

3.1.4 Policy Dialogue

During the Strategy period, the Bank will strengthen its policy dialogue with the authorities in order to improve the investment climate and support reform efforts. The Bank continues to coordinate closely with other IFIs and the business community, including partcipation in the International Business Council.

As noted above, the Bank will seek co-financing opportunities with other IFIs and bilateral institutions to mobilise greater resources, especially projects that could enhance regional cooperation. 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

The past two years have seen an upsurge in commercial activity, including in manufacturing, processing and services. Most investments, however, continue to be small (limiting the Bank's ability to make a meaningful impact through traditional operations) making the ETC Initiative all the more important. The Bank continues to play a significant role in policy issues. For example, the Bank helped form and continues to participate in the International Business Council (IBC) and also participates actively in President Akaev's coordinating council on investment. In the Strategy period, the Bank will:

- Promote key items in the Government's Investment Matrix to develop the investment climate, including reduction of bureaucracy, simplified taxes and tax administration, and key legal reforms.
- Speak out for adoption of strong governance standards by Government and investors. For example, the Bank helped convince the IBC to amend its charter to promote international covenants on best corporate governance practices.
- Seek successful investments with foreign and Kyrygz partners. To this end, the Bank will increase marketing to Russian, Kazakh, Chinese and Turkish investors who are likely to increase their activities in the Kyrgyz Republic. It is probable that many of these companies will be first-time borrowers from an international institution; therefore, the Bank will need to demonstrate sufficient flexibility and also will hope to apply TC resources to streamline due diligence, particularly as it relates to Kyrgyz companies.
- Implement the ETC Initiative for smaller companies. The Bank will roll out its TAM programme more effectively and will introduce the BAS programme after its successful implementation in Kazakhstan and Uzbekistan.
- Expand the Micro Finance Facility. The MSEFF is successfully providing more than 1,000 loans per month (valued at more than USD 1 million). The Bank will further develop the MSEFF with new partners (including new banks and non-bank lending institutions). Rural areas and the agriculture sector will be given special attention in the future development of the MSEFF.
- New projects, such as the Co-Financing Facility and the Direct Lending Facility could help to reach partner banks' relatively larger clients. Implementation requires significant cooperation wihtin the Bank and also TC to make Bank financing more viable for smaller projects.
- Finally, the Bank hopes to reinvigorate its DIF activities. Experience with DIF projects has demonstrated that investments can be successful, but depend on the quality of the Bank's partners. The ETC Initiative should allow the Bank to access TC for management and monitoring of these small investments which is vital to successful development of the DIF portfolio.

3.2.2 Telecoms

Progress has been made on regulatory and legal reform. The sector is fully liberalised in accordance with the Republic's commitment to WTO and competition exists in the mobile, internet, paging and related segments. The Bank has exposure to KT through a USD 9.4 million 15-year sovereign guaranteed loan (November

1994). KT has been converted to an open joint stock company and partially privatised (through the voucher privatisation programme). The Bank continues to support Government efforts to privatise KT and is hopeful that negotiations with a strategic investor can be completed not later than 2005.

- The Bank is prepared to work with potential investors once the sale is completed and, if not successful, the Bank would expect to continue working with the Government to improve KT's operating performance, including, potentially, by supporting a tender for a private management contract.
- In addition, the Bank continues to seek opportunities to support alternative private sector operators. For example, there is growing interest in the Kyrgyz mobile sector from Russian and Kazakh operators.
- The Bank will continue to provide targeted TC including by supporting universal access initiatives for poorer members of society. The Bank is prepared to support commercial mechanisms to bring information technology to the broader population.

3.2.3 Agribusiness

Agribusiness forms the backbone of the local economy and is the main source of employment and growth. Improvements in the business climate for this sector in recent years should help the Bank identify viable investment opportunities, either directly for large enterprises or, through financial intermediaries, for SMEs.

- The Bank recently commissioned a study to help identify agribusiness opportunities and held a workshop for these identified investee companies. Since most projects are small, they are likely to be financed under ETC Initiative products such as DIF, DLF and MCFF.
- Increased interest from agribusiness companies in the CIS also may provide opportunities for financing. Such CIS connections would enhance Kyrgyz agribusiness companies's access to regional markets.
- The MSEFF plans to develop specialised loan products and support banks in acquiring the necessary know-how and capacity to provide finance to SMEs in the agriculture sector.

3.2.4 Property and Tourism

The property and tourism sector shows increasing vibrancy, largely due to increasing investment in Bishkek and Issyk Kul by Kazakh investors. Again, many projects remain small and should be channelled through KICB or benefit from the new Co Financing Facility or even the MSEFF.

The Bank also will seek larger projects suitable for direct financing. There is increasing interest in both retail housing development and in commercial offices and markets. The Bank will seek to build upon experience gained in the successful Ala Archa DIF investment as well as the Hyatt Hotel financing.

3.2.5 Financial Institutions

The Bank's key goal is to increase financing for the private sector via banks, while also strengthening and improving the institutions themselves and the financial sector more generally. Thus, the Bank will seek opportunities to facilitate the entry of new investors or to encourage consolidation of smaller institutions. The Bank will also work with existing clients to provide new products and increase limits available under existing programmes, such as MSEFF and TFP. As noted elsewhere, in the 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 Co-Financing Facility will allow the Bank to support its Kyrgyz partner banks to meet the needs of their relatively larger clients. Going forward, key initiatives include:

- To consider equity investments, where the Bank's role can improve corporate practices. Investments could be alongside foreign investors – Russian, Kazakh or Chinese are the most likely – or from amongst existing banks/shareholders. The Bank should encourage further consolidation amongst Kyrgyz banks. Significant TC may be required to enhance quality within Kyrgyz banks.
- To support financial institutions which have been or will be privatised (such as Kairat, Settlement and Clearing Company, Kyrgyz Agricultural Finance Corporation). Again, TC requirements will be assessed and provided.
- To introduce new products, such as mortgage finance and leasing. The Bank could provide targeted TC for the legal and institutional development of these non-bank financial institutions.
- To consider targeted assistance, at the request of the local authorities, to strengthen the legal framework (including improvement of the Pledge Law), to streamline collateral procedures, to underpin development of a Credit Bureau and to support implementation of Deposit Insurance scheme.

3.2.6 Infrastructure

The Bank will focus on municipal and regional infrastructure, power and telecommunications (noted above). Given the importance of trade to the Kyrgyz Republic's development, the Bank also will seek opportunities to support regional transit initiatives, through provision of policy support at least, if not with financing.

Kyrgyz infrastructure has deteriorated due to lack of investment, including in city transport, waste and water and district heating. At the same time, municipal entities are either legally or institutionally restrictred from assuming direct loans. Therefore, the Bank will remain engaged in areas where it has particular expertise, including:

- Policy dialogue with the Government and other IFIs and donors to improve the concessions law. Should the concessions law proceed, the Bank would implement concession financing for SeveroElectric, modelled on the recent Pamir concession project in Tajikistan. Besides financing, the Bank expects to provide TC to review tariff setting mechanism and also the social consequences of tariff reforms.
- SeveroElectric Concession could provide the first opportunity (in the Kyrgyz Republic) to blend EBRD finance with donor grants (as proposed within the ETC Initiative). Other potential projects requiring a blending of donor grants to

support EBRD finance could take place in the municipal water or waste sector (in Bishkek or Osh) or in high priority regional transport links.

