IX Rural Financial Market Development in the Kyrgyz Republic: Fast-Track Transition

The Kyrgyz Republic became an independent country in December 1990 along with several other republics in Central Asia. The republics had long been under the central planning system of the USSR. They were dependent on each other for natural, human, and financial resources, and on Russia for governance. The transition from a centrally planned economy to a market economy has been a challenge for all the newly independent republics in Central Asia, including the Kyrgyz Republic. They entered the transition period with a large-scale, low-productivity, highly inefficient, poorly managed, and inflexible enterprise and agriculture sector (Rosegrant and Hazell, 1999). Selected indicators for the newly independent Central Asian republics are presented in Table IX.1. The data indicate that the Kyrgyz Republic is among the poorest of these countries.

The Kyrgyz Republic, nonetheless, was the earliest reformer among the newly independent republics and is now considered to be the most liberal and open of them in terms of political and economic conditions (Table IX.2). A rapid transition path modeled after the central European countries was adopted in 1991 with a strong emphasis on macroeconomic reforms (ADB, 1996). Consequently, while the GDP declined quite sharply for four consecutive years, it became positive in 1995 and has been growing steadily since then. Inflation declined from 225 percent in 1992 to 17 percent in 1997 (IMF, 1998a; Rosegrant and Hazell, 1999).

Furthermore, microeconomic reforms have been implemented. Csaki and Nash (1998) report that substantial

Table IX.1: Comparison of Selected Indicators for Central Asian Republics

Country	GNP per capita ($, 1996)	Average annual growth rate (%, 1990–1996)		Agriculture value added: (% of GDP, 1996)	Population in rural areas (%, 1996)	Rural population living below $1/day (1993)
		GDP	Agriculture			
Azerbaijan	480	-17.7	-6.0	23	44	
Kazakhstan	1,350	-10.5	-15.3	13	40	2.0
Kyrgyz Republic	550	-12.3	-4.6	52	61	18.9
Tajikistan	105	-16.4			68	
Turkmenistan	940	-9.6			55	4.9
Uzbekistan	1,010	-3.5	-1.8	26	59	

Source: World Bank (1998e).

Table IX.2: Resources, Distortions, and Reform in Central Asian Republics (from de Melo et al., 1997)

	Azerbaijan	Kazakhstan	Kyrgyz Republic	Tajikistan	Turkmenistan	Uzbekistan
Natural resources	Rich	Rich	Poor	Poor	Rich	Moderate
Liberalization index[a]	0.38	0.48	0.67	0.31	0.20	0.41
Political freedom[b]	3.2	4.4	6.8	1.8	1.4	1.6
Macroeconomic distortions[c]	1.0	1.07	1.03	1.01	1.27	1.15
Structural distortions[d]	-0.03	-0.62	-0.53	-0.49	-0.87	-1.15
Neighbor with thriving market economy[e]	No	No	No	No	No	No
Liberalization index 5 years after reforms[f]	0.44	0.61	0.82	0.39	0.22	0.58

a Average of the liberalization index (input, output markets, and privatization); the higher the better.
b Average of the index of political freedom; the higher the better.
c Degree of macroeconomic distortions; the lower the better.
d Degree of structural distortions; the closer to 1 the better.
e If the country has a thriving market economy as a neighbor? (yes/no)
f Source: Macours and Swinnen (1998). Liberalization of internal and export markets, enterprise privatization, and banking reforms are included in this index.

changes have occurred in the country, especially in agricultural reforms. The information in Table IX.3 shows that, compared with its neighbors, the country ranks first in terms of implementation of land, rural finance, and input-market reforms. Despite the reforms, the proportion of households considered to be poor steadily increased from 35 percent in 1992 to 40 percent in 1993 to 49 percent in 1996 (World Bank, 1997b). As of January 1997, the shares of poor and very poor in the urban population were 39 and 16 percent, respectively, while they were 58 and 31 percent, respectively, in the rural population (Badu, 1998).

About 3.8 million people, 82 percent of the population, are dependent on agriculture for their livelihood. The agricultural sector accounts for 42 percent of employment and its share in GDP increased from 35 percent in 1991 to 52 percent in 1997 (IMF, 1998a). It is believed that the agricultural sector has growth potential and has a clear advantage, at least in the medium run, over the industrial sector to lead economic growth.

Table IX.3: Status of Agricultural Reforms in Central Asian Republics

	Scores			
Country	Land reform[a]	Input supply[b]	Rural finance[c]	Total
Azerbaijan	6	5	4	15
Kazakhstan	5	7	5	17
Kyrgyz Republic	6	6	6	18
Tajikistan	2	5	3	10
Turkmenistan	2	1	1	4
Uzbekistan	1	1	1	3

[a] Land reform. 1-2: large state farms; 3-4: implementation launched recently to privatize farms; 5-6: advanced stage of privatization but not yet complete; 7-8: most land privatized but titling not done; 9-10: private ownership.

[b] Input supply. 1-4: State controlled; 5-7: privatization in progress; 8-10: privatized markets.

[c] Rural finance. 1-2: Soviet-type system with specialized agricultural bank to channel loans to agricultural sector; 3-4: new banking regulations introduced but commercial banks yet to emerge; 5-6: restructuring of existing banks and emergence of commercial banks; 7-8: emergence of financial institutions servicing agriculture; 9-10: efficient and competitive financial system that serves agriculture.

Source: Csaki and Nash (1998, p. 12).

Therefore, agricultural development has become a priority for policymakers (Mudahar, 1998). In addition, the Government declared 1998 as the year of renaissance for rural areas and initiated a comprehensive poverty alleviation program called *Araket* (meaning 'initiative'). Development of the small and medium enterprise (SME) sector in rural areas through implementation of microcredit projects has been identified as one of the major strategies to facilitate rural development. It is in this context that the strengthening of rural finance has become an important issue.

OVERVIEW OF THE FINANCIAL SECTOR

The financial sector in the country is still evolving and information about its current status is fragmentary. The information presented in this section is drawn from the existing literature and anecdotal evidence provided by people familiar with the country's financial sector.

The Government and several multilateral donors are simultaneously involved in developing new institutions and restructuring old ones that were in place at the time of Independence. Rapid financial sector reforms have been implemented under the heavy guidance of and with funding from the IMF and the World Bank. The Government has been enthusiastic in implementing the reforms because they are expected to ease financial constraints faced by the newly privatized and private sectors that are perceived to be the engines of economic growth. Furthermore, the extensive financial support previously provided by the former USSR for governmental activities had to be replaced by a reformed banking sector.

The financial sector has transcended from a monobanking system in the early 1990s to a complex system composed of State-owned and private commercial banks, and nonbank financial institutions. Currently, financial services are provided by Savings and Settlement Companies (SSCs), two large system banks primarily owned by the Government, eight commercial banks owned partially by the Government, six private commercial banks with foreign collaboration, several nonbank financial institutions (such as the Kyrgyz Agricultural Finance Company (KAFC), rural credit cooperatives (RCCs), several donor-funded rural and microfinance programs, including credit unions and village banks), and informal finance (ADB, 1997d).

With the transition to a commercial financial system, there has been an impressive expansion in the number of banks and bank branches since 1992. The four State-owned banks expanded rapidly and private commercial banks were allowed to emerge. The share of the State-owned banks in total bank assets declined from 100 percent in 1990 to 80 percent in 1992 and to about 11 percent in 1997 (EBRD, 1998). However, they became accustomed to injections of funds from the State and suffered losses when the State could no longer support them.

The overdues in the banking system at the beginning of 1996 accounted for over 3.6 percent of GDP and the volume of nonperforming loans exceeded 60 percent of the banking sector's lending portfolio. As a result, some banks have declared bankruptcy and several others have lost their licenses to conduct banking operations. Seven banks, including the State-owned Agroprombank that primarily serviced the agricultural sector and the State-owned Elbank that mobilized deposits, were closed. In addition, two State-owned banks, Promstroi Bank and AKB bank, were recapitalized so that they could continue to service the rural sectors (Lailieva, 1998). Furthermore, the Government, with the help of the World Bank, created a nonbank financial entity called KAFC in 1996. The Elbank was replaced in 1996 by SSCs, which are State-owned entities, to mobilize deposits and effect payments. A debt-resolution agency was created to collect and write off nonperforming loans made by Agroprombank and liquidate the assets of Elbank.

A favorable environment now exists for financial sector reforms but several problems remain. Laws on banks and banking have been enacted but the effectiveness of the banking laws has been weak due to enforcement problems (EBRD, 1998).[1] The legal rules are unclear. For example, the new law on pledging was enacted in 1997 and allows for registration of titles and provides clear guidelines for contract rights. However, the delineation of rights between creditors and third parties who purchase the collateral is not clear. Therefore, there are problems in foreclosing the collateral in case of default. In addition, the laws are not clear on the physical possession of the collateral during the contract period and the banks still insist on exclusive physical control over it. For example, pledged apartments are required to remain unoccupied and vehicles and mobile machinery should be left with the bank (Lee and Meagher, 1999).

The legal and regulatory frameworks for nonbanks, such as insurance and leasing companies and pension funds, are being developed but procedures for implementation are unclear. New regulations have been issued for loan provisioning. Competition is encouraged as evidenced by licenses being issued for three new foreign banks in 1997. However, the banking sector is still highly concentrated, as indicated by the share of the five largest banks, which own about two thirds of bank assets (EBRD, 1998).

Private savings and financial intermediation remain low. The banking sector lacks skilled staff who can evaluate risks and borrower business plans. Mechanisms for asset registry and collateral valuation, and the legal framework for foreclosure of collateral are underdeveloped. The regulatory guidelines, although formulated, have been difficult to implement due to the lack of skilled personnel. Very little information exists that is useful for conducting market-based transactions. The old system of concealing information from the public is still evident. It has been difficult to convince the bankers to provide transparency in banking operations. Although data on balance sheets and income statements of

[1] The legal rules are unclear and sometimes contradictory, and supervision activity is ad hoc. There are few procedures to enforce the law and there is a lack of trained staff for implementation.

all commercial banks are now being collected and published by the central bank in a monthly bulletin called Banking Herald, the data are not up to international accounting standards (Lee and Meagher, 1999).

At the microlevel, although the population is generally familiar with banks and trusts Government-backed financial systems, it has been difficult to garner trust for new institutions. Indigenous initiatives for creating institutions supported by local resources have been limited. Financial reforms have been largely top-down initiatives and the basic structural transformation of the economy to induce a change in the financial system has been lacking.

The financial sector has evolved rapidly over a short time, but major challenges remain, especially in serving the rural economy. The Government has been reluctant to shift completely to the new paradigm of a market-oriented financial market out of fear of underserving rural areas.

APPROACH TO RURAL AND AGRICULTURAL FINANCE

The country experienced a sharp drop in growth of real GDP from 7.5 percent per year in 1989 to negative 10.9 percent in 1996. Output in 1996 was only 56 percent of the 1991 level. Growth in the agriculture sector declined less than overall GDP but the agricultural value added in 1996 was only 95 percent of the 1991 value (Rosegrant and Hazell, 1999). There was a shift back from commercial to subsistence farming.

The country's fall in agricultural output and the shift backward into subsistence farming have been attributed to credit constraints. Therefore, expanding rural finance is considered important to increase agricultural production, but it is assumed that market-oriented banking will be biased against the agricultural sector. As a result, while banking generally has been liberalized, many restrictions remain regarding rural banking. The old paradigm of directed credit is still prevalent in the form of emergency credits for agriculture, which is considered to be one of the priority sectors.

Rural financial institutions are few, weak, and not yet financially viable. As mentioned, two loss-making banks that serviced rural areas were closed and two new institutions, KAFC and the SSCs, were created with heavy donor involvement, while two other banks were recapitalized so that they can continue to service rural areas. Real interest rates were initially negative for formal financial institutions but became positive in real terms beginning in 1996. However, there is wide variation in nominal interest rates charged by the various credit schemes implemented by the Government and donors in rural areas. They ranged from 12 to 39 percent per annum during the 1995/96 crop season; the inflation rate was 35 percent in 1996.

A huge demand exists for financial services in rural areas. It was estimated that by 1999 small enterprises in rural areas would require about $30 million in short- and long-term credit. The total demand for credit in rural areas, excluding households, may exceed $80 million. The Government budgetary allocations and bank and donor credit to the sector are far below the estimated requirement for external financing (World Bank, 1997b). In addition, there has been an increase in the demand for deposit services. Substantial potential exists in rural areas for deposit mobilization, and it has been suggested that rural households could save up to $84 million and small enterprises up to $8 million annually (ADB, 1997d). Although local deposits could finance the demand by rural enterprises for external finance to a significant extent, less emphasis has been placed by the formal banking sector on deposit mobilization.

An ADB survey observed that less than 10 percent of the demand for savings and credit services for all private enterprises and households in rural areas was met by the banking sector. Commercial bank lending to the agricultural sector in 1995 dropped by 43 percent in real terms compared to 1992; the decline was only one percent for industries and the construction sector, and 16 percent for other sectors. The share of household loans in the loan portfolio of the rural branches of commercial banks was less than 4 percent in 1996 (ADB, 1997d).

Much of the private farming in the country has little access to short- or long-term credit. The use of farm inputs such as fertilizers and chemicals has significantly declined, reportedly due to liquidity constraints. This has resulted in reduced returns to farming (see Box IX.1). In addition, a survey of agribusiness enterprises in rural areas revealed that emerging private firms face considerable constraints in accessing external finance due to lack of collateral (World Bank, 1997b).

Box IX.1. Is Credit a Constraint to Farm Profitability?

A study by the World Bank (1997b) argues that underutilization of land and inputs by private farmers is likely due to credit constraints. It was reported that the consumption of chemicals and fertilizers declined from 210 and 4,530 thousand metric tons (t), respectively, in 1990 to 81 and 2,380 thousand t, respectively, in 1993. A simulation exercise based on data from interviews with private farmers showed that releasing credit constraints would clearly improve the rates of return from farming, especially for small farms. Farms without credit constraints were assumed to have access to loans at 30 percent per annum. Credit programs that provide loans at reasonable cost should be able to improve profitability. The rates of return for private farms with and without credit constraints, derived from simulations, are provided in Table IX.4.

Table IX.4: Returns to Farming With and Without Credit Constraints

Private farm size (ha)	IRR (%) - With credit constraint	IRR (%) – Without credit constraint
Up to 5	5	10
5–10	5	9
10–20	6	9
Above 80	6	11

IRR: Internal rate of return
Source: World Bank (1997b).

THE EVOLUTION AND CURRENT STATUS OF KEY RURAL FINANCIAL INSTITUTIONS

Currently, two banks service rural areas. The Promstroi Bank provides loans to the agriculture sector through 23 of its 26 branches and the AKB-Kyrgyzstan services the rural nonfarm private sector through 20 of its 25 branches. As of 1997, it was reported that 60 percent of loans outstanding at the Promstroi bank and 65 percent at the AKB-Kyrgyzstan were rated as nonperforming. Agricultural loans made by the AKB-Kyrgyzstan in 1996 to collective and state farms accounted for 10 percent of its loan portfolio (ADB, 1997d). All the agricultural loans were considered to be nonperforming and it has stopped lending to the agriculture sector. In addition, nonbank institutions such as KAFC and the SSCs provide loan and deposit services in the place of Agroprombank and Elbank. There are also several donor-initiated microfinance programs that provide small loans primarily to the agriculture sector.

The chronology of major events in the evolution of formal financial institutions relevant to rural finance is provided in Table IX.5. The allocation of credit to the agricultural sector began in 1991 with the conversion of the former branches of Agroprombank-USSR that were located in the Kyrgyz Republic into Agroprombank-Kyrgyzstan. The bank was made responsible for servicing the agricultural sector and was primarily funded through budgetary provisions to direct credit to rural areas. The majority of loans were short term in nature. The market share of Agroprombank in total short-term lending by banks was about 89 percent in 1993. These loans accounted for one third of the total loan portfolio of Agroprombank (Table IX.6). The short-term loans were generally allocated to the rural nonfarm sector; the majority of farm borrowers were state and collective farms (World Bank, 1995b).

Until 1993, credit directed to agriculture through the banks was highly subsidized and provided under special programs. For instance, Agroprombank was directed to provide Som136 million ($22.19 million) in special credit to State and collective

Table IX.5: Chronology of Events Relevant to Rural Finance in the Kyrgyz Republic

Year	Events
Until December 1990	Part of Soviet Union financial system.
June 1991	National Bank of Kyrgyz Republic (NBKR) established.
December 1991	Kyrgyz branches of three former Soviet Union State banks reconstituted into Promstroi Bank, Agroprombank (agricultural bank), and AKB Kyrgyzstan. Elbank declared as nation's savings bank.
1992	Two-tier banking system introduced with NBKR as central bank.
1993–1996	Subsidized crop loans issued under state budgetary provisions.
1994	Deposit and lending rates liberalized; proposal to discontinue directed credit; reduction of domestic financing of budget deficits.
December 1994	Government initiated a resolution program for nonperforming direct loans and Agroprombank was significantly affected.
1995	Government set up an interministerial working group on rural finance to provide emergency seasonal credit and develop effective rural financial system for medium- and long-term loans.
1995	Nonbank financial institutions encouraged to expand.
November 1995	Rural credit cooperatives (RCCs) established by the Ministry of Agriculture and Food as nonbank financial institutions to channel in-kind loans to farmers.
June 1996	NBKR undertook comprehensive reform of financial sector.
1996	Closure of Elbank (savings bank) and Agroprombank (agricultural bank).
July 1996	Settlement and Savings Companies (SSCs) set up to mobilize savings; use branches of former Agroprombank and Elbank, and post offices.
1996	Kyrgyz Agricultural Finance Corporation (KAFC) established for rural lending as replacement for Agroprombank (supported by funds from the World Bank).
1997	Asian Development Bank supports a project to set up rural credit unions to mobilize deposits and provide production credit.
1997	Tacis-EU initiates regional agricultural credit development project on a pilot basis.

Sources: Compiled from ADB (1997d); Tacis (1997a, 1997b); World Bank (1998e).

Table IX.6: Short-term Credit to Agriculture from All Banks and Agroprombank, as of September 1993

Percentage of banks' credit for long-term agricultural loans	1.9
Percentage of banks' credit for short-term agricultural loans	17.7
Percentage of Agroprombank credit for short-term agricultural loans	31.8
Market share of Agroprombank in total short-term lending by banks to agriculture	89.4

Source: World Bank (1995b).

farms. The central bank (National Bank of Kyrgyz Republic) provided funds to Agroprombank at a nominal annual interest rate of 190 percent with an agreement that the Government would subsidize the interest rate by 90 percent. This allowed the bank to charge borrowers a nominal rate of 103 percent with 3 percent as its spread. Given the inflation rate at that time, this implied a real interest rate of a negative 74.6 percent (World Bank, 1995b). Indeed, these directed credits were disguises for outright grants to the agricultural sector since the repayment rate was very low.

Producer prices for farmers were very low in 1993–1994. Real interest rates, although negative, were rising and small private farms were unable to service their debts. Many private farms voluntarily stopped borrowing from banks as nominal interest rates exceeded 300 percent by fall 1993. Several illiquid collective farms were unable to privatize because shareholders were reluctant to assume their debts and they were also unable to access new loans. Hence, these farms shifted from the production of commercial crops, such as cotton, to subsistence farming of food crops. The arrears problem, rapid inflation, and rising interest rates led the State and collective farms increasingly to substitute barter exchanges for cash transactions (World Bank, 1995b). The default rates at the Agroprombank increased from zero percent in 1991 to 13.5 percent by the end of 1993, and there was a substantial decline in the bank's profitability. The Government, however, did not bail out the bank but reduced the subsidies and liberalized lending and deposit rates by 1994. As a result, Agroprombank could not service its old loans from the central bank and became ineligible for new loans (World Bank, 1995b). The bank reduced its volume of lending to the agricultural sector and finally suspended all its loan operations in December 1995. It continued to try to collect on old loans but was eventually closed in 1996.

Although closure of Agroprombank left a void in rural financial markets, the general conclusion was that it was a step in the right direction to close the bank rather than bail it out. The costs involved in recapitalizing it would have far exceeded the benefits because the bank was poor in both liquidity and skilled personnel. Moreover, the bank could not shed its image as a public bank that made cheap loans and was lax on loan collection.

Along with financial reforms, the Government has continued to provide subsidized farm credit through local government budgetary provisions. A summary of these budgetary provisions is provided in Table IX.7. The allocations were justified as a stop-gap arrangement until an alternative replaced the Agroprombank. The Government provides these subsidized funds to agriculture under the Emergency Financial Support Program (EFSP) through regional and district authorities. The loans have been made at an explicit nominal interest of zero to 30 percent per annum while inflation in 1996,

Table IX.7: Allocation of Budgetary Resources for Farm Credit, 1992–1996 (million som)

Year	Exchange rate (som per $[1])	Budgetary allocations	Other sources
1992	192.80	21.0	
1993	6.13	40.0	
1994	10.84	140.0	
1995	10.82	258.0	
1996	12.81	278.0	125
1997	17.36	130.0	

[1] For 1993–1997, the data refer to som per $. For 1992, the data represent Russian rubles per $. Data for exchange rates obtained from ADB Economic and Statistics Website, October 1998. *Available: http://www.asiandevbank.org.*

Data source: Tacis (1997a).

for example, was 35 percent. Up to 1996, the Ministry of Agriculture and Food disbursed farm inputs as in-kind loans to farmer groups that were constituted as credit unions under the EFSP to a value of Som875 million ($63.31 million) as of 1996. These disbursements constituted a major portion of total credit to the agricultural sector during 1994 to 1997. However, the total outreach of these various budgetary allocations is reported to be very small.

The rural credit cooperatives (RCCs) were formed in 1995 as an alternative financial network to replace the ailing Agroprombank. They were established under the direction of the Ministry of Agriculture and Food with 85 percent of the funds provided through budgetary allocations and the rest as grants from Japanese and EU sources. However, they have been a failure in terms of outreach and loan repayment. Most of the funds from these RCCs were channeled to State, collective, and private farms that were rejected from bank finance due to poor performance. Member loyalty, crucial to a cooperative institution, was missing because the RCCs were formed by the local government. Currently, the RCCs play a very minor role in financing the rural sector (ADB, 1997d).

There was a need for an alternate formal financial institution, because the budgetary allocations, the RCCs, and the banks could not effectively service the agricultural sector. Therefore, the KAFC was formed in 1996 as a nonbank financial institution to develop a community-based rural finance system and to fill the perceived void created by the closure of Agroprombank. The KAFC was scheduled to begin its operations by mid-1997 but was delayed due to several logistical problems.[2] It is too early to assess the importance and role of this institution in servicing the rural sector.

The terms and conditions of the KAFC have been designed to provide short-, medium- and long-term finance to private farmers, former collective farms, state farms, and agroprocessing

[2] Therefore, the Government had to continue to provide emergency credit for the 1997 crop season through budgetary resources (Tacis, 1997a).

firms. The purposes of loans include working capital, onfarm investments in buildings and irrigation infrastructure, purchase and lease of farm machinery and equipment, and improvement in the quality of livestock. The main activity of the clients should be agriculture and they should not have defaulted on any previous loan; the reputation of the client is important in addition to collateral. Short-term loans are those made for less than a year, medium-term loans are up to three years, and long-term loans are made for three to five years. The Corporation accepts Government securities as the most preferred collateral, followed by real estate. The value of collateral is expected to cover the principal and interest due. Interest rates are determined based on the term of the loans, with lower rates for short-term than for long-term loans (KAFC, 1997). While the criteria for loans from KAFC are strict and market based, they may be difficult for private farmers to meet due to limited collateral. The Government will continue to be the sole shareholder of KAFC in the immediate future but shares will eventually be issued to the private sector. This may reduce governmental intervention in the institution, but care may be required to prohibit monopolistic behavior of few shareholders. The activities of KAFC need to be carefully monitored because the regulatory framework to supervise nonbank financial institutions has yet to be strengthened.

While the KAFC was created to replace the agricultural lending previously done by Agroprombank, there remained a need for an institution to replace the rural deposit mobilization and payment services provided by Elbank. For this purpose, the SSCs were established in July 1996. They were designed solely to mobilize deposits through a network of 49 branches of the former Agroprombank and Elbank. Of these 49 branches, 47 are located in rural areas. Savings and demand deposits, payments and cash transfers, debit card services, safety deposits, and foreign currency and security services are provided by the Companies. The current volume of deposits mobilized in rural and urban areas is unknown.

Tacis-EU (Technical Assistance for Central Asian Independent States by the European Union) proposed a Pilot Agricultural and Food Development Program in Kul *oblast* (district) in 1998 as a regional, agricultural, credit development project to establish a sustainable credit institution. The project is structured as a regional, secondary agricultural bank to service local requirements. The repayment of funds disbursed to farmers by the Ministry of Agriculture and Food since 1995 will be used to form a revolving fund. Private farmers' associations will be formed based on crops cultivated and these associations will be used as a means to provide supervised credit, technical and marketing services, and other facilities required to support agricultural production (Tacis, 1996, 1997a). Although the program was designed as an alternative to the cooperatives and credit unions supported by other international donors, it appears to be a revival of old models for directed credit. It is too early to determine how this program will be implemented and what the results will be.

MICROFINANCE

Donors and the Government are active in providing small loans and microloans to farmers and microentreprenuers. It is reported that most donor programs are not legally authorized to provide financial services, but several function under special arrangements with the central bank under bilateral agreements. These initiatives are directed towards poverty eradication through employment creation. A national microcredit summit was held in the Kyrgyz Republic in July 1998 to focus on issues and lessons learnt by the service providers. This was the first of its kind to be held in Central Asia.

There are currently 19 donor-assisted microfinance schemes that service the rural areas. A profile of these programs is provided in Table IX.8. The programs include schemes sponsored by Tacis-EU, US-Kyrgyz joint Agricultural Commission, CARITAS/HELVETAS, German Agency for

Technical Cooperation/German Development Bank (GTZ/KfW), European Bank for Reconstruction and Development (EBRD), United Nations Development Programme (UNDP), Mercy Corps, FINCA (Foundation for International Community Assistance), ADB, and an IDA (International Development Association)-World Bank sponsored pilot program called Peoples Development Project. All programs, except for the GTZ/KfW and EBRD-sponsored programs, focus on short-term lending for the purchase of farm inputs. They employ diverse lending methodologies although the majority lend through groups. These are different from the Grameen-type groups that are based on joint liability. Here the members are organized into groups but the loans are provided on an individual basis with individual liability. The groups are used only to apply peer pressure. Most of these programs, except for those of FINCA and ADB, provide credit services only. FINCA and ADB promote voluntary savings through village banks and credit unions, respectively. The donor programs that do not explicitly require collateral use several types of substitutes: FINCA uses a group guarantee and graduated lending while the ADB-assisted credit unions use group pressure as collateral.

These programs generally charge high interest rates that are positive in real terms and most record repayment rates of outstanding loans of between 70 and 100 percent. The higher repayment rates are found in programs that use individual borrowing within voluntarily formed groups, such as farmers' associations or credit groups. Higher repayment rates have also been found in programs that provide technical assistance along with credit. The group members, although not liable for the loan, apply pressure on their peers to repay loans on time so that their group's reputation can be maintained (UNDP, 1998). In-kind loans are generally preferred to cash loans, which is consistent with the observation that credit-constrained private farmers also face difficulties in accessing input markets.

The size range of short-term loans made through these donor programs is usually \$100 to \$1,000. The Ministry of Labor and Social Protection, Mercy Corps, GTZ/KfW project, credit unions supported by ADB, the United States-Kyrgyz

Table IX.8: Donor Programs for Microfinance and Agricultural Finance

Program	Activity	Average loan size	Nominal annual interest rate (percent)	Length of loan	Comments
Central Asian American Enterprise Funds	Debt and equity investment to private businesses	$300,000 to $5 million			Funded by US Congress
Fund for Enterprise Restructuring and Development	Loans to private businesses	Up to $1 million	12.5 on US Dollar loans	Up to 2 years	
GTZ/KfW (German development bank)	Loans to private businesses		9 on DM loans	5--7 years	Investment loans
European Bank for Reconstruction and Development (EBRD)	Loans to private farms	$50,000 to $500,000	13–15 on Dollar loans	5 years	Business development services provided
US-Kyrgyz Commission on Agriculture and Rural Development	Loans to farmers and agricultural enterprises	Som18,000 to 250,000	80% of inflation		Implemented through Mercy Corps
CARITAS/HELVETAS	Private farmers; women microentrepreneurs	$500–$10,000 for farmers; $500–$5,000 for women	12 for farmers; 15 for women	6 months to 3 years for farmers and women	Established in 1997
Asian Development Bank -Credit Unions	Loans and deposit services	Som25,000	36		Scheduled to expand to 260 branches
Mercy Corps	Production loans to farmers	Som10,000 for farmers with 5–50 ha.	2 for first 6 months; 5 for 7th and 8th months, 10 thereafter	6–12 months	Established in 1995

(Continued next page)

Table IX.8 (cont.)

Program	Activity	Average loan size	Nominal Annual interest rate (percent)	Length of loan	Comments
Mercy corps	Microenterprise loans	Som2,000	4.5 per month	6–12 months	Only for women; pilot project
United Nations Development Programme	Loans for poverty alleviation	$250 per person in a group of 3 to15 persons for productive purposes	40–42	8–12 months	Funded through NGOs that organize credit groups; also provide training to NGOs and borrowers
FINCA	Loans and deposit services to women	$152 per member			Village bank methodology
Agriculture Business and Credit Advisory Service (Tacis), Pilot Agriculture Finance Development Project (Tacis)	Technical assistance to agricultural firms				
Agriculture training and services (Tacis)	Extension services to farmers				
Policy advice and business support (Tacis)	Business services for agricultural enterprises				

Sources: ADB (1997d); Oliver (1997); Tacis (1997b)); FINCA (1998).

Commission on Agriculture and Rural Development, and KAFC provide loans to nonpoor rural clients of up to $2,800. FINCA provides small loans, promotes savings programs, and provides technical support for the self-employed poor through village banks;[3] the average size of the first loan is about $152. While all programs require a business plan, FINCA does not insist on it if the loan is less than $100. Several require participation in training programs. Loans from the Mercy Corps are made only to members of farmers' associations, and ADB-supported credit unions target only their members, but all other programs are open to all rural clients (Martino et al., 1997).

The geographical coverage and outreach of the 19 donor programs have been limited. It is estimated that less than 12 percent of private farmers currently participate in these programs (World Bank, 1997b). The total amount of lending for the agricultural sector under all these schemes is estimated to be less than $1.5 million per agricultural season, while the estimated demand for loans by the sector is around $80 million. In addition, although 45 percent of the population lives under the poverty line, most of these programs do not support the very poor. The World Bank has proposed to support a Small Farmers Credit Outreach Program that would target households slightly above the poverty line. KAFC and the ADB-supported credit unions also target households above the poverty line. A proposal to target exclusively the very poor households through the Kyrgyz People's Initiative Project is currently being discussed (World Bank, 1997b). FINCA began operations in

[3] Savings and credit groups or village banks are the mechanisms used by FINCA to make loans. The village banks are composed of 10–30 members, primarily women, who operate as a mutual support group to facilitate disbursement of credit, recovery of loans, and management of group savings. The groups meet every week over the course of a four-month cycle to repay loans and make deposits. The group members are required to save about 20 percent of the loan amount in the group's internal fund, which is controlled by the group to use as a secondary source of capital to lend for short-term loans to group members. As of July 1998, the clients had saved over $342,250. Banks that have larger savings are able to obtain larger loans from FINCA (FINCA, 1998).

1995 and appears to reach poor women. Up to July 1998, about 90 percent of its 34,946 short-term loans worth $3.6 million were made to poor women with a repayment rate of 98 percent.

In addition to donor programs, the Government in 1997 disbursed microloans to women in the amount of about Som5,000 per borrower in each of six districts (Badu, 1998). However, outreach to poor clients under the Government microcredit programs has been very poor. Less than 20,000 clients have been serviced and the proportion of very poor clients is small.

Few of the above microfinance programs focus on savings mobilization. Institutional and financial viability are not fully understood and there has been a lack of an enabling environment to promote microenterprise activities (UNDP, 1998). Except for FINCA, the financial viability of the microfinance programs is poor (ADB, 1997d).

Generally, the criteria for participation in all the above microfinance programs are based on a minimum land holding and/or membership in a farmers' association (Wadwa, 1998). While the criteria help to screen applicants and monitor them at low cost, they may also exclude landless applicants demanding external financing.

INFORMAL FINANCE

Although informal finance exists, its share in the total financial transactions of households has been very small. A recent ADB survey stated that only 5 percent of rural households and 2 percent of rural nonfarm enterprises reported receiving loans from informal sources such as family and friends. None had loans from moneylenders. Informal loans were small, averaging about $285 for households and about $405 for rural enterprises (ADB, 1997d).

Some private farmers reported using informal finance for buying inputs. The arrangements generally involved in-kind loans for farm inputs made by traders and farmers with a promise to repay a prenegotiated volume of farm product at harvest. The inputs lent out by farmers were surplus items from subsidized in-kind loans made by the Government. This indicates that governmental programs suffer from targeting leakage because loans are being provided to those who may not require them. Several of these informal contracts were based on barter such that interest rates were not transparent (World Bank, 1997b).

CURRENT POTENTIAL AND CONSTRAINTS FOR RURAL FINANCE

Within only eight years since independence, the country has moved from a monobanking system to a financial system composed of several financial institutions. However, it has been difficult to develop a comprehensive rural finance strategy due in part to diverse opinions regarding the estimates of the demand for finance in rural areas. While the World Bank estimates farm credit demand at $82 million in 1999, the Kyrgyz agricultural department estimates it at $55 million (UNDP, 1998). The difference in the estimates is due in part to diverse methodologies and a lack of detailed information.

The demand for financial services in the future will be determined by the evolving structure of the rural economy (see Box IX.2). By 1996, more than half of the former collectives were dismantled and land was distributed to private farmers. In addition, land rights have become tradable since 1995 (Bloch et al., 1996). It has now become important for small peasant and private farms to form cooperatives voluntarily to purchase inputs and sell products in order to achieve economies of scale, and obtain loans from the banks (Kawai, 1996). With economies of scale and tradable land rights there may be more consolidation of farmland through purchases; voluntary associations and cooperatives may emerge to buy inputs and market production collectively.

Box IX.2. Evolving Structure in Rural Kyrgyz Republic

Land reforms were launched in 1991 and vigorously pursued until mid-1994, and again since 1996. Several farm types, such as peasant farms, private farms, cooperatives, associations of peasant farms, joint-stock companies, and small enterprises, were formed out of the former collectives and State farms. Former members of collectives were allowed to lease land for 99 years from the collectives and State farms, and farm them as private and peasant farmers (Bloch et al., 1997; Rosegrant and Hazell, 1999). The peasant associations and cooperatives were formed by the voluntary consolidation of peasant and private farms. The collectives were also allowed to reorganize themselves as joint-stock companies or to declare bankruptcy, with property divided among the former members.

The information in Table IX.9 shows that since 1991–1993, the proportion of farmland of private and peasant farms, and associations of peasant farms has increased, while that of collectives and State farms has decreased. However, from 1993 to 1995, the average farm size of peasant farmers declined from 18 to 12 ha, and the average size of cooperatives fell from 13,000 to 699 ha. Some peasant farms were smaller than 0.25 ha. (Bloch et al., 1996). Contrary to the expectation of the Government, about 45 percent of the farmland still remained as collectives and State farms as of 1996 (World Bank, April, 1998). It was estimated that at the end of 1997 there were 23,000 private farms, 1,500 family farming associations, 860 voluntary collectives, and 15 joint-stock farm enterprises (Martino et al., 1997).

It is reported that lack of access to external capital restricts the members of the collectives from claiming private plots for farming. Furthermore, while the limits on maximum farm sizes were eliminated in 1994, the limits on minimum farm sizes were fixed at 1 ha for individual farmers and 5 ha for associations of peasant farmers. This has led to the consolidation of peasant and private farms (World Bank, 1998e).

Table IX.9: Percentage Share of Various Farm Types in Total Area of Agricultural Land

Type of farm	1991–1993	1994	1995
Peasant and private farms	8	13	12
Associations of peasant farms			12
Cooperatives	13	9	11
Collective farms	32	35	25
State farms	37	31	23
Others (joint-stock companies, etc.)	9	12	17

Source: Bloch et al. (1996).

The consolidation of farmland may require long-term mortgage loans for purchases and long-term loans to buy machinery and equipment. In addition, loans to individual farmers within a voluntary association may be required. However, the collateral laws are inadequate to deal with voluntary collective farms where titles are individually owned but decisions are jointly made. Little information is collected to use in creating a credit history for these farms. In addition, leasing may emerge as an option to purchasing farm equipment and machinery for voluntary associations. But the leasing laws are poorly developed. Furthermore, information is scanty on the governance structure of these new types of voluntary collectives.

Providing financial services to the evolving rural economy will require flexibility by the financial institutions. The current status of the banks is inadequate to deal with the changing rural sector. Even though the donor-initiated cooperatives and credit unions may be useful, they face constraints, including a weak legal and regulatory framework. In addition, there is no national cooperative administration and it will take a long time to institute one. Also, the ability of the credit unions to provide agricultural production credit is unknown.

There is a need to provide deposit services in rural areas but a paradox exists wherein donors initiate projects based on donor capital even though there is a vast potential to mobilize local deposits. Few donor programs have incorporated savings components into their programs. Although the Government created the SSCs to mobilize deposits and they have a wide network, there may be problems if they cannot profitably make the loans necessary in order to pay attractive interest rates to their depositors.

There has been a gradual liberalization of interest rates and a decline in the disbursement of subsidized loans through budgetary allocations. As a result, the country has been acclaimed as the leader among its neighbors in the effective implementation of financial sector reforms. Political intrusions, however, remain in the form of emergency loans to agriculture. Furthermore, reforms have yet to be initiated in the areas of prudential regulation and supervision, especially measures for the mushrooming nonbank financial institutions. The skill levels of bank employees remain low and access to information in remote rural areas has been difficult. All these constrain the provision of rural financial services.

It has been very expensive to litigate and courts are often corrupt because judges and prosecutors are paid very low salaries. A survey in 1996 of business persons in urban areas found that the justice system is rated as unfair. It is estimated that court fees account for 10 percent of the amount in controversy. It was reported that weak legal institutions constrain the financial health and growth of private firms (Lee and Meagher, 1999). These types of problems may be even more severe in rural areas. It is important to improve the court systems to enable creditors to be confident that financial contracts can be effectively enforced. In the absence of an effective legal system, the banks tend to be very conservative and insist on a high level of safe collateral that few borrowers can afford to offer.

FUTURE DIRECTIONS

Much has been achieved within a short period in transforming the financial sector, but a careful assessment of performance is now necessary in order to identify remaining bottlenecks and gaps. Several isolated and small projects are in place but information on their achievements and problems encountered is very limited. As a result, it is difficult to identify specific policies, projects, or interventions that are needed now for development of a strong financial sector. In the absence of reliable specific information, the priorities identified for financial sector development in other transition economies are used as a guide here.

In other transition countries, it has been found that the process of building a strong financial sector has encountered problems because of the lack of an appropriate policy environment and financial infrastructure needed to facilitate a market-based economy (World Bank, 1996b). There is a serious lack of information about these basic problems of policies and infrastructure in the Kyrgyz Republic. Although well intentioned, the donors' approach so far has focused more on building institutions to channel funds than on strengthening the policy environment and infrastructure. Initially there was logical concern about a collapse in production that might be caused by liquidity constraints. In the rush to keep funds moving and to build new financial institutions, some of the fundamentals were ignored. There is a need to re-order priorities with greater attention to creating an appropriate policy environment and institutional infrastructure. Moreover, donor efforts to create institutions seem to be uncoordinated and it is not clear how these efforts will lead to an integrated financial market. Correcting fundamental problems may be the highest priority in the Kyrgyz Republic and resolving them may produce higher returns in financial sector development at this stage than investing in small and isolated projects to create and build financial institutions.

Creating the Policy Environment

The current policy environment in Kyrgyz Republic is generally favorable for implementing policies that will strengthen the financial sector and help it meet the growing demand for financial services. However, efforts are still required to convince policymakers to shift to the new paradigm in providing financial services in rural areas. It may be time for donors to stop supporting directed credit programs and instead take the lead in disseminating the largely negative results of directed credit in this country and elsewhere.

In the short run, there is an urgent need for the Government to create a comprehensive rural financial policy in consultation with the donors who may fund some of the activities to implement it. It is crucial that the fragmented and isolated donor initiatives should be legally recognized and be folded into a more integrated approach to developing the financial markets. If left uncoordinated and disconnected, these well-intentioned individual efforts to increase liquidity in rural areas may actually raise total costs of providing services and undermine the creation of a true financial market. Donors intending to work in the financial sector should make a long-term commitment to the task as an incentive for the country to stay on course with its financial reforms.

The current endeavor to stabilize inflation and increase competition among the financial institutions is a step in the right direction and should be continued along with efforts to liberalize interest rates. The rural financial policy needs to consider trends in inflation when determining the price for financial services, especially interest rates for loans and deposits. However, determination of inflation rates has been difficult in transition countries due to rapid changes in the economy and lack of appropriate methodologies to measure inflation accurately, especially in rural areas (World Bank, 1996b). It is important to continue the currently successful efforts to stabilize exchange rates and inflation, and to develop robust methodologies to collect information required for calculating inflation.

The Kyrgyz banking legislation enacted in mid-1997 authorized the central bank to regulate and supervise the banking sector. However, the law still allows the central bank to function as a fiscal agent for the Government by establishing a link between the banking and tax systems that is prone to abuse (Lee and Meagher, 1999). Reforms are required to separate the banking and fiscal systems.

Creating and Strengthening the Financial Infrastructure

While some of the legal and communication infrastructure inherited from the former USSR has become obsolete for a market-based financial sector, new infrastructure has been created since Independence. However, immediate attention is required to explore ways to both create and strengthen the financial infrastructure, which involves information, legal and regulatory systems, transportation, and communication systems. Experiences in Russia and Romania have shown that poor infrastructure, especially in regulatory and information systems, may constrain the growth of the financial sector.[4]

In the short run, governmental intervention is essential to create a strong bank regulatory and supervisory capacity. As the central bank assumes the responsibility of regulator, it will be important to assess its capacity to handle challenging tasks in two areas. First, a system is needed for the supervision of nonbank financial institutions and NGOs without stifling their innovative methodologies to provide services at low cost. This is an immediate priority since the KAFC is a nonbank institution and several donor-initiated rural and microfinance projects operate as NGOs. Second, the country so far has been immune to the financial and economic crisis in Asia because the capital account has been controlled and foreign direct investments have been limited.[5] However, the situation may

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[4] Analysis underway in Romania is documenting how an inadequate legal framework for creating, perfecting, and enforcing security interests constrains and drives up the costs of lending (Fleisig and Pina, 1998).

[5] Also, trade has been limited with Russia, a country that has been severely affected by the financial crisis. Less than 20 percent of total exports go to Russia and the GDP exposure due to the trade is less than 9 percent. Most of the exported goods are nonagricultural in nature (EBRD, 1998).

change if trade becomes liberalized and more important in the country. If this occurs, it may induce a higher level of hard-currency borrowing by domestic banks and firms. The recent experiences in Southeast Asia show that such a trend must be supported by a proper regulatory capacity.

It is also essential to develop information collection and dissemination systems about borrowers. There has been little information flow among financial intermediaries to facilitate the learning process and to conduct assessments needed for corrective measures. Donors can play an active role in this area. First, an assessment should be made of the current information systems and bottlenecks for operation of independent credit bureaus. Second, there is a need to create an information-sharing culture among the financial intermediaries. Third, the intermediaries need to be trained to collect information, such as their client's financial liabilities and repayment performance, which can be used to assess the creditworthiness of applicants. In all these efforts, it is important for donors to build up local human resources to become independent in information management by the time the donors leave the scene.

Experience to date has shown that there is a need to strengthen asset registry and valuation systems for both movable and immovable properties because collateral is important to consummate transactions in the early stages of banking sector development. Observers have also noted that leasing laws need to be perfected for them to become an alternative way to acquire fixed inputs. The donors can help by funding exploratory travel for Kyrgyz nationals to learn about successful asset registry and leasing systems in other countries.

Institutional Development

The current donor approach to institutional development in the country is questionable for several reasons. It involves many uncoordinated efforts and heavy subsidization leading to unsustainable operations. Client targeting has resulted in leakages and limited outreach. Furthermore, the development of separate institutions to provide loans and mobilize deposits in rural areas may be unwise and hamper the financial viability of institutions because of the foregone economies of scope and scale. An immediate priority is to assess the implications of this approach for the entire financial sector and the rural economy before attempts are made to build more institutions.

The microfinance initiatives of the donors and Government are in their early experimental stages. These initiatives should be carefully monitored and information should be exchanged among the programs. The legal status of microfinance needs to be resolved to enable the new programs to evolve into a more permanent status. Given the limitations of microfinance in serving the agriculture sector, it may be better suited to serve rural nonfarm than farm enterprises. The microfinance organizations need to be sensitive to local conditions and avoid the blind replication of models proven successful elsewhere. A few programs have modified the Grameen group-lending approach to suit the Kyrgyz culture, which has an aversion to group liability. However, collateral substitutes have yet to be developed to replace adequately collateral and group liability. Donors may usefully support skill development of personnel and provide start-up capital. However, there is a clear need for performance-based projects with clear exit strategies. The donors should exit once the capacity has been built to mobilize local resources through local deposits or through linkages with local banks.

Strong institutions are run by skilled employees. After evaluating the skill levels of the employees, opportunities for continuous skill enhancement should be provided to them as part of institutional development. The donors should assess the local capacity for training bank employees and initiate projects to create bank training institutes if none exists. There may be opportunities to achieve economies of scale in training by developing a regional-level training institute for banking employees in the Central Asian region.

It will be important to monitor the AKB-Kyrgyzstan and Promstroi banks to evaluate how they are performing after recapitalization. Information is sparse regarding the structural reforms that may have accompanied the injection of new funds. Key issues will be the status of loan recoveries and whether or not revenues are covering costs. If problems persist, it may become necessary to close down these operations or consider privatizing them.