

SECTOR ASSESSMENT (SUMMARY): MULTISECTOR FOR PRIVATE SECTOR DEVELOPMENT

A. Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. Since the collapse of the Soviet Union, the Kyrgyz Republic has focused on private sector development as the key engine of growth. The private sector accounts for 75% of gross domestic product (GDP). It is dominated by a large number of small entities in the informal sector, mainly farmers, individual entrepreneurs, and small enterprises. The informal economy was estimated at around 20.6% of the total economy in 2012. Other estimates put the number at 25%–80% of GDP. Formal small and medium-sized enterprises (SMEs) and individual entrepreneurs constitute about 31% of GDP and 19% of employment. Employment in the formal sector is largely in labor-intensive activities in agriculture, garment production, and retail trade.

2. Despite progress in improving the investment climate, policy distortions and market failures in key areas still constrain private sector growth in the Kyrgyz Republic.¹ Real and perceived corruption continues to be high. Businesses fear breaches of contractual obligations without fair compensation. Access to finance is limited because of a low level of domestic savings, low and inefficient financial intermediation, high real interest rates, a narrow finance sector, and a heavily cash-based economy. The gap between the workforce skills needed by the growth sectors and the skilled labor available is widening. An inefficient and ineffective public sector continues to own and be responsible for operating infrastructure and delivering services, in addition to its policy and regulatory roles. Private sector participation in infrastructure is low.

B. Finance

3. The finance sector is dominated by banks, with 24 commercial banks (16 with foreign ownership of more than 50%) operational as of the end of December 2014. The role of banks as financial intermediaries has grown since 2011, with assets, loans, and deposits all increasing faster than GDP. Total banking sector assets account for 82.0% of total financial sector assets, increasing from 31.7% of GDP in 2013 to 35.4% in 2014 (footnote 1). The banking loan portfolio has doubled in size since 2000. Access to finance has improved overall but formal financial intermediation is still in its infancy, with the ratio of domestic credit to GDP, including lending by nonbank institutions, at 20% in 2013. A little over one-third of the population saved in 2014, but only 3.7% have a bank account and only 1.0% saved at a financial institution.² An estimated 35.5% of the population received a loan in 2014, but only 11.3% have a loan at a financial institution. Because of high collateral requirements (averaging 187% of loan value in 2013), most investment financing comes from the retained earnings of existing enterprises and from household savings. A large share of the population remains financially excluded, despite strong growth in the banking industry. The government securities market is small (3.0% of GDP in 2013). The longest bond maturity is 2 years. Capital markets and the insurance industry are nominal in size and have been stagnant for many years.

¹ ADB. 2014. *The Kyrgyz Republic: Strategic Assessment of the Economy – Promoting Inclusive Growth*. Manila.

² In the Kyrgyz Republic only banks and credit unions are legally allowed to take deposits. Deposits in credit unions amounted to Som58 million as of the end of September 2014, which represents 0.14% of total deposits. Microfinance organizations require special license to be able to offer demand deposits.

4. The microfinance sector has grown rapidly, with assets accounting for 6.8% of GDP in 2013 and providing nearly one-third of the economy's total credit. The structural issues being faced by the sector are reflected in recent consolidation, to 230 microfinance institutions and 142 credit unions in mid-2014, down from 355 microfinance institutions and 190 credit unions in 2012. The sector is highly concentrated, with the largest 11 institutions (well capitalized and with access to domestic and foreign funding), accounting for 80% of the loan portfolio. Almost half of all microfinance lending is to agriculture, and more than one-quarter to trade. As of late 2013, 67.2% of microfinance organization (MFO) clients were women. MFOs have wider outreach than banks but are legally constrained in the products they can offer. There are significant challenges for existing MFOs to transform into deposit-taking nonbank financial institutions. Larger institutions such as Bai Tushum and FINCA have opted instead to transform into commercial banks. However, this is not an option for the vast majority of MFOs.

5. Women entrepreneurs face particular constraints in accessing finance, including high collateral requirements, and fund their businesses from family savings.³ It is estimated that only 1%–2% of loans over \$3,800 are made to women, indicating a significant gender gap. Women also have limited access to market institutions (trade and business associations), market information, and education. The agriculture sector is also credit constrained. While credit to the sector has increased to 17.6% of the total share of loans by commercial banks, it is still much lower than agriculture's share in GDP (22%) and total employment (35%).

6. The share of noncash payments to total payments is low. Key building blocks of the financial and communications infrastructure and regulatory framework for mobile financial services exist, but are in the early stages of development. Two out of 24 banks and a few nonbank institutions have taken initial steps in this area, hoping to capitalize on their early mover advantage, but their activities are currently unregulated.