- Seek opportunities to support development of renewable energy, in particular to consider energy efficiency projects. This could entail financing via the banking system or special purpose institutions, supported by appropriate training and TC.

3.2.7 Natural Resources

With Kumtor Mining Company's incorporation into Centerra, the company's shareholders committed to stay in the Kyrgyz Republic for the foreseeable future. In fact, exploratory investment at the Kumtor mine will be higher this year and next than in any previous years.

The Bank's continuing involvement – now as a minority shareholder – allows the Bank to continue to monitor and also highlight Kumtor's high corporate standards and retain a policy dialogue with the Government. Moreover, the Bank can seek associated investments and TCs. Presently, the Bank is initiating two TC projects – the first builds upon Kumtor's environmental initiatives in the surrounding region and the other would review commercial upstream and downstream business linkages. Both TCs should help increase public awareness of the positive impact of the Kumtor investment in KR.

Via its involvement in the Kumtor project, the Bank indirectly impacted for the better development of KA (the Kyrgyz shareholder) and helped ensure Government commitment to EITI. Most recently, the Kyrgyz Government and KA have requested Bank consideration of various financing requirements – both short- and long-term. These financings can provide the Bank with an opportunity to support commercialisation, and even eventual privatisation, of Kyrgyz Altyn.

Meanwhile, the Bank continues to consider other, larger gold deposits in the Kyrgyz Republic, in the expectation of working with high-quality natural resource sector partners.

4. IFIs and Multilateral Donors

4.1 IMF

The Executive Board of the IMF completed its fifth review of the Kyrgyz Republic's arrangements under the three-year Poverty Reduction and Growth Facility (PRGF) and approved the three-year programme in June 2004. The total disbursements under the PRGF amounted to SDR 54.28 million (about USD 81 million). The PRGF was approved in December 2001 with a total access equivalent to SDR 73.4 million (about USD 110 million).

4.2 World Bank and MIGA

To date, WB 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. Ongoing 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 Modernization; Urban Transport; Power and District Heating; Rural Water Supply and Sanitation.

MIGA provided a USD 5 million guarantee and a USD 5.3 million loan to support the start-up and operation of a new airline, Kyrgyz Air. MIGA also provided a guarantee of USD 885,000 for Manas Cargo Management.

4.3 IFC

IFC's portfolio reached USD 48 million at end 2001, but had fallen to USD 17 million at end 2003. The largest investment is Kumtor, with additional investments in a packaging plant and the financial sector. In 2002, through the Small Enterprise Fund (SEF) programme, IFC made an investment of USD 1.4 million in a pasta plant. In the framework of the EBRD-IFC SME Central Asia Cooperation Fund, in 2003, IFC signed agreements with AKB "Kyrgyzstan" and in 2004 with Ineximbank under the EBRD-sponsored MSEFF.

4.4 ADB

ADB's Country Strategy (CSP) for 2004-2006 was approved on 25 November 2003. The focus is on poverty reduction through private sector-led economic growth and selective support for human development. Given constraints on external borrowing, the CSP envisages annual lending of USD 30 million. To date, ADB has approved 22 loans, all on concessional terms, totalling USD 553 million, of which 12 loans with a net approved loan amount of USD 273.5 million are ongoing.

4.5 IDB

The Kyrgyz Republic became a member in 1993. IDB has approved financing of USD 63.5 million for 14 projects, including six concessional loans, two instalment sale operations, and six technical assistance grants. IDB co-financed the Bishkek-Osh Road project with ADB; a 220-kV transmission line and Osh airport projects with the Kuwait Fund for Arab Economic Development. The Kyrgyz Republic joined the Islamic Corporation for Development of Private Sector (private arm of the Bank) in 2002, and ICD is developing private sector projects.

4.6 UNDP

UNDP has been implementing the Second Country Cooperation Framework (CCF) 2000-2004, which focuses on democratic governance, poverty reduction, conflict prevention, environment protection, HIV/AIDS prevention and cross-border cooperation. In 2003 UNDP provided USD 4 million in technical assistance. UNDP is finalising its Country Programme 2005-2010.

4.7 EU

The European Commission has approved the Central Asia Action Programme 2004. The main focus is regional cooperation on border management, international drug smuggling, transport, energy and environment. The regional budget is EUR 14 million. At the national level, the EU approved EUR 3.2 million for projects in the fields of trade, statistics, customs, good governance and higher education. The EU approved another EUR 10 million to continue poverty alleviation programmes in the Ferghana valley (including Uzbekistan and Tajikistan).

III. ANNEXES

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Annex 1 Political Assessment

In the two years since the adoption of the last country strategy, the Kyrgyz Republic has continued to make progress towards implementation of the principles of multi-party democracy, pluralism and market economy as envisaged in Article 1 of the Agreement Establishing the Bank. The Government has carried out wide-ranging market and democratic reforms, although some intended reforms were not fully implemented.

The country's current political agenda is mainly driven by parliamentary and presidential elections which are due to take place in 2005. A key issue is the succession to President Askar Akayev, who has been President since the country's independence, as the Constitution limits the President's terms in office to two.

The Government's human rights record has worsened in the area of freedom of the media, although an independent printing house was allowed to begin operations. Albeit subject to Government pressure at times, civil society and the political opposition are generally able to voice their concerns about Government policy.

Past and Forthcoming Elections
The Kyrgyz Republic has many political parties, including genuine opposition parties, a relatively strong and active civil society and, notwithstanding challenges and setbacks in democratic transition, continues to feature well in the regional context.

The country's first post-Soviet Constitution was adopted in 1993, providing the legal foundation for developing checks and balances among the executive, legislative and judicial branches of power. The presidency continues to be a dominant branch of power, although Parliament has become more independent and both are facing increasing public scrutiny. In accordance with the Constitution, the judiciary is formally independent but, in practice, is subject to pressure from the executive.

Four constitutional referenda have been called since the adoption of the Constitution, introducing numerous amendments to the country's basic law. The latest constitutional referendum was held in February 2003, as a result of a constitutional process initiated in summer 2002 and aimed at reducing heightened political tensions in society. These were caused by the Aksy events of March 2002 (which involved the shooting of peaceful demonstrators in the south and subsequent massive demonstrations across the country).

President Akayev was first elected unopposed in 1991. He was then re-elected in 1995 and in 2000. His current term in office expires in 2005. According to the Constitution, President Akayev is not allowed to run for a third successive term in office. Unless the Constitution is amended to allow him to run again, President Akayev is due to step down at the end of his current term, thus setting a precedent for a first peaceful transfer of power in the region. Undoubtedly, presidential succession is a key political issue affecting the domestic political agenda in the country in 2004 and 2005. A law on Immunity of Presidents was passed in 2003 establishing extensive guarantees of legal immunity and financial privileges to Presidents and former Presidents.

