

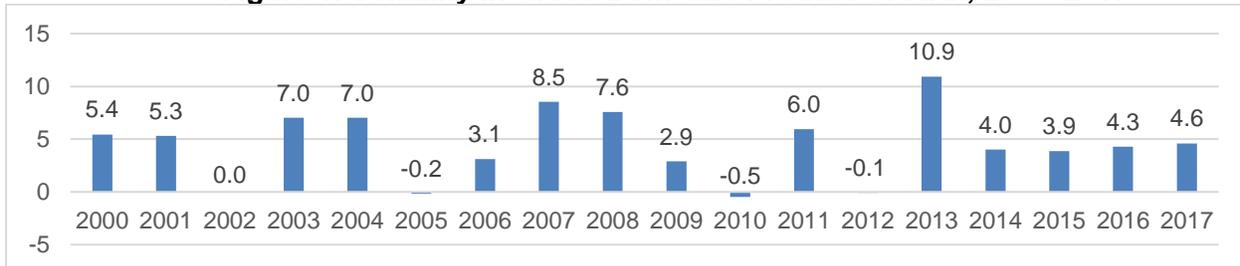
INCLUSIVE AND SUSTAINABLE GROWTH ASSESSMENT

I. RECENT GROWTH, POVERTY, INEQUALITY, AND ENVIRONMENTAL DYNAMICS

1. **Growth was moderate and subject to volatility.** The Kyrgyz Republic's gross domestic product (GDP) was about \$7 billion in 2017. At \$1,167, the country's per capita GDP was on the lower end of Central Asian economies.¹ The economy grew at an average annual rate of 4.4% during 2000–2017 (Figure 1), but growth was volatile because of (i) in-country political events (2005 and 2010), (ii) external developments (2008–2009 global financial crisis and a regional economic slowdown mid-2014 onwards because of low oil prices), and (iii) limited production of gold (2002 and 2012). Growth averaged 5.5% per year over 2013–2017, driven mainly by the performance of the gold mining industry, private consumption (largely influenced by inflow of remittances), and the fiscal stance that determined government spending pattern and expenditure levels—both recurrent expenditure and public investment. Average inflation was 6.8% in 2013–2015, but fell to 0.4% in 2016 mainly due to lower food and fuel prices and the appreciation of the national currency som. It rose to 3.2% in 2017.² Given the openness of the economy, inflation is influenced by the movement of the exchange rate and inflation in its trading partners.³

2. Despite moderate economic growth, the structure of the economy has been changing. The share of agriculture has declined from 36.6% in 2000 to 14.4% in 2016, while industry has marginally increased from 25.8% (average over 2000–2004) to 27.7% (average over 2012–2016) and the services sector increased from 32.1% (2000) to 57.3% (2016). Of the total agricultural output, recent estimates show crop production accounting for 51%, livestock including milk and meat at 47%, with the agriculture services, forestry, and fisheries less than 2%.⁴ Trade-related services, transport, and education are key segments in the services sector.

Figure 1. Volatility in Gross Domestic Product Growth, 2000–2017



Note: The average growth during 2000–2017 was 4.4%.

Source: International Monetary Fund World Economic Outlook Database April 2018 and Asian Development Outlook

3. **Industry growth depends on narrow economic base.** Gold mining accounts for about 40% of annual industrial production, while gold exports account for 6%–10% of GDP and 30% of the annual value of exports. The forward and backward link between mining and the rest of industry is limited. Growth in the non-gold industries—agro-processing, food and beverages, garment-and-textiles, leather products, wooden and paper products, petroleum refining, chemicals—has been stagnant because of low competitiveness and inadequate incentives to expand. Given this limited domestic production base, the country relies on imports, including for food and fuel. Total imports have been high and averaged 82.1% of GDP in 2008–2017.

¹ International Monetary Fund. 2018. *World Economic Outlook Database*. Washington D.C. (accessed 26 July 2018).

² Inflation has stayed within or below the National Bank of Kyrgyz Republic target of 5%-7%.

³ The economy's openness is reflected in the trade-to-GDP ratio, which grew from 95.1% in 2005 to 108.7% in 2016.

⁴ Food and Agriculture Organisation of the United Nations. 2016. *Office of Evaluation Country Programme Evaluation Series. Evaluation of FAO's contribution to the Kyrgyz Republic*. Rome.

4. **Structural factors strain balance of payments situation.** The balance of payments continues to be strained because of the narrow export base, concentration of trade with a few countries, large trade deficits (financed partially by workers' remittances), and low foreign direct investment. These have made growth susceptible to changes in the external environment, such as low global oil prices since mid-2014.

5. Trade deficits have been large and averaged about 35% of GDP in 2013–2017. The large inflow of remittances has contained the current account deficit that averaged 12.7% of GDP in 2013–2017. Remittances, which averaged about 30% of GDP during 2011–2017, are responsible for the viability of external accounts and for stimulating domestic consumption and growth. However, this heavy dependence on remittances exposes the country to potential external shocks and economic volatility.⁵ The large current account deficit is a structural problem that is unlikely to improve unless the domestic production base diversifies and becomes more competitive. Rapid export growth is a viable way for a country to narrow the trade deficit and bring the current account deficit to sustainable levels. Therefore, the Kyrgyz Republic must improve competitiveness across sectors. Fiscal prudence and exchange rate flexibility will also help in the process. The current account deficit is primarily financed by external official borrowing (including loan-financed public investment projects) and foreign direct investment. Foreign direct investment averaged 8.0% of GDP per year during 2013–2017, but it has not picked up outside mining, power, and some manufacturing subsectors. Because of the persistent pressures on the balance of payments, a managed floating exchange rate is being pursued. Foreign exchange reserves are estimated at \$2.2 billion, equivalent to about 4.4 months of import cover at the end of 2017.