C. Trade

7. At the policy level, the country has a generally open environment for trade and investment. Its trade–GDP ratio rose from 95% in 2005 to more than 143% in 2013, indicating the increasing importance of trade to the economy. The commitment at the policy level, however, has not translated into commensurate and effective support at the institutional level. Exports are heavily concentrated on a few markets such as the Russian Federation, Kazakhstan, and the People's Republic of China, and the export base is limited to minerals, agriculture, and textiles. Gold accounts for more than 40.0% of total exports, and the Kumtor Gold Company alone accounted for 7.5% of GDP in 2014. This heavy concentration on a few markets represents a risk to exporters should these economies contract or erect nontariff barriers, increasing the costs of moving goods across borders. The level of technology currently used in exported products is very low, depriving the country of spillover effects and linkages with local suppliers. Quality assurance infrastructure in the form of equipment and laboratories is outdated. The local technical knowledge to analyze and implement international quality standards is also lacking. Financial products catering to the specific requirements of traders, especially SMEs, are limited.

8. The foreign direct investment (FDI) Regulatory Restrictiveness Index for the Kyrgyz Republic is roughly in line with the Organisation for Economic Co-operation and Development average and compares reasonably well with neighboring economies such as the People's Republic of China, the Russian Federation, and Ukraine. FDI has been increasing in the last few

³ ADB–United Nations Development Programme. 2010. *Kyrgyz Republic: Situational Analysis, Barriers and Opportunities for the Development of Rural Women's Entrepreneurship* (Russian). Bishkek.

years but is concentrated in a few sectors and investors. FDI was 27% of GDP in 2013, up from an average of 19% during 2011–2013, though there was a sharp decline (by 35%) in 2014. Most of the FDI is in the resources extraction sector, largely concentrated in the Kumtor gold mine.

D. Education

9. A shortage of skilled or qualified workers is a major constraint on private sector development. This is mainly due to deterioration in the quality of general and vocational education, the education system's inability to offer training that meets market skills needs, and out-migration of skilled workers. An individual's levels of education and skills are important determinants of employability and wages. Fifty percent of the country's high school graduates do not go on to higher education or vocational schools, and prevalent youth unemployment is considered a cause of simmering social unrest.⁴

E. Public Sector Management

10. To ensure consistency and predictability in the budget formulation process, the government has used a 3-year budget plan since 2005. The medium-term budget framework has improved, but the link between the framework and the annual budget and between the Public Investment Program and the republican budget are inadequate. The strategic allocation of resources and budget execution capacity are weakened by low predictability of funds and frequent ad hoc policy initiatives. However deviations have been declining, with figures for 2013 showing less than 3.0% deviation between actual and planned expenditures, down from 3.1% in 2012. The budget classification system is in line with international standards and provides an adequate picture of general government activities. Almost all known off-budget funds, except fiscal reports of some government agencies and the energy sector, have been consolidated into the budget. Internal audit systems have improved but capacity is still limited.

11. With the introduction of a revised Tax Code in 2009 the government significantly improved tax policy and administration. Value-added tax constitutes the largest share of revenues (33% of the total in 2013). The overall tax base is narrow, given the significant size of the informal economy, although eliminating 75% of business licenses is helping improve tax compliance. Tax revenues represented 25.6% of GDP in 2013. Automation of tax and customs is improving revenue performance.⁵ The introduction of risk-based inspections will contribute to better allocation of resources and reduce corruption.

12. The civil service is currently being reformed. Entrance to employees is open and based on competitive exams. In 2013, functional rearrangements between agencies and ministries were made after a large-scale functional review. In 2015, opportunities for better vertical coordination between central, provincial, and local administrations will be assessed. Accountability of public officials has improved with the introduction of Councils of Public Oversight in all ministries and public agencies in 2010. Public access to information on public affairs and decision making has been improving, including online information on budget, procurement, and elections. The e-procurement portal is being piloted in some agencies and will be rolled out during 2015. Combating corruption remains a high priority for government. A new anticorruption strategy and the Anti-Corruption Service were introduced in 2012 and, to eliminate risks, the government is increasingly targeting corruption prevention.

⁴ <http://www.adb.org/Documents/CPS/?id=KGZ-2013>

⁵ With Asian Development Bank assistance, the government has introduced an integrated tax administration system that centralizes all tax databases, and a unified automated information system in the State Customs Services.

F. Government's Strategy

13. The government is addressing the continuing constraints on private sector development through the National Sustainable Development Strategy (2013–2017).⁶ The strategy aims to (i) create an environment conducive to domestic and foreign investment that will increase domestic productive capabilities; and (ii) improve the efficiency of public sector management and administration, and the employability of the country's human capital. The national Export Development Program 2014–2017 is the strategic blueprint to increase and diversify exports, including to the Eurasian Economic Union market. The Education Development Strategy 2012–2020 is focused on improving access to education, enhancing the quality and efficiency of education services, and strengthening sector management and performance. The legal, regulatory, and institutional framework for public–private partnerships (PPPs) has been established, largely in line with international good practice. Key focus areas under the Private Sector Development Program 2015–2017 approved in March 2015 include reforming investment legislation, simplifying trade and customs procedures, further automating tax payments and tax reporting, and improving public administration. The Investment Promotion Agency has been established to promote investment.

G. ADB Sector Experience and Assistance Program

14. The experience of the Asian Development Bank (ADB) shows that, if provided with a suitable enabling environment, the private sector can contribute to stable economic growth by creating jobs and producing higher value-added products and services. ADB sovereign⁷ and nonsovereign⁸ initiatives have helped the Kyrgyz Republic to address key constraints to private sector development. ADB will continue to expand access to finance and financial services, particularly to SMEs and women, through the use of innovative technologies backed by sound regulatory frameworks. PPP assistance will continue to further strengthen institutions and processes, build government operational capacity, and establish financial support mechanisms for infrastructure.⁹ Trade and investment diversification will be supported. This will be particularly important in light of the Kyrgyz Republic's accession to the Eurasian Economic Union. Trade facilitation support will also continue to be provided.¹⁰ ADB will also support the government's education strategy to increase the responsiveness of the educational and vocational education system to current and future industry needs, and produce more skilled and qualified workers.¹¹

15. Some of the lessons from ADB's work in the above sectors regarding private sector development include (i) the need for long-term, sustained and consistent engagement with the government to ensure effective implementation of cross-sector reforms; and (ii) the value of programmatic assistance, underpinned by results-oriented policy actions, combined with targeted technical assistance and related projects. These lessons have been incorporated in the proposed policy-based program. ADB's interventions will continue to be closely aligned and coordinated with those of international financial institutions and bilateral development partners.

⁶ Government of the Kyrgyz Republic. 2013. *National Sustainable Development Strategy, 2013–2017*. Bishkek.

⁷ ADB. 2015. *Completion Report. Kyrgyz Republic: Investment Climate Improvement Program (Project Number: 941544-022, 41544-082, 41544-084; Grant Numbers: 0120-KGZ (SF), 0319-KGZ (SF), 0393-KGZ (SF))*. Manila.

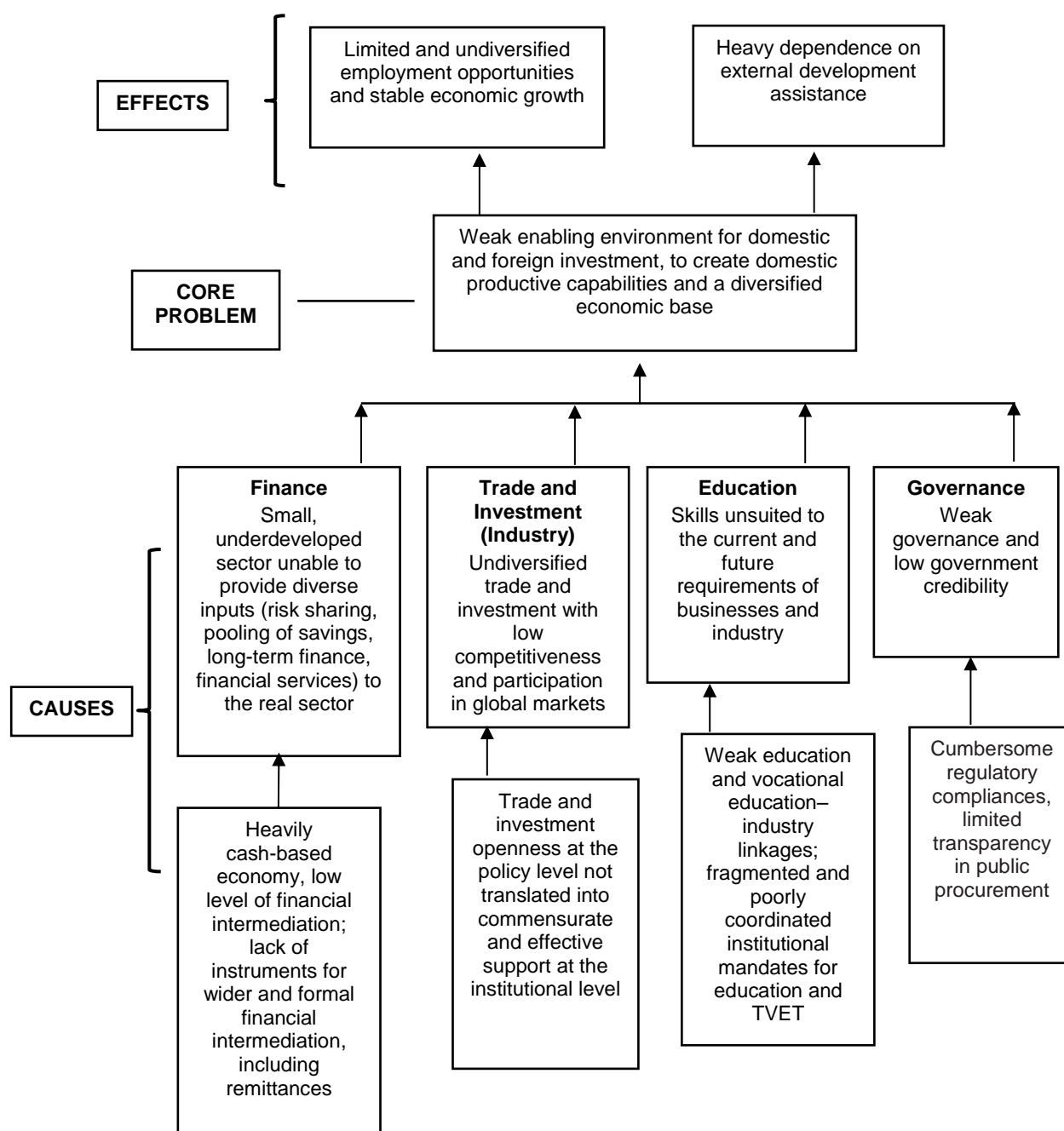
⁸ ADB. 2012. *Senior Unsecured Loan in Kyrgyz Investment and Credit Bank for Small and Medium-Sized Enterprise Finance*. Manila.

⁹ ADB. 2014. *Technical Assistance to the Kyrgyz Republic for Strengthening the Enabling Environment for Public–Private Partnerships*. Manila (TA 8688-KGZ, \$1,000,000, approved on 21 July).

¹⁰ A more robust and fully deployed single window facility is being supported under Central Asia Regional Economic Cooperation Regional Improvement of Border Services (RIBS) Project (46124-001).

¹¹ ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Grant to the Kyrgyz Republic for the Second Vocational Education and Skills Development Project*. Manila.

Problem Tree



TVET = technical and vocational education.

Sector Results Framework (Multisector for Private Sector Development, 2013–2017)

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Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	Indicators with Targets and Baselines	Outputs with ADB Contribution	Indicators with Incremental Targets	Planned and Ongoing ADB Interventions	Main Outputs Expected from ADB Interventions
Improved business environment and investment climate	<p>Share of private investment in GDP increased to 20.0% in 2014–2023 (baseline 2008–2013: average of 18.3%)</p> <p>Number of products exported with competitive advantage increased from 63 in 2011 to 80 (average 2013–2017)</p>	<p>Financial deepening and access to finance increased</p> <p>Comprehensive PPP program fostered</p> <p>Trade and investment facilitated</p> <p>Transparency and efficiency of doing business increased</p>	<p>Government implements regulations for e-money, operators of payments systems, and remote financial services approved by 2017</p> <p>Banks and other financial institutions/intermediaries introduce innovative financing products for SMEs (warehouse receipts, risk sharing facilities, climate finance, and/or Islamic finance) in financial intermediaries by December 2016</p> <p>Government approves infrastructure development and financing strategies for three sectors, including PPP and climate finance, with priority projects for private participation by March 2017</p> <p>Government implements the technical requirements of the Generalized System of Preference (Plus)</p> <p>Government implements the full e-procurement system in central government agencies by 2018</p>	<p>Planned key activity areas</p> <p>Business environment and investment climate reforms (13%)</p> <p>Finance sector development (22%)</p> <p>Pipeline projects with estimated amounts Second ICIP Subprogram 1, \$20 million (2015) Second ICIP Subprogram 2 \$23 million, 2017 Senior Loan Facility to Bai Tushum \$10 million, 2015 (nonsovereign)</p> <p>Ongoing projects with approved amounts Women's Entrepreneurship Development Project (\$1.5 million) CAREC Regional Improvement of Border Services Project (\$8.4 million) Strengthening Education System Sector Development Program (\$22.0 million) Second Vocational Education and Skills Development Project (\$20.0 million)</p>	<p>Pipeline projects Prudential supervision and conditions for finance sector deepening strengthened</p> <p>Regulatory framework to support the structured development of mobile financial services and electronic payments implemented</p> <p>Government financial support mechanisms and fair, open selection processes for PPPs established</p> <p>Budget or other financial arrangements for annual review of the sovereign credit rating confirmed</p> <p>Government resolution mandating all public procurement agencies to use e-procurement system as shared infrastructure approved</p> <p>Ongoing projects Full e-procurement system made operational in at least 20 government entities</p>

ADB = Asian Development Bank, CAREC = Central Asia Regional Economic Cooperation, GDP = gross domestic product, ICIP = Investment Climate Improvement Program, PPP = public–private partnership, SMEs = small and medium-sized enterprises.

Source: Asian Development Bank.