Prior to the presidential elecions, there will be parliamentary elections in February 2005. Jogorku Kenesh, the country's two-chamber parliament, was last elected for five years in 2000. The OSCE/ODIHR monitored the election and concluded that it did not comply with OSCE commitments. According to the organisation, these elections were characterised by a series of negative trends that ultimately prevented a number of political parties and candidates from competing in the election on a fair and equal basis.

The final OSCE/ODIHR report on the parliamentary elections noted a bias in state media in favour of pro-Government parties, cases of interference in the electoral process by state officials and lack of independence of the courts, resulting in a selective use of legal sanctions against candidates. In accordance with the amendments introduced by the constitutional referendum of 2003, the forthcoming parliamentary elections will change the structure of the parliament by creating a one-chamber legislature with a reduced number of deputies.

In view of the criticisms of previous elections, the upcoming local, parliamentary and presidential elections in 2004 and 2005 offer a crucial opportunity for the Kyrgyz Republic to prove its democratic credentials by conducting free and fair elections, with good voter participation, a choice of candidates and media that is free to report on the conduct and outcome of the voting.

In preparation for the series of forthcoming elections, the OSCE/ODIHR has been actively involved in advising the Government on amendments to the electoral code and related legislation. Political parties increased their activities in anticipation of the imminent local and parliamentary elections, petitioning the presidency to reintroduce the partial proportional voting system that was abolished by the 2003 constitutional referendum.

Human Rights Conditions and the Rule of Law
The Government's overall human rights record remains poor, although there were improvements in some areas. Attempts to suppress media freedoms in 2002 and 2003 raised concerns. In addition to the closure of some opposition newspapers, there were reports of physical attacks on journalists and members of their families. Human Rights Watch has documented human rights violations, particularly in the areas of political participation, freedom of assembly and freedom of expression.

However, the Government softened its control over printed media in 2004 by allowing the establishment of an independent printing house, effectively breaking the monopoly of the state-controlled Uchkun publishing house. The Kyrgyz Republic mass media benefits from unhindered access to the Internet. Government institutions, opposition groups and media outlets have their websites and have established greater Internet access for the general public.

In June 2004 parliament rejected a proposal from the Kyrgyz President aimed at easing the Republic's libel laws. Parliament voted to keep criminal liability for the offence of libel punishable by up to three years in prison. The rejected draft law envisaged the removal from the Criminal Code of the provisions stipulating criminal responsibility for slander and insults to a person's honour and dignity expressed in public statements or the media.

Some progress has been made in further reducing the scope of application of the death penalty. A moratorium on the death penalty, in place since 1998, has been extended until the end of 2004 by a presidential decree.

In the area of labour rights, the Constitution and the laws provide for the rights of workers to form trade unions and to organise and bargain collectively. The law prohibits forced labour, including by children. However, there have been reports of practices involving child labour during the last two years. According to the reports from various NGOs, child labour was particularly evident in the southern agricultural regions of the country during the cotton-picking season. The Government of the Kyrgyz Republic is bound by international commitments under the ratified core ILO conventions and the ILO Convention 182 on the worst forms of child labour.

With regard to human trafficking, the 2004 US State Department Report on Trafficking in Persons 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 significant efforts to bring itself into compliance. The report refers to improved law enforcement efforts and continued work with NGOs and international organisations. At the same time it encourages the Government to make further progress in addressing official corruption, protecting victims by referring them to shelter and instituting witness protection programmes.

Corruption is widespread and remains a serious problem. The existing levels of corruption in the country threaten stability in society, negatively affect the investment climate and undermine the confidence of the international community. The authorities recognize the importance of fighting corruption and have established various committees for devising anti-corruption programmes based on international experience. A real problem is implementation of the adopted recommendations, laws and regulations in practice.

External Relations

The land-locked Kyrgyz Republic is keen to develop relations with all its neighbours and to actively promote regional cooperation. A multi-dimensional foreign policy has led to good relations with the large powers such as Russia, China and the United States. In conformity with this orientation, the country is the only one in the region which was able to allow both US (a coalition military base at Manas airport) and Russian (a permanent military base in Kant) military presence on its territory.

A member of the CIS, and a party to its Collective Security Treaty, the Kyrgyz Republic is an active member of various regional security and economic organisations, ranging from the Shanghai Cooperation Organisation, also including Russia, China, Kazakhstan, Uzbekistan and Tajikistan, to regional economic groupings such as the Central Asian Cooperation Organisation and the Eurasian Economic Community. If the security element of the regional organisations appears to be working, the multilateral economic structures have yet to prove their effectiveness.

On the bilateral level, the country maintains strong economic ties with Russia and other CIS countries. There was a visible rapprochement in relations with Kazakhstan reflected in the improved conditions for transit of Kyrgyz goods via Kazakh territory and an increased flow of Kazakh investment into the country. Relations with the other large immediate neighbour, Uzbekistan, remain difficult over the issue of border demarcation and border crossing, which significantly reduce cross-border economic activities. 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 September 2004)

Investment	Signing Date	Total project cost € million	EBRD finance € million	Stage
Kyrgyz Telecommunications	16/11/94	40.4	7.6	Repaying
Kyrgyzstan Credit Line	16/02/95	8.5	8.5	Repaying
Kumtor	04/05/95	501.0	32	Completed
Transmission Network Improvement Project	22/05/95	30	30	Repaying
Kyrgyz Agribusiness Company	29/08/95	15.9	5.9	Completed
Kyrgyz Agribusiness Company : Divestment	17/10/95	0.7	0.7	Completed
Demirbank Kyrgyzstan (portage equity)	07/11/96	2.6	0.5	Disbursing
Joint Venture Italkyr CJSC	27/11/97	18.9	6.4	Repaying
Talas Transmission Network Improvement Project	18/12/97	19.9	18.8	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	Disbursing
KAC Revised Investment	04/06/99	4.8	4.8	Repaying
KAC Revised Investment	20/07/00	0.6	0.6	Repaying
Regional TFP: Ineximbank (formerly Eridan Bank)	18/12/00	0.3	0.3	Signed
Kyrgyz Investment and Credit Bank (KICB) (debt & equity)	04/05/01	6.4	1.6	Disbursing
DIF - BDC-Vytas	11/05/01	1.3	0.7	Disbursing
DIF - Kalipso	19/05/01	1.1	0.6	Disbursing
DIF - Issyk-Ata Hydro Power Station Rehabilitation	30/05/01	0.8	0.4	Disbursing
Regional TFP: Kyrgyz Investment and Commercial Bank (KICB)	08/06/01	0.8	0.8	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	2.6	1.0	Disbursing
Kyrgyz Republic - Inexim Bank - equity participation	31/10/03	3.1	1.1	Disbursing
Kyrgyz MSEFF - Inexim Bank, Tranche 2	25/03/04	2.4	1.1	Disbursing
Centerra	30/05/04	20.3	20.3	Repaying
Country Total		**687.2**	**146.5**	

Annex 3 Current Portfolio Stock

(as at September 2004)

Sector	Portfolio € million	Undrawn Commitment € million	Operating Assets € million
Energy	34.7	0.0	34.7
Financial Institutions	13.4	1.2	12.2
General Industry	1.8	0.0	1.8
Specialised Industries	10.8	0.0	10.8
Agribusiness	3.0	0.0	3.0
Bank Equity	3.5	0.0	3.5
Bank Lending	7.1	0.9	7.1
General Industry	1.8	0.0	1.8
Natural Resources	14.5	0.0	14.5
Power & Energy	20.1	0.0	20.1
Property & Tourism	4.4	0.0	4.4
Small Business Finance	2.8	0.1	2.8
Telecoms, Informatics & Media	3.4	0.0	3.4
Country Total	**60.7**	**1.2**	**59.5**

Annex 4 TC Projects committed in the Kyrgyz Republic

From September 2002 to September 2004 – total of 19 commitments

Commitment Name	€ Committed	€ Disbursed	Fund Approved Date	Commitment Stage	Sector	Funding Code
Roundtable on the Kyrgyz Deposit Protection System	7, 736	6,969	05/05/04	Committed	Finance, Business	CA3F
Kyrgyz MSEFF – Micro and Small Credit Advisors	800, 000	419,293	17/11/03	Disbursing	Finance, Business	ECT
Kyrgyz MSEFF – Micro and Small Credit Advisors	200, 000	0	17/11/03	Committed	Finance, Business	EIPF
Community TAM Programme – Pokrova	200,000	58,240	09/06/04	Committed	Manufacturing	LUX
TAM Feasibility Study in the Kyrgyz Republic	13, 600	12, 791	10/12/02	Disbursing	Manufacturing	SWI
Calypso & Vytas Audit 2003	25, 000	25, 000	07/04/03	Closed	Finance, Business	SWI
Kyrgyz Republic – Deposit Insurance	28, 000	28, 000	23/09/03	Disbursing	Finance, Business	SWI
TAM – BIK	85, 500	36,661	24/09/03	Committed	Manufacturing	SWI
TAM – Strategic Plan for the Walnut Timber Industry	25, 700	13, 467	24/09/03	Disbursing	Manufacturing	SWI
TAM – Sadus	85, 500	35,499	24/09/03	Committed	Manufacturing	SWI
Kyrgyzstan Credit Line for Micro Enterprises – Start Up	20, 000	20,000	16/12/03	Committed	Finance, Business	SWI
Extension to Kyrgyz Deposit Insurance project	2,400	2,400	17/03/04	Closed	Finance, Business	USSP
International Banking Conference	50,000	0	07/06/04	Committed	Finance, Business	SWI
Market, Technical & Financial Due Diligence for Residential Property Development	39,480	0	15/09/04	Committed	Construction	SWI
Kyrgyz Republic – MSE Credit Advisors – regional expansion	391,733	391,729	03/06/03	Disbursing	Finance, Business	USSP
Kyrgyz Republic – MSE Credit Advisors – regional expansion	432,757	371,478	03/06/03	Disbursing	Finance, Business	USSP
Kyrgyz Republic – MSE Credit Advisors – regional expansion	0	0	26/11/03	Committed	Finance, Business	USSP

TC Projects continued

Commitment Name	€ Committed	€ Disbursed	Fund Approved Date	Commitment Stage	Sector	Funding Code
Kyrgyz Republic – MSE Credit Advisors – regional expansion	408,377	57,848	18/05/04	Disbursing	Finance, Business	USSP
Kyrgyz Republic – MSE Credit Advisors – regional expansion	456,706	0	08/09/04	Committed	Finance, Business	USSP
Country Total	**3,272,488**	**1,479,374**				

Annex 5 Legal Transition

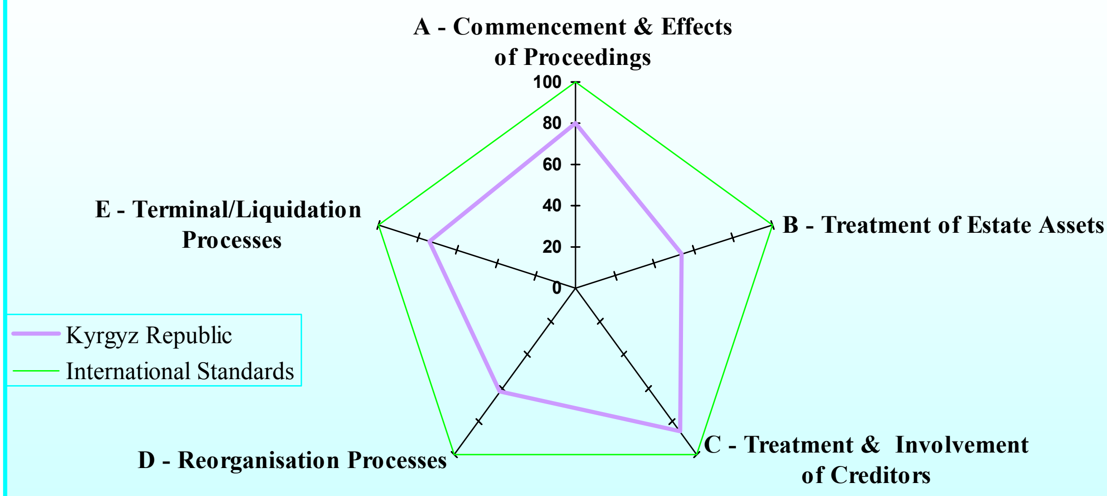
Assessment of the Kyrgyz Republic's Commercial Laws

Bankruptcy

The main law governing bankruptcy and insolvency is the Law on Bankruptcy (Insolvency) (the "Insolvency Law") of 1998, as amended, which was rated as "medium compliance" in EBRD's Insolvency Sector Assessment Project of 2003. The Insolvency Law provides for both liquidation and restructuring and applies to all commercial enterprises, other than certain types of state-owned business.

The Insolvency Law provides a well-defined threshold test for insolvency (see chart below). A debtor is deemed insolvent if it is unwilling or unable to make a payment (of a certain minimum amount, depending on circumstances) to a creditor when due. Bankruptcy proceedings may be initiated by a debtor in anticipation of not being able to make payments.

Kyrgyz Republic
Different Aspects of Insolvency Legal Framework (2003)



Note: The extremity of each axis represents an ideal score, i.e. corresponding to international standards such as the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group's "Legislative Guidelines for Insolvency Law", and others

Source: EBRD Insolvency Sector Assessment Project, 2003

Bankruptcy cases may be initiated by creditors and debtors fairly easily and are heard by the *Arbitrazh* court, which is not a specialised bankruptcy or commercial court. The Court must consider the petition for bankruptcy within five days, considerably better than elsewhere in the region where bankruptcy petitions may languish for weeks.

Once a petition is filed, an immediate stay of proceedings is imposed to prevent the debtor from unlawfully disposing of assets and prevent creditors from taking immediate enforcement ("stripping") actions. Unfortunately, there is no mechanism for parties to apply to obtain relief from the stay of proceedings. These provisions do not apply to secured creditors who, during the stay, may have recourse to their contractual rights. In fact, the Insolvency Law is unusual in the region in that the contractual rights of secured creditors are preserved during bankruptcy proceedings. As a result, a secured creditor may immediately seize and sell pledged assets and file an unsecured claim for deficiency, if any, arising from such sale.

The Insolvency Law could be strengthened. The notice provisions, for example, provide for publication of a notice that insolvency proceedings have been commenced but do not provide for specific notice to known creditors. There appears to be no positive obligation for insolvency administrators to review the books and records of the debtor to ascertain and notify creditors. This could cause creditors to lose some of their rights simply by virtue of not having seen the published notice.

The court may appoint an insolvency administrator, but there is no licensing body establishing qualifications for administrators. Once an administrator realises upon assets, the law imposes rules on distribution which work against secured creditors: the first-ranking claims (after the costs of the bankruptcy process) belong to individuals for whom the debtor is liable, for damages inflicted to their "life or health". The law does not provide guidance on what constitutes a debtor's "liability" (for example, whether the claims of such individuals must be liquidated or not). Thereafter the claims of retirement and salary benefits for employees, for the 3 months preceding the bankruptcy, are satisfied. After these two categories, claims of unsecured creditors are dealt with pro rata.

The most significant limitation relates to re-organisation. The law is not clear who retains the management functions of a debtor during restructuring and does not limit the ability of suppliers to refuse to supply essential services (such as electricity and natural gas). Although the law does provide detailed rules for filing and approval of a re-organisation, absence of provisions allowing for re-organisation financing make restructuring difficult to achieve in practice.

Capital Markets

The primary legislation governing securities markets includes the Law on Securities Market (1998), the Law on Investments in the Kyrgyz Republic (2003) and the Law on Investment Funds (2003). The principal regulator is the State Commission on Securities, whose head is appointed by the President.

According to the 2004 results of EBRD's Securities Market Legislation Assessment Project, Kyrgyz securities market legislation (i.e., "law on the books") has been rated "low compliance" compared to international standards, indicating insufficient legislation in a securities market at an early stage of development. Most countries in this category do not have regulation of financial intermediaries or collective investment schemes. There is usually insufficient regulation or training for securities markets regulators, intermediaries or service providers, to the extent that these entities exist at all. According to the Assessment Project results, further reform is particularly needed in the areas concerning the regulator, collective investment schemes and money laundering.

Company Law and Corporate Governance

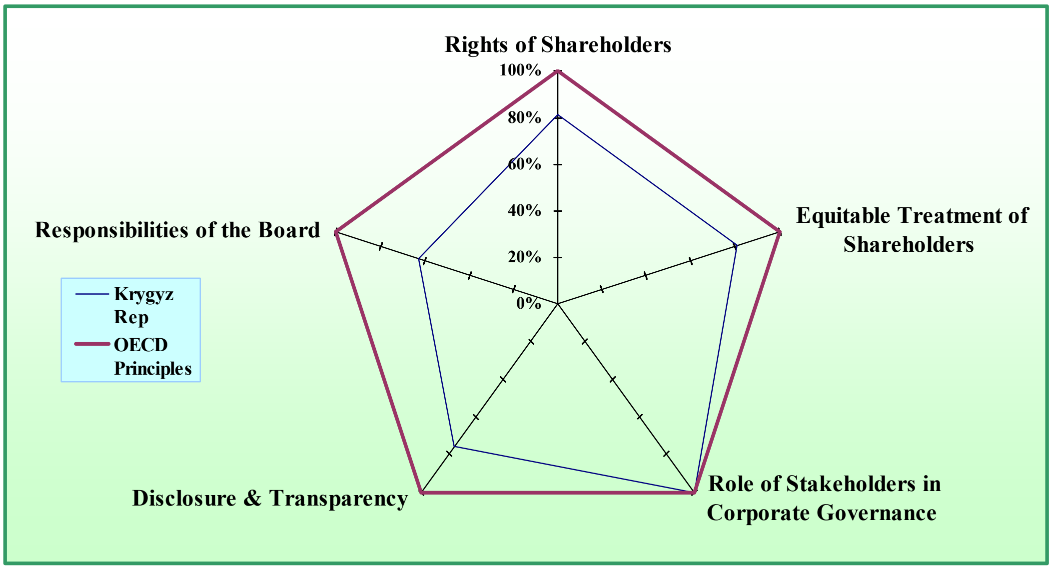
The Kyrgyz Republic adopted a new Law on Joint Stock Companies in 2003. This law, together with the Civil Code and relevant securities market legislation, establishes the framework for corporate governance.

According to the 2003 results of the EBRD's Corporate Governance Sector Assessment Project, the Kyrgyz Republic is a country whose existing corporate governance related laws (i.e., "law on the books") when compared to the OECD *Principles of Corporate Governance* were rated among "medium compliance" countries. General reform priorities for countries in this category are to improve implementation and enforcement of existing legislation, while continuing to reform laws.

Compared to 2002 results, the Kyrgyz Republic received an improved rating in 2003 due to promulgation of the new Law on Joint Stock Companies in 2003 mentioned above. The new law has made some important steps towards improving the corporate governance legal framework, such as strengthening the general assembly of shareholders, expanding shareholders' rights, clarifying functions of the board of directors, enhancing mechanisms in relation to protection of shareholders and companies from interested-party transactions and introducing mandatory buy-out rules.

Kyrgyz Republic

Different Aspects of Corporate Governance Legal Framework (2003)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD *Principles of Corporate Governance*. The fuller the 'web', the closer the corporate governance laws of the country approximates these principles.

Source: EBRD Corporate Governance Sector Assessment Project, 2003 assessment

However, there remains room for improvement. Based on the EBRD Corporate Governance Sector Assessment Project in 2003 (see above chart), rules governing responsibilities of the board of directors still fall short of international standards. Furthermore, overall disclosure and transparency rules under the existing corporate governance legal framework are inadequate. Finally, the Law contains inconsistencies which can cause uncertainty for shareholders. In particular, there are contradictions regarding the rules for selecting board members which have been used to thwart the law's intentions to protect minority shareholders.

Concessions

The Law on Concessions and Foreign Concessionaire Entities was approved in 1992 and amended on 8 March 2003 (the "Concessions Law"), although a number of other acts should be taken into account. These are the 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, for instance, the Water Act and the Mineral Resources Act introducing the licensing system, seem to be applicable.

The co-existence of so many pieces of legislation creates uncertainties as to the exact application of each law and leads to a risk of inconsistencies.

As can be seen from its title, the Concessions Law provides that only foreign entities (states, citizens, and joint ventures) may become concessionaires, thus discriminating against Kyrgyz nationals.

A Concession is defined as "a permit given by the KR Government to a foreign investor to run certain kinds of entrepreneurial activities connected with leasing property, land and underground mineral resources". The duration of a concession specified under the Concessions Law is from 5 to 50 years.

Under the Concessions Law, the Government approves the list of objects offered for concession (it being unclear whether this is a general list or particular for every concession) and defines the documents to be attached to the proposal, adopts the decision on granting concessions and is involved in concession agreement analysis. The concession agencies are responsible for preparing a list of objects offered for concessions, receiving bids and concluding concession agreements. However, coordination between the central and local Governments is not specified, which raises concerns should the central Government disagree with an agreement negotiated by the local Government, or vice versa.

Lack of clarity in defining subjects and activities also makes the Concessions Law unappealing. 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. The Concessions Law states that agreement objects may include land, underground resources, property and "certain economic activities within a certain territory".

One of the basic principles of concessionary activities is the competition-based approach to selection. Unfortunately, the tender procedure is left to be defined by Government and there is no reference to the possibility of awarding concessions without competitive procedures.

Further significant shortcomings include: (i) no possibility of lenders and the concessionaire to choose applicable law, (ii) no possibility for lenders to "step in" and substitute the concessionaire in event of default, (iii) relatively tight restrictions on the possibility of transferring concession agreement objects to a third party. This lack of flexibility may deter potential investors.

On the other hand, the Concessions Law does contain a number of positive elements, in particular, a clear reference to compensation in case of early termination and the possibility of referring a dispute to international arbitration.

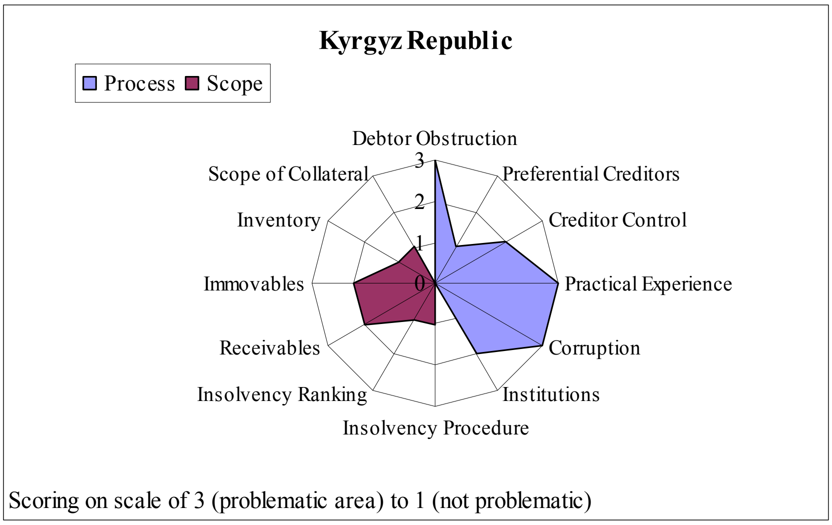
Secured Transactions
Although the Kyrgyz Republic has had a comprehensive legal framework for charges since 1997, it is not a functioning system and a number of reform initiatives have been taken, with support of international investors and foreign advisers, in particular EBRD and USAID.

Secured transactions are governed by the 1997 Law on Pledge and supporting regulation, the Mortgage Law and also some provisions of the Civil Code. Security over movable assets can be of two kinds: possessory (where possession is transferred to the creditor) and non-possessory (where the debtor retains the collateral). Non-possessory pledge must be registered in order for the creditor to gain preferential rights against third parties. Despite the business-orientated provisions of the law (among the most liberal in the Central Asia), the endemic problem has been its implementation, which tends to add unnecessary layers of bureaucratic procedures or, worse, to distort the principles as enacted in the legal provisions.

In May 2004, a draft law supported by EBRD and others was passed by Parliament at the second reading which, if finally adopted and properly implemented, should improve the conditions in which collateral is granted to secure credit. The areas where improvements will be needed in implementing the reform are, inter alia:

1. *The system for registration of charges* – The present registry is paper-based and overall experience with it is negative. Until a simple, efficient and inexpensive procedure can be put in place, it would be counter-productive to make registration compulsory as it would de facto prevent the viability of some transactions (especially micro-finance).
2. *Respect of Priority Ranking* – In principle, registration of the pledge grants the creditor preferential rights in the property against third parties (including subsequent secured creditors). However, it was reported that courts would not always recognise this priority ranking, which is a severe blow to the benefits of secured credit.
3. *Enforcement* – Problems arise from the debtor's obstruction to enforcement, whether enforcement is directly led by the creditor or by the court. Since, in both cases, the creditor must give notice and wait 30 days before starting enforcement or filing a petition, the debtor has ample opportunity to organise obstruction, (see chart below which highlights the problem). Enforcement can take 9 to 15 months. In a survey conducted by the EBRD in summer 2003, the Kyrgyz Republic scored a little over 6 on a scale of 10, ahead of Turkmenistan, Uzbekistan and Russia, but behind Kazakhstan, Belarus and Ukraine.

Qualifying factors in the charge enforcement process



1 = no significant problems or limitations
2 = relatively minor problems or limitations
3 = major problems or limitations

The fuller the "web" of the graph, the more serious the problems are in each of the respective categories.

Process factors	Scope factors
Debtor obstruction: The possibility for the debtor to prevent, slow down or otherwise obstruct the enforcement proceedings to the detriment of the chargeholder. Legitimate exercise of right of defence or appeal is not included. **Preferential creditors:** The impact of claims of other creditors (other than prior-ranking secured claims) on the satisfaction of the secured creditor's claim. **Creditor control:** The ability of the creditor to control or influence the conduct of the enforcement procedure. **Institutions:** The reliability of the courts and other institutions necessary to support the enforcement process. **Practical experience:** The general level of practical experience with the enforcement process in the country in question. **Corruption:** The impact of corruption within the court system on the enforcement process.	**Insolvency procedure:** The impact of the debtor's insolvency on the enforcement process. **Insolvency ranking:** The priority of the secured creditor's claim upon insolvency of the debtor. **Receivables:** An assessment of the simplicity and certainty of the enforcement process for a charge over receivables. **Immovables:** An assessment of the simplicity and certainty of the enforcement process for a charge over immovables. **Inventory:** An assessment of the simplicity and certainty of the enforcement process for a charge over inventory.
	Source: EBRD New Legal Indicator Survey 2003

Telecommunications
The telecommunications sector is currently regulated by the National Communications Agency (NCA) and governed by the Telecommunications Law (1998). The Telecoms Law reflects all modern principles in western telecommunications regulatory thinking, creating NCA as an independent regulator with sufficient powers to implement regulations, enforce competition, monitor licensing and administer tariff and interconnections. NCA carries out policies set by the Ministry of Transportation and Communication.

The Kyrgyz Republic has made substantial progress in improving the environment for telecoms. Since 1991, the country has been engaged in expansion and upgrade of its network. KT, the state telecoms operator, operates and maintains the country's telephone network. KT was restructured as a public corporation in 1997 and first offered for partial privatisation in 2000. Further efforts at privatisation are under way, through an international tender. In accordance with the Government's WTO commitments, the market for telecoms was formally liberalised in January 2003. Accordingly, private operators, already active in mobile, paging, data and internet markets, now compete in a fully liberalised marketplace.

With many of the sector framework issues addressed (i.e. strategic policy, law and institution) the challenge now is to implement individual frameworks that underpin modern telecoms regulation. The challenge is to address critical areas of tariffing, interconnection, universal access and the relationship of the regulator with the national competition/anti-monopoly authority and legislative framework. The Government and NCA are understood to have made some inroads in this respect.

To capitalise on the benefits of a competitive marketplace, the Government must move to implement necessary mechanisms to support the new regulatory framework (e.g. tariff rebalancing, workable interconnection regime and a mechanism for securing appropriate universal access). Further, to allow KT access to the capital and expertise, the Government should ensure privatisation moves forward in a timely manner.

Legal Transition Assistance

Telecommunications Regulatory Development Programme
The EBRD assisted the Kyrgyz Republic during 1998 with a framework and institution building TC project, covering elaboration of strategic policy; drafting of a new telecoms law; and establishment of an independent regulator. The sector policy is now in place, a new framework law was adopted in 1998 and an independent sector-specific regulatory authority, NCA, is now functioning. Following a request from the Government the Bank will begin providing further TC to provide advice and assistance on sound universal access. Additionally, the Bank will provide assistance with implementation of tariffing and interconnection reforms. Assistnace in this area should form part of a regional universal access initiative in the context of the Early Transition Countries (ETC) Initiative.

Annex 6 Bilateral Assistance

Canada

Canada has funded development projects in the Kyrgyz Republic through the Canadian International Development Agency (CIDA). Given CIDA's focus on specific countries, existing programmes in KR are being concluded and limited new programming (small projects carried out through Embassy-managed funds) will be considered.

France

2001: EUR 202,670 for technical assistance (of which EUR 107,510 for education).

2002: EUR 466,430 for technical assistance (of which EUR 203,850 for education) and EUR 118 100 for debt cancellation and consolidation.

2003: EUR 440,000. No further details available at this time.

Germany

Development cooperation started in 1992. More than EUR **162 million** has been committed since then. At present the **focus** of assistance is on **economic reform and building of a market economy.**

Major ongoing and planned projects in this context are: promotion of small and medium-sized enterprises; vocational training support programme; development of cooperative financing mechanisms in rural areas; promotion of product and service cooperatives; promotion of self-help initiatives in rural areas and an integrated food security programme in the **Batken** province.

Main financial cooperation projects are: improvement of electricity supply in **Bishkek**; improvement of municipal infrastructure; development of a national emergency system and combat of tuberculosis.

Together with other donors the Government of the Federal Republic of Germany is looking into the possibility of supporting a **sector programme for the health sector**.

Italy

The Kyrgyz Republic benefits from bilateral assistance from Italy for projects promoted by NGOs and for those of a humanitarian nature. In 2002, the Italian parliament approved financing of EUR 100,000 in favour of the Children's Hospital "Altyn Balalik" (law No. 180/92). Italy also participates in The Global Fund to Fight AIDS, Tuberculosis and Malaria which recently allocated USD 6.2 million to KR to be disbursed over the next two years.

Japan

Japan commenced bilateral assistance to the Kyrgyz Republic in 1991 and remains a major donor. According to OECD (DAC) data, Japan was the top donor in 1999 and 2000, ranked second in 1998 and 2001, and was fourth in 2002.

At the end of FY 2003 (March 2004), total commitments of loan aid stood at JPY 25.7 billion, and pledges of grant aid had reached JPY 8.63 billion. Disbursements of technical assistance amounted to JPY 5.06 billion.

Currently the four priority areas consist of: (i) transition to a market-oriented economy; (ii) basic human needs (BHN: primary health care and education etc); (iii) economic infrastructure; and (iv) agriculture.

Prior to the increase of the country's debt burden and the current rescheduling period, yen loans were extended mainly to the transport sector (airport and roads). Grant aid is continuing in such areas as health and medical care, structural adjustment support and food production. Human resources development (technical cooperation) is also ongoing in various areas related to the market economy, public administration, fiscal and financial policy as well as the environment. Development surveys have been conducted in areas including finance, communications and natural resources. Japanese volunteer aid workers (JOCV) have been working in the Kyrgyz Republic since 2000.

Switzerland

The Kyrgyz Republic is a priority country for Swiss economic cooperation. The orientation of the future **seco** programme is fully consistent with the priorities and objectives set by the Government in its National Poverty Reduction Strategy (2002). It will also respect main lines of intervention defined between the Swiss Development Cooperation (SDC) and **seco** in their *Joint Swiss Mid-Term Programme for Central Asia* (2002-2006), i.e. (i) establishment of reliable and adequate infrastructure as a basis for economic and social development; (ii) improvement of macro-economic framework conditions; (iii) development of the private sector, focusing on SME.

The main axes of the **seco** bilateral cooperation programme are as follows:
- close coordination with other donors and active participation in direct (bilateral or multi-donor) policy dialogue with the Government;
- strong focus on supporting efforts aiming at improved public finance;
- contribution to infrastructure financing;
- improvement of the business environment, the promotion of SMEs, and diversification of exports;
- decentralisation efforts;
- institutional and capacity building of partners when preparing new projects or programmes;
- projects and activities which are results-based and incorporate clearly defined performance indicators (including expected contribution to poverty reduction);
- good governance (political, public, and corporate levels).

Swiss development aid flows (millions CHF)

	1997	1998	1999	2000	2001	2002
seco	5.6	2.2	1.2	1.1	0.1	12.3
SDC	6.7	5.0	7.0	8.8	7.4	9.0
Total	**12.3**	**7.2**	**8.2**	**9.9**	**7.5**	**21.3**

UK

KR is a key target country for DFID assistance. Total UK aid of GBP 3.5 million is included in the current financial year, and is focused on governance, including large commitments in water, sanitation, health, and rural livelihood sectors.

The UK is strongly committed to harmonisation and working closely with IFIs, including joint programmes, which support WB and ADB loans of over USD 60 million. The UK also is working in close collaboration with the WB and the Kyrgyz authorities to implement the USD 30 million GSAC (Governance) Loan.

The UK has a strong commitment to and new programme on HIV/AIDS, supporting regional cooperation.

US

KR is important to US security and foreign policy interests, due to its role in helping in the global war on terrorism and the positive influence the Kyrgyz Republic has on stability within Central Asia. KR has been one of the most progressive countries in the FSU in pursuing market reforms. USAID's focus is to strengthen democratic principles, improve public health, and foster economic development. USAID in KR has provided USD 28 million in FY 2003 devoted to:

- Economic Reform (USD 11.9 million) –
    - SME development – business advisory services, accounting training, and business and economics education;
    - Support for EBRD partner banks and microfinance institutions;
    - Reduction of investment constraints and customs modernization;
    - Commercial law reform;
    - Private land ownership;
    - Banking sector reform;
    - In the Ferghana Valley city of Osh, focus on improving agricultural practices and introducing higher value crops.
- Energy and Water (USD 1.7 million) –
    - Support for a regional transboundary energy and water programme designed to improve interstate cooperation, particularly in the Syr Darya Basin;

  - In Osh oblast, pilot programmes to further develop farm-level irrigation management and complete efforts to strengthen Government capacity to improve forecasting river flows;
  - Tariff reform for electricity and pilot heating efficiency demonstration projects in schools and other buildings.
- Democracy and Media (USD 5.6 million) –
  - Strengthening political processes and institutions, civic organizations, and expanding sources of independent information;
  - Parliamentary development;
  - Commercial law;
  - Judicial reform;
  - Local governance;
  - A new civil society programme will support NGOs through training, technical assistance, and grants;
  - Human rights defenders programme;
  - Expanding access to information, USAID sponsors civic education, media and anti-trafficking.
- Conflict Mitigation (USD 0.9 million) –
  - Reducing the threat of extremism and ethnic- or resource-based conflicts in Central Asia, mostly through the Community Action Investment Programme (CAIP) in communities in the Ferghana Valley.
- Health and Population (USD 5.4 million) –
  - Focus on four critical health areas with the overall goal of creating a higher quality primary health care system. These are (i) increasing the quality of primary care; (ii) training healthcare professionals in implementation of DOTS approach to treating TB and other infectious diseases; (iii) preventing spread of HIV/AIDS; and (iv) training health staff in better pre-natal care.
- Basic Education (USD 0.7 million) –
  - Programmes to improve teaching methodology and curricula, increase parent and community involvement, assist with rehabilitation of schools, and strengthen administration capacity in nine clusters of selected primary and secondary schools in the Kyrgyz Republic. In addition, USAID is funding the Kyrgyz National Scholarship Test, which provides a fair opportunity for school graduates to receive state grants for higher education.

Annex 7 Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004
						Estimate	*Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	2.1	3.7	5.4	5.3	0.0	6.7	6.0
Private consumption	30.3	0.7	-4.2	1.6	4.2	9.7	na
Public consumption	-45.5	3.5	7.5	0.0	-0.2	0.2	na
Gross fixed capital formation	-1.1	27.7	26.4	-1.9	-7.3	-1.4	na
Exports of goods and services	-8.7	-10.4	10.5	-3.2	8.1	2.5	na
Imports of goods and services	1.5	-4.9	0.4	-13.8	13.1	1.8	na
Industrial gross output	5.3	-4.3	6.0	5.4	-10.9	17.0	na
Agricultural gross output	2.9	8.2	2.6	7.3	3.1	3.8	na
Employment			*(Percentage change)*				
Labour force (end-year) 1/	2.2	2.1	1.7	1.8	2.0	na	na
Employment (end-year) 2/	0.9	3.5	0.2	1.1	3.5	na	na
Unemployment (end-year) 1/	5.9	7.4	7.5	7.8	8.6	na	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	10.5	35.9	18.7	6.9	2.0	3.1	6.2
Consumer prices (end-year)	16.8	39.8	9.5	3.7	2.3	5.6	5.0
Producer prices (annual average)	7.9	53.7	30.7	12.0	4.8	4.6	na
Producer prices (end-year)	31.3	43.6	22.9	5.2	6.0	7.8	na
Gross average monthly earnings in economy (annual average)	23.6	24.9	16.9	18.6	15.8	12.9	na
Government sector 3/			*(In per cent of GDP)*				
General government balance 4/	-9.5	-12.7	-9.9	-5.5	-5.3	-5.0	-4.2
General government expenditure 4/	33.9	34.0	28.5	25.9	28.0	27.1	na
General government debt	110.7	134.3	113.3	102.1	107.2	102.6	na
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	17.5	33.7	11.7	11.3	33.9	33.4	na
Domestic credit (end-year)	22.6	5.0	10.0	-8.1	18.9	10.9	na
			(In per cent of GDP)				
Broad money (M3, end-year)	14.5	13.6	11.3	11.1	14.6	17.6	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Official rate 5/	54.0	51.6	32.8	10.7	4.4	4.0	na
Money market rate 6/	43.7	47.2	32.3	19.1	7.0	4.0	na
Deposit rate 7/	35.8	35.6	18.4	12.5	5.9	5.0	na
Lending rate 7/	73.4	60.9	51.9	37.3	24.8	21.7	na
			(Soms per US dollar)				
Exchange rate (end-year)	29.4	45.8	48.3	47.7	46.1	44.2	na
Exchange rate (annual average)	20.8	39.0	47.7	48.3	46.9	43.7	na
External sector			*(In millions of US dollars)*				
Current account	-364	-184	-91	-51	-63	-53	-80
Trade balance	-221	-89	4	40	-54	-83	-120
Merchandise exports	535	463	511	480	498	590	629
Merchandise imports	756	551	507	440	552	673	749
Foreign direct investment, net	87	38	-7	-1	5	17	72
Gross reserves, excluding gold (end-year)	164	230	205	230	290	359	na
External debt stock	1,480	1,647	1,704	1,678	1,785	1,966	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.1	3.9	3.8	4.9	5.0	5.3	na
			(In per cent of exports of goods and services)				
Debt service	21.8	24.8	24.8	24.3	14.1	17.3	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	4.7	4.7	4.7	4.8	4.8	4.8	na
GDP (in millions of soms)	34,181	48,744	65,358	73,883	75,367	83,421	93,918
GDP per capita (in US dollar)	350	266	289	321	334	395	na
Share of industry in GDP (in per cent)	20.8	24.7	27.2	26.8	21.3	20.9	na
Share of agriculture in GDP (in per cent)	36.1	34.9	34.2	34.5	34.4	35.2	na
Current account/GDP (in per cent)	-22.1	-14.7	-6.6	-3.3	-3.9	-2.8	-3.7
External debt - reserves (in US$ million)	1,317	1,418	1,499	1,448	1,495	1,607	na
External debt/GDP (in per cent)	89.9	131.8	124.4	109.6	111.1	102.9	na
External debt/exports of goods and services (in per cent)	247.6	312.3	297.5	299.2	280.6	263.4	na

1/ Based on labour force data from World Bank Development Indicators.
2/ The number of employed in legal entities which excludes employment in agriculture and forestry. Based on data from the National statistics Committee (NSC).
3/ General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign-financed Public Investment Programme. General government expenditure includes net lending.
4/ Accrual basis except for 1998 which is cash basis.
5/ Lombard rate from International Financial Statistics.
6/ Weighted average rate on interban k loans in soms with 1-90 days maturity, from International Financial Statistics.
7/ Weighted average over all maturities from International Financial Statistics.