6. **Highly concentrated export markets.** The high concentration of commodities in the export basket is matched by an equally high concentration of the country's trading partners. Three markets—Switzerland (mainly gold), Kazakhstan, and the Russian Federation—account for 65% of exports. The Russian Federation, the People's Republic of China (PRC), and Kazakhstan account for more than 70% of imports. Reflecting the fragility of the country's external accounts, commodities other than gold—such as agro-based products, clothing, mineral fuels, and re-exports of manufactured products from the PRC—account individually for 3%–5% of exports. Excessive dependence on gold exports is also problematic because it is an exhaustible resource.⁶ The concentration of exports in a few products reflects the lack of diversification of the domestic production base and low productivity across sectors.

7. **Improved fiscal management, but fragility remains.** Fiscal consolidation remained a priority under the International Monetary Fund's 3-year Extended Credit Facility approved in April 2015. The tax-to-GDP ratio averaged 20%; including the nontax revenue (6%–7% of GDP), total revenues have ranged between 26% and 28% of GDP. However, government expenditure has fluctuated between 29% and 33% of GDP because of a rise in salaries, social expenditures, and foreign-financed public investment projects in the run-up to the presidential elections in 2017. The government plans to lower the fiscal deficit, which averaged 3.3% during 2010–2017, to 2.5% in 2018. Direct taxes are less than half of indirect taxes, indicating room to increase revenue by rationalizing the tax structure, streamlining, and widening of tax base. On the expenditure side, the government supports an inclusive growth agenda by spending 15% of GDP on education, health, and social benefits during 2013–2017—that is about 45% of total government expenditure.⁷ Better targeting would make social sector expenditures more effective and make it

⁵ Remittances depend on migration of Kyrgyz working population, which also affects the labor market. The migrants tend to be young (18–35 years old) and educated (89% of migrants have completed secondary school).

⁶ Gold resources would be exhausted in 3 decades at the current level of production. Natural Resource Governance Institute. 2017. *Improving Resource Governance in Kyrgyz Republic: 12 Priority Issues for Mining Sector*. New York.

⁷ In 2016, expenditure on education was 6.6% of GDP, health 2.9%, and social security and welfare 5.5%.

more rationalized. To contain the fiscal deficit, the government is working to expand the tax base, improve tax administration, reduce tax exemptions, and control spending by streamlining non-priority purchases, adopting an action plan for reforms of public sector personnel remuneration, and strengthening public procurement.⁸ Total public and publicly guaranteed debt to GDP as per official data was at 56% in 2017, making the economy's debt servicing capacity vulnerable to further shocks. The fiscal deficit has been financed by official development assistance (ODA) from bilateral and multilateral sources, as well as public borrowing from external and domestic sources. Total ODA averaged 8.8% of gross national income in 2012–2016, or \$584 million a year.⁹ ODA accounted for 34.2% of central government expenditure in 2014–2016. The share of loans in ODAs rose to 47.7% in 2011–2014 from 30.8% in 2007–2010. The PRC is the country's largest partner aiding primarily in transport and energy sectors.¹⁰ The Asian Development Bank (ADB) is the largest among multilaterals in the country with the second-largest ODA share.

8. Inadequate job creation in the formal sector. The labor force participation rate fell from 64.9% in 2000 to 63.1% in 2016, at a time when the percentage of the population 15–64 years old increased from 59.6% to 64.1%.¹¹ Female labor force participation declined from 55.0% in 2000 to 49.4% in 2017; as male participation remained constant at about 75% in that period.¹² While only 509,000 jobs were added during 2000–2011, some 1.1 million people joined the working age population (15–64 years).¹³ With the economy unable to create sufficient jobs domestically, emigration of workers has been massive. About 80% of the migrant laborers from the Kyrgyz Republic work in the Russian Federation with the rest in Kazakhstan, Turkey, and the United Arab Emirates.¹⁴ According to official estimates, 574,200 Kyrgyz migrants were in the Russian Federation as of April 2016, of which 61.2% were men and 38.8% women. Remittances, which were 0.6% of GDP in 2000, rose to 12.7% in 2005, 26.4% in 2010, and averaged 30% of GDP during 2011–2017 (footnote 11). In 2017, remittances were 26.8% of GDP.

9. A significant proportion of economy activity is in the informal sector, which is outside the government's control and pays no taxes. The unemployment rate was estimated at 7.8% in 2015, while the proportion of youth not in education, employment, or training jumped from 10.6% in 2007 to 21.4% in 2015 (footnote 11). This is an important adverse development since a third of the population is below 15 years old. About 33.7% of the population live in urban areas. The contribution of agriculture to GDP, which directly or indirectly supports the rural population, has fallen sharply. This is one of the main factors underlying the still high poverty rates.¹⁵

10. Poverty remains high, but inequality has declined. Economic growth coupled with high social expenditures have led to a decline in the proportion of people living below the national poverty line—from 37.0% in 2013 to about 25.4% in 2016 (1.6 million people).¹⁶ The proportion

⁸ The fiscal deficit reduction impact of these measures may be diluted by the adoption in 2017 of the Universal Monthly Benefit for Low Income Families with Children Program and an increase in civil service salaries and pension.

⁹ Organisation for Economic Co-operation and Development. 2017. *Geographical Distribution of Financial Flows to Developing Countries Disbursements, Commitments, Country Indicators*. Paris.

¹⁰ National Institute of Strategic Studies. 2016. *2015–16 Knowledge Sharing Program with Kyrgyz Republic: Effective Utilization of Financial and Human Capital for Sustainable Development of the Kyrgyz Republic*. Bishkek.

¹¹ ADB. 2017. *Key Indicators for Asia and the Pacific*. 2017. Manila.

¹² International Monetary Fund. 2017. *Fourth and Fifth Reviews under the Three-Year Arrangement under the Extended Credit Facility*. Washington, D.C.

¹³ ADB. 2018. *Strategic Framework for Free Economic Zones and Industrial Parks in Kyrgyz Republic*. Bishkek.

¹⁴ ADB. 2014. *Kyrgyz Republic. Strategic Assessment of the Economy: Promoting Inclusive Growth*. Manila.

¹⁵ About 36% of population in the bottom 40% of income distribution work in agriculture. World Bank. 2017. *Kyrgyz Republic Economic Update Fall/Winter 2017*. Washington, D.C.

¹⁶ The official poverty line, calculated based on the cost of meeting basic needs, was Som31,145 per year per capita in 2017. Poverty is estimated by the quarterly Kyrgyz Integrated Household survey covering 5,000 households.

of population below the \$1.90 purchasing power parity a day threshold was 1.4% in 2016. The poor are concentrated in rural areas with about 60% living in the southern part of the country. Inequality, in its different dimensions, has declined. Over 2009–2014, the growth rate of household expenditure of the bottom 40% of the population was 0.4% per year compared with the 1.1% contraction for the entire population. And while the household expenditures did not grow in 2011–2016, the corresponding growth rate of household expenditures for the bottom 40% of the population was 0.6% during the same period. The Gini coefficient correspondingly declined from 0.310 in 2000 to 0.268 in 2016 (footnote 11).

11. **Social Indicators have improved marginally, but challenges remain.** The country is ranked 120 of 188 nations in human development indicators in the category of medium human development.¹⁷ The Kyrgyz Republic's Human Development Index (HDI) value increased marginally from 0.632 in 2010 to 0.664 in 2015. Life expectancy rose from 68.5 years to 70.8 years. Expected years of schooling increased from 12.1 to 13.0 years, but mean years of schooling has remained virtually unchanged at 10.8 years. The inequality adjusted human development index (IHDI) was 0.582 in 2015, implying a 12.3% loss in HDI indices (life expectancy, education, and decent standard of living) because of inequality. Despite heavy social sector spending, the country ranks low on social indicators, suggesting that the resources have not been effectively used and targeting remains weak. The delivery mechanism for state-financed services needs improvement and the amount being spent on different schemes requires further rationalization. While access to some basic services such as health and education has improved, access to and the quality of water supply and sanitation remains problematic.

12. Approved in 2012, the National Health Reform Program supports a sector-wide approach and aims to improve health indicators in four areas: maternal and child health, cardiovascular diseases, tuberculosis, and HIV infection.¹⁸ There is a wide difference between the official maternal mortality rate and those reported by the country's development partners.¹⁹ Despite high public spending, health outcomes vary both spatially and across wealth index quintiles of households. For infant and under-5 mortality, rural areas recorded 1.5 times more deaths per 1,000 live births compared with urban areas. The under-5 child mortality rate for the poorest wealth index quintile is twice that of the richest quintile.²⁰ The number of new HIV infections has risen slightly, while tuberculosis incidence has fallen. Recent health policy initiatives include introduction of mandatory health insurance, creation of family medicine centers, and initiation of the first phase of drug provision for all insured persons at the primary health care level.

13. **Gender disparities persist.** The government estimates that about 67.0% of all self-employed women and 53.8% of men are in agriculture.²¹ These workers have no fixed income and could include unpaid family workers. In education, near gender parity has been achieved in enrollment to primary and secondary levels, but gender stereotyping persists in the choice of vocational training and university degrees. Tracking of students in gender-appropriate courses,

¹⁷ United Nations Development Programme. 2017. International Human Development Indicators. Compared with regional countries, Kyrgyz Republic ranks better than Tajikistan (129), but is behind Turkmenistan (111), Uzbekistan (105), Armenia (85), and Kazakhstan (56).

¹⁸ Ministry of Kyrgyz Republic and World Health Organization. 2015. *Monitoring Official Development Assistance to the Health Sector of the Kyrgyz Republic (First Edition)*. Bishkek.

¹⁹ As per data reported by development partners, the maternal mortality ratio (per 100,000 live births) rose from 74 in 2000 to 76 in 2015 with a corresponding decrease in the proportion of births attended by skilled health personnel from 98.6% to 98.4% in that period.

²⁰ National Statistical Committee of Kyrgyz Republic and United Nations Children's Fund. Kyrgyzstan Multiple Indicator Cluster Survey 2014.

²¹ National Statistical Committee of the Kyrgyz Republic. 2017. *Women and Men of the Kyrgyz Republic: Gender Disaggregated Statistics, 2012–2016*. Bishkek.

coupled with gender gaps in the transition from school to work and rising conservative perceptions that a women's place is in the home, have kept female labor-force participation rate low at 49.4% in 2015 (compared with 77.1% for males).²² In addition, the unemployment rate for women in 2015 was 9.0% compared with 6.5% for men. The country continues to have a gender wage gap: women's average wage—across all sectors—was 75% of men's wages in 2015.²³ In 2016, women represented 29.7% of the heads of small firms, 36.9% of medium-sized firms, and 29.3% of top managers in large enterprises (footnote 21). Despite the adoption of quotas in the Election Code in 2007 and 2011, women's political representation is below the 30% threshold. Women constitute 19.2% of parliamentarians on the Supreme Council. Violence against women remains high as 25% of women 15-49 years old have experienced physical or sexual violence from their partners.²⁴ The new National Action Plan on Gender Equality for 2018–2020 has identified economic empowerment of women, improvements in functional education, increasing women's access to justice, and expanding women's political participation as priority areas. Although gender-based budgeting has been piloted, it has not been scaled up. The Gender Policy Department in the Ministry of Labor and Social Development has the mandate to implement the action plan. However, it is understaffed and depends on support from development partners.²⁵

14. Membership in Eurasian Economic Union would allow greater integration. Despite being part of Eurasian Economic Union (EEU) since August 2015, the country has not made significant gains in the diversification of industry and competitiveness. Thus, it has been unable to reap the benefits of a larger market through higher-value and diversified exports. The EEU is a customs union that aims to promote the free movement of goods, services, capital, and people.²⁶ Accession to the EEU can potentially benefit the Kyrgyz Republic in the long-run by facilitating deeper integration with neighboring countries, especially the Russian Federation, and undertaking macroeconomic and structural reforms.²⁷ To support the free movement of goods, preexisting sanitary and phytosanitary border controls are being replaced by mandatory EEU regulations that are harmonized with international standards. However, more improvements are needed and capacity must be strengthened further. In October 2017, Kazakhstan tightened controls on the Kazakh–Kyrgyz border to intensify phytosanitary and customs checks of merchandise entering the country.

15. The EEU has set targets to improve macroeconomic stability. These include a maximum fiscal deficit of 3% of GDP, public sector debt not exceeding 50% of GDP, and an average inflation rate of 5%. The Kyrgyz Republic is not in compliance with the first two targets. Since the EEU is not a common currency area, exchange rates among members are permitted to fluctuate, which can impact the dynamics of trade within the union. A gradual harmonization of the regulatory legislation for financial markets is envisaged to strengthen financial integration with EEU. A Russia–Kyrgyz Development Fund was established to support the country during the transition to

²² This is defined as the duration or the speed with which youth make the transition from leaving the formal education system to entering a job that lasted longer than 3 months. Various factors, such as level of educational attainment, degree course, age, gender, economic situation, employment legislation, work–life balance affecting those with household responsibilities, aid or constrain an individual's smooth transition into the labor market. Cross-country studies show that women tend to have slower transitions into their first jobs.

²³ National Statistical Committee of the Kyrgyz Republic. 2016. *Women and Men of Kyrgyz Republic: Gender Disaggregated Statistics, 2011–2015*. Bishkek.

²⁴ National Statistical Committee. *Kyrgyz Republic Demographic and Health Survey 2012*. Bishkek.

²⁵ As of November 2017, the department has filed only three of its five positions.

²⁶ The other members of EEU are Armenia, Belarus, Kazakhstan, and the Russian Federation. The total GDP of EEU is estimated at \$2.5 trillion with a population of 185 million.

²⁷ ADB. 2017. *Major Outcomes of the Two Years of Integration of the Kyrgyz Republic to the EEU*. Draft. The initial phase of accession to EEU was not free of political and administrative problems such as the trade and transit restrictions on the Kyrgyz–Kazakh border in late 2017, which was subsequently resolved.

the EEU norms. The Kyrgyz Republic still lags in compliance in tax administration with EEU's requirement. It needs to strengthen the capacity of fiscal bodies, increase transparency in budget revenue, streamline administrative procedures, and raise the tax discipline of business entities. Although the EEU market will continue to remain important given the geographical proximity, other export markets could also be developed through bilateral trade agreements and by exploiting the opportunities that will be created for domestic companies to join global value chains.

16. **Accession to European Union's Generalized System of Preference Plus.** In January 2016, the European Union (EU) granted the Kyrgyz Republic Generalized System of Preference Plus trade privilege, allowing for lower or zero tariffs on 6,000 products, primarily in agriculture, textiles and apparel. Exports to EU rose by 53% in 2016. According to government statistics, 50 Kyrgyz Republic enterprises exported \$68 million worth of products to EU countries during January–November 2016, including beans, garments, honey, nuts, and dried fruits, and mushrooms. This trade privilege has enabled the Kyrgyz Republic to diversify its export markets and products. However, this opportunity also presents challenges. The EU has complex rules and standards covering food safety, customs clearance procedures, product classification, and rules of origin. Further, the size of the EU market implies that domestic companies in Kyrgyz Republic should have the financial and production capabilities to be able to meet the demand volume requirements. Since the value chain of textiles and agriculture products starts at the regional or oblast level, the capacity of regional or oblast-level governments will need to be strengthened to support enterprises in their areas of responsibility. This can include providing timely and relevant information on EU product requirements and standards, sources of local financing to expand production, and skills requirements at the firm level.

17. **Environment protection for sustainable growth.** Predominantly mountainous, the Kyrgyz Republic is subject to extreme environmental conditions and vulnerability. Major environment-related challenges impacting sustainable development include land degradation, threats to agriculture production and food security, and natural hazards. There is a large unfinished agenda to ensure sustainable development. In the coming years, the government intends to strengthen risk-based environmental assessment of large manufacturing enterprises, restore natural ecosystems and sewage treatment facilities, introduce energy saving and green technologies, and adopt environmentally sound management of industrial and consumer waste. The country's focus on addressing climate change covers mitigation and adaptation measures. Priority adaptation measures were developed by the government in 2013 and covered water resources, agriculture, disaster risk management, forestry, and biodiversity.

18. **Overall assessment.** Poverty has declined but remains high. Inequality is low and falling. Growth in 2013–2017 was broadly inclusive and sustainable. However, the economic expansion was moderate and volatile because of the narrow manufacturing and export base, as well as excessive dependence on foreign remittances. Diversification of the economy's production capacity has not progressed much and a large proportion of the economy is still informal. Job creation has not kept pace with the annual addition to the labor market. The government allocated a high proportion of budgetary resources for social expenditures, especially health, education, and social benefits. However, the effectiveness of social sector expenditures needs to be rationalized. Gradually, the excessive burden on the budgetary resources can be reduced by greater involvement of the private sector through public–private partnerships (PPPs). Gender inequality remains a concern. The country has taken steps towards integration with the EEU, which has increased the market size, but substantive benefits have yet to accrue to the Kyrgyz Republic. Greater competition will eventually provide an opportunity for domestic firms to reap economies of scale and become more diversified. The recent renewal of ties with Uzbekistan in 2017 is significant, leading to an increase in trade and greater cooperation on transboundary

issues. In 2017, Uzbekistan was the fourth-largest export destination and the sixth-largest source of imports. The government is committed to tackling environment-related issues to make growth more sustainable. Institutions and governance needs considerable strengthening.

II. KEY IMPEDIMENTS FOR INCLUSIVE AND SUSTAINABLE GROWTH

19. The key challenges facing the Kyrgyz Republic in pursuing its goals of well-being for its people and creating safe and a favorable environment are (i) gradually increasing economic growth by diversifying the manufacturing and the export base, and promoting new growth drivers to create gainful employment; (ii) improving inclusivity of economic growth by aiming for balanced regional development, augmenting environmental sustainability, and enhancing governance for improving the quality of services; and (iii) strengthening regional cooperation initiatives. The government is working closely with development partners to address some of these challenges, which involve a combination of physical investments, institutional development, and governance and environment issues. ADB should push to increase the effectiveness of outcomes.

A. Support Growth and Economic Diversification

20. The main impediments are improving the availability and quality of infrastructure, increasing private sector participation, promoting new drivers of growth, and increasing the organizational capacity of government to sequence private investments around these new growth drivers.

21. **Leveraging energy endowments and potential.** The country's energy sector is characterized by a few large hydropower stations in the Naryn cascade. In addition to hydropower generation, the country has isolated local diesel generators and two coal and gas-fired heat and power plants in Bishkek in the north and Osh city in the south. These have collectively allowed the country to achieve 100% electrification. This system design was optimal when the central planners of the former Soviet Union developed the power system of the Kyrgyz Republic. Most of the major power generation was built in the 1970s. The skilled technical staff have maintained the power generation systems well, allowing the hydropower generators to work beyond their technical lives. However, the power distribution system has become the weaker link because of inadequate investments. On the consumer side, energy efficiency remains a problem as electricity is seen as an abundant cheap resource and consumers have almost no access to efficient appliances, except lights. The government plans to break out of the low-technology adoption mindset in the energy sector, introduce incentives to improve energy security, and reduce the overall cost of gasoline imports. Many people have switched to electricity for space heating as electric heaters are considered a cheaper solution because of the hydropower-based low tariffs, which is the reason for the shortage of power during winter. The city of Bishkek has piloted solar thermal technology for water and space heating, which could be adopted in the city to reduce the summer energy demand from residential customers.

22. Following the global trend in 1990s, the Kyrgyz Republic unbundled the energy sector into power generation, transmission, and distribution, and a regulator was appointed to set tariffs. Since there was no stated target from the unbundling exercise, it is hard to assess whether it achieved the intended outcome. Introducing competition in generation was not possible because of the overall small power system of the country and one generation plant—the Toktogul Hydropower Plant units—contributes close to 40% of power generation. Like most of the Central Asian countries, the Kyrgyz Republic energy sector depends on substantial direct and indirect subsidies. The sector is highly subsidized with the total cost of the energy sector subsidy at about 3% of the GDP in recent years. The National Energy Holding Company was established in 2016

to manage and coordinate sector companies, and the responsibility for energy policy was transferred to the State Committee for Industry, Energy and Subsoil Use. The government has focused on developing domestic energy resources, enabling demand management and loss reduction, pursuing tariff reforms, improving the financial performance of utility companies, encouraging private sector participation, and expanding regional power exports.

23. Improving transport connectivity to foster growth. Suboptimal transport networks remain an impediment to accelerating economic growth. Even so, the country's rankings and aggregate scores in the World Bank's Logistics Performance Index have improved recently. The aggregate score for 2018 was the second-highest that the Kyrgyz Republic has attained during 2007–2018.²⁸ With the exceptions of the two regional Central Asia Regional Economic Cooperation (CAREC) road corridors (Bishkek–Osh road and the Bishkek–Torugart road), the budgetary allocation is limited for maintaining the other roads at international standards.²⁹ Roads are also damaged by the adverse effects of climate change and require more investment in maintenance. The railway system is not integrated into the transportation system because of different gauge specifications of the Russian and the PRC systems. Effective transshipment facilities are required to facilitate international traffic through the country. The challenges include the slow pace of reforms related to attracting private investment for road maintenance, road safety, lack of an integrated transport system with railway gauge interoperability, and limited air connectivity to regional hubs. A master plan covering all three modes of transport (roads, railways, and aviation) has been developed for implementation up to 2025. While the master plan provides a long-term road map for the sector, the government's focus has been on roads since they account for about 95% of passenger traffic and more than half of freight traffic (footnote 29).

24. Persistent weak investment climate. Despite efforts by the government, ADB, and other development partners, the investment climate remains weak and has not adequately facilitated the diversification of the manufacturing sector. Preferential tax, financing, and regulatory treatment of micro, small, and medium-sized enterprises encourages domestic firms to remain small. This inhibits their growth, adoption of new technologies, competitiveness, and export orientation.³⁰ While these firms create jobs, these are low-paid informal sector ones. Because job creation in the formal sector has been inadequate, domestic labor is forced to migrate to neighboring countries in search of employment. Complex legal procedures and regulations discourage domestic firms from expanding and increasing productivity. New entrants get little encouragement and the informal nature of the economy remains large and intact.³¹ The country ranks 77th of 190 countries in World Bank's Ease of Doing Business index.³² The main problems cited are getting electricity, trading across borders, enforcing contracts, and resolving insolvency. Underlying these impediments is weakness in governance, particularly the prevalence of corruption. The government is aware of the importance of a stable and predictable investment climate in spurring private sector-led growth and reaping the potential benefits of EEU membership and broader regional cooperation. Attention is being paid to improving contract enforcement, strengthening property rights, reducing bureaucratic procedures, and fighting corruption. Aligning the tax structure for firms, including micro, small, and medium-sized

²⁸ World Bank. 2018. *Logistics Performance Index. Country Scorecard: Kyrgyz Republic 2018*. Washington, D.C.

²⁹ ADB. 2018. *Kyrgyz Republic. Sector Assessment (Summary): Transport*. Internal document.

³⁰ R. Mogilevski and I. Lukashova. 2017. *Promoting Good Jobs for Inclusive Growth in the Kyrgyz Republic: Policy Options*. Bishkek. Draft.

³¹ ADB. 2015. *Program Completion Report: Investment Climate Improvement Program*. Manila. The report noted, "Despite an improvement in the business environment, firms in the Kyrgyz Republic have had limited progress in developing new product capabilities: the number and sophistication of products exported with comparative advantage by Kyrgyz Republic firms has declined."

³² World Bank. 2018. *Doing Business 2018. Reforming to Create Jobs*. Washington D.C.

enterprises, will provide an incentive for firms to join the formal sector of the economy. Preferential treatment can be extended to small formal firms in access to credit, infrastructure, and inputs. Addressing these issues can take considerable time, as it involves introducing structural changes as well as overcoming resistance to change from entrenched interest groups.³³

25. **Underdeveloped finance sector adversely affects private sector development.** The sector is small with 24 commercial banks with total assets of \$2.62 billion as of December 2016, accounting for 87% of the financial system. Most of the banks are located around the cities of Bishkek and Osh, providing about 80% of credit to the private sector. Much of the remainder is covered by microfinance institutions whose registered borrowers account for 10% of the country's population. Total domestic credit to the private sector in 2017 was 23% of GDP, well below the average of about 43% for lower middle-income countries. Credit is concentrated around three urban centers—Bishkek, Osh, and Jalal-Abad— while most of the depositors are from Bishkek. Credit growth is constrained by high interest rates, short repayment periods, and high collateral requirements. More than half of the customer deposits are demand deposits; only about 10% have a tenor of more than 1 year. Much of the loans denominated in Kyrgyz som are concentrated in agriculture and trade. The share of foreign currency loans fell from 53.6% in 2013 to 44.0% in the end of 2017, while foreign currency deposits dropped from 53.7% to 48.7%. Although the economy is predominantly cash-based, regulations have been changed to increase electronic transactions through payment cards, ATMs, and point-of-sale terminals. The International Monetary Fund is working with government to strengthen the banking subsector.

26. **Inadequate effort to promote new drivers of growth.** The Kyrgyz Republic's reliance on gold mining, public investments, and remittances as key drivers of growth will need to decrease as it has progressively increased the vulnerability and volatility of the economy. New sectors, especially manufacturing industries and some from the services sector, will need to take the lead in driving stable economic growth. Given quality infrastructure, appropriate policies, and institutional framework, these enterprises could become the main job creators and diversify the export potential of the economy. The government's medium-term development strategy envisages considerable opportunities in the development of agribusiness (particularly livestock, fruits, and vegetables), tourism, and industrial clusters of consumer goods across regions involving textiles, apparel, leather products, and footwear. Although agricultural productivity remains low, export-oriented subsectors are emerging that have high potential for development.³⁴ Dry beans is the largest agricultural export with an average total export value of \$50 million during 2009–2016, followed by fresh milk and dairy product exports at \$20 million and cotton at \$19 million. These products are produced in different regions of the country and their promotion has implications for balanced regional development. Tourism in the service sector is emerging as a major contributor for expanding employment. Tourism's share of GDP was 4.8% in 2016. In 2014, Kyrgyz Republic received 2.8 million visitors, with an estimated total of US\$143 per arrival. The total number of international arrivals reached 3 million in 2015, of which 41% was for leisure. Although more than 80% of tourists come from Kazakhstan and the Russia Federation, their purposes and in-country destinations are diverse (footnote 34).

B. Improve Access to Public and Social Services

27. The major imperatives are (i) creating productive jobs in the formal sector; (ii) improving the quality of human resources to increase employability; (iii) raising health standards by focusing

³³ International Monetary Fund. 2017. *Letter of Intent from the Prime Minister of Kyrgyz Republic to the IMF at the conclusion of the Third Review of the Extended Credit Facility*. Washington, D.C.

³⁴ ADB. 2018. *Country Diagnostic Study for Kyrgyz Republic. Improving Growth Potential*. Manila.

on water supply, sanitation, and urban development; and (iv) assisting in creating new growth centers. Inclusivity will also increase by improving governance and addressing concerns on agriculture, environment, and climate change. These are also the focus of the national development strategy.

28. Inadequate productive job creation in the formal sector. Absorption of labor in more productive jobs requires an improvement in the educational system. Skill creation needs to be more closely aligned with the labor market. The focus of the government's medium-term strategy, 2018–2022 is to create jobs in agro-processing and sustainable tourism, and by developing consumer goods clusters. Investments to improve agricultural value chains, post-harvest technologies, and logistics are planned. Tourism will be promoted by adopting appropriate policies, regulations, and road maps, with focus on regional tourism. Cluster development in consumer goods will be prioritized. These are to consist of the textile cluster for cotton and silk in Osh and Jalal-Abad; leather, wool and meat products cluster in Naryn; and a footwear cluster in Bishkek city. The education system faces challenges of old infrastructure, outdated teaching content, insufficient teacher training, and lack of effective quality control. It needs to shift towards a greater role for private institutions at the primary and secondary professional level. The scope for PPPs needs to be further explored. Periodic monitoring, analysis, and adjustment will be needed to add to the quality of the education and skills development program. Policy options will have to be developed for integrating primary and secondary technical and vocational education and training (TVET), deploying an integrated education management information system, and institutionalizing centers of excellence.³⁵ The competency-based training system, which was introduced in 2011 with ADB support and a key step in addressing skills mismatch in labor markets, needs to be scaled up.

29. Access and quality of water supply and sanitation systems are suboptimal. While the percentage of the population with access to safe drinking water was 89.9% in 2016, those with access to improved sanitation and centralized sewerage was only 30.2%. The lack of access to basic services has a disproportionately higher negative impact on women. Even in areas that are connected to water supply systems, the reliability of service remains an issue. Water quality is also inadequate: almost 42% of the rural water is untreated.³⁶ The ability of the sector to self-finance expansion and improve the quality of water is limited by substantial water loss and nonrevenue water. The government estimates that water-related diseases cost the country about \$70 million annually. Local governments are responsible for water supply, wastewater treatment, and sanitation. In urban areas, the systems are run by *vodokanals* (water companies); in rural areas, these functions are with local governments with weak capacity (footnote 36). A central government agency is necessary to ensure that appropriate standards are observed across the water sector, minimum quality is assured, and full cost-recovery tariffs charged. Legal amendments are needed to make local governments fully responsible for the provision of water, including tariff-setting and meeting service standards. Water treatment and sanitation in rural areas remain unresolved challenges and need to be addressed on a priority basis.³⁷

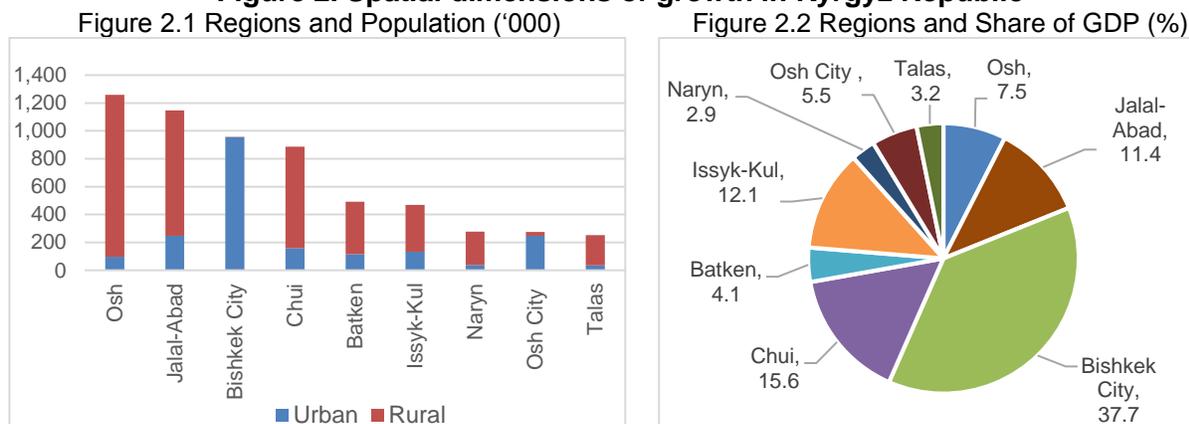
³⁵ In the Kyrgyz Republic, lyceums provide primary TVET to develop skilled workers, while colleges provide secondary TVET to develop middle-level specialists. Students who wish to enter primary or secondary TVET must complete grade 9. Currently there are no pathways for students between these two levels, thus secondary TVET does not follow from primary TVET. About one-third of colleges providing secondary TVET are affiliated with higher education institutions. When entering higher education, graduates of these colleges are given credit for their previous education.

³⁶ ADB. 2018. *Kyrgyz Republic. Sector Assessment: Water Supply, Sanitation, Urban Sectors (Summary)*. Manila. Internal document.

³⁷ There is a high correlation between poverty and lack of access to water supply. An ADB study found two-thirds of the rural population without access to water supply lives in Jalal-Abad and Osh oblasts, where poverty is the highest.

30. **Lack of urban development has decelerated creation of new growth centers.** About 33.7% of the country's population lives in urban areas. Bishkek (population 1 million) in the north and Osh (population 400,000) in the south are the two largest cities, accounting for about 60% of the total urban population and about 45% of the country's GDP.³⁸ The three southern regions of Osh, Jalal-Abad, and Batken, which account for close to half of the country's population, contribute less than 30% of the country's GDP (Figure 2.1 and 2.2). In response, the government has developed the concept of Regional Policy of the Kyrgyz Republic, 2018–2022. The objective here is to develop economically competitive clusters of SMEs that use local raw materials available to develop the respective regions. Successful implementation is expected to narrow the gap between the more prosperous northern regions (Bishkek, Chui, and Issyk-Kul) and the economically deprived southern regions (Osh, Jalal-Abad and Batken). Twenty regional development centers, or growth points, have been identified with potential for development; in the initial phase, 5–6 will be developed. Improving agriculture through new irrigation projects and providing better maintenance of existing projects will receive renewed focus. Regional and strategic roads will be developed to facilitate trade. With a conducive investment climate and better infrastructure, agro-industrial clusters are expected to be potential growth drivers. Other areas for development are tourism, livestock breeding, construction, petrochemical, medical equipment, and pharmaceuticals. The government will take measures to improve the tax regime and strengthen public administration capacity of local governments. Decentralization will also be pursued. While the government will undertake infrastructure development, private enterprises (including in manufacturing) will be encouraged by utilizing the PPP modality. Human resource development in the identified growth points will be prioritized. Regional development is expected to create jobs, thus reducing the incentive for migration.

Figure 2. Spatial dimensions of growth in Kyrgyz Republic



GDP = gross domestic product.

Source. National Statistical Committee of the Kyrgyz Republic and Regional Policy Conception of Kyrgyz Republic.

31. **Weak governance is an impediment to sustainable development.** Various public financial management (PFM) indicators suggest some improvement over 2009–2015, with the exception of policy-based fiscal strategy and budgeting.³⁹ The budget process has become more credible, comprehensive, and transparent, with better accounting, recording, and reporting. The following PFM weaknesses related to budgets were identified: (i) the composition of expenditure

³⁸ The urban areas consist of 25 cities and towns—2 national-level or large cities (with population over 100,000), 4 medium-sized (with population 50,000–100,000), and 19 small towns (with population less than 50,000). Four towns—Jalal-Abad, Karakol, Tokmok, and Uzgen—account for another 15% of the urban population. The remaining 25% of the urban population is spread across 19 small and medium-sized towns, implying a dispersed population.

³⁹ World Bank. 2015. Kyrgyz Republic Public Expenditure and Financial Accountability Report. Washington, D.C.

shifts during implementation, (ii) a tracking system for payments arrears is not in place, (iii) accurate program costs are not estimated, (iv) limited progress has been made in medium-term fiscal planning, (v) national accounting and reporting standards for the public sector are not developed, and (vi) training needs of various ministries have not been undertaken. Some progress is reported in transparency in taxpayer obligations and effectiveness of tax administration. The government has adopted a Public Financial Management reform strategy for 2016–2025, complemented with a strategy for developing corporate financial reporting and audit for 2014–2020. Steps were taken to strengthen public procurement. The government enacted a new public procurement law in 2015, which sought to introduce modern procurement methods and enhance disclosure of information and data. An e-procurement portal was developed and made operational in 2014 with ADB support.⁴⁰ However, the government has initiated some amendments to the public procurement law that will include specific provisions to use direct contracting in certain instances and emergencies, despite concerns raised by multilateral and bilateral development partners. These amendments are before parliament and have not yet been made. The government has also taken steps to reduce corruption.⁴¹ The World Economic Forum’s 2017–2018 Global Competitiveness Report identified corruption as an impediment to doing business. To counter corruption, the government plans to make greater use of technology.

32. Greater use of information and communication technologies to improve interaction between government, businesses, and users of public services is envisaged under the Taza Koom digital transformation program. The program also involves rolling out a regional fiber optic network to improve digital connectivity, increase digital transactions, and improve service delivery to communities and businesses. An action plan approved in August 2017 identified activities including the Digital Central Asia South Asia (CASA) project with World Bank support, an interoperable information technology platform that connects all ministries to support service delivery to businesses and communities, and e-security. Nevertheless, capacity of the State Agency for Information Technologies and Communications, which is the agency leading the activities in this area, is weak and needs strengthening.

33. **Water resources sector most vulnerable to climate change.** In 2015, hydropower sources accounted for 3,068.5 megawatts of the total 3,920 megawatts of installed power generation capacity. As a result, the per capita greenhouse gas emissions are estimated to be less than a third of the global average. However, the Kyrgyz Republic is vulnerable to the adverse effects of climate change, particularly in agriculture, water resources, and energy. The country requires considerable investments for climate change adaptation to reduce risks to critical infrastructure, vulnerable communities, natural ecosystems, and services.⁴² The water resources sector is most vulnerable and estimated to account for more than half of total economic losses in the absence of climate change adaptation actions.⁴³ Disasters triggered by natural hazards like floods and earthquakes are frequent and estimated to cost the country 1%–1.5% of the GDP annually. Water-related disasters include droughts in northern districts (such as those experienced in 2009 and 2014), landslides (2003, 2004, 2017), and flooding (2007 and 2012) in

⁴⁰ ADB. Kyrgyz Republic: Implementing the e-Procurement System. <https://www.adb.org/projects/46397-001/main>

⁴¹ The Transparency International’s Corruption Perception Index (CPI) ranks the country 135 of 180 countries in 2017. Some improvement has taken place since 2012 when the rank was 154 of 176 countries.

⁴² ADB. 2016. *TA-8119 REG: Economics of Climate Change in Central and West Asia – Adaptation Component (Co-financed by the Asian Clean Energy Fund under the Clean Energy Financing Partnership Facility and the Climate Change Fund)*. Manila.

⁴³ Government of Kyrgyz Republic. 2015. *Nationally Determined Contributions for UN Framework Convention on Climate Change*. Bishkek.

southwest districts.⁴⁴ Each year the country has more than 3,000 earthquakes, of which 10–20 have magnitude of more than 5 (footnote 44). The country’s geographic remoteness is exacerbated by its topography: more than 90% of its territory is mountainous, with half of it averaging more than 2,500 meters in elevation.

34. The Kyrgyz Republic is located at the heart of the Central Asian biodiversity hot spot and home to 1% of world species and 3% of the world fauna.⁴⁵ In addition to the country’s difficult topography, agriculture is constrained by waterlogging, salinization of irrigated land, and pollution from chemicals. Overgrazing and deforestation of lands contribute to soil erosion and especially affect dryland agriculture. The poor technical condition of irrigation and water distribution systems needs priority attention, as it is leading to water loss. Encouraging resource-preserving, low-waste technologies and green business are priorities. Adequate finance for these is a challenge. To address this, a Secretariat on Climate Finance is planned to be established.

C. Leverage Regional Cooperation and Integration

35. As part of the ongoing CAREC work on economic corridors, ADB has supported the Almaty–Bishkek Economic Corridor (ABEC) to spur economic growth and create jobs through greater private investments, trade, and agglomeration of economic activities.⁴⁶ An investment framework assessment has been further developed under ABEC.⁴⁷ The success of ABEC will depend on the government’s organizational ability to guide the identification of new growth drivers, create a supporting environment for private sector development, and formulate planning pathways to sequence private investments around these new identified drivers. Further, free trade zones and industrial parks can complement the development of economic corridors in promoting balanced regional growth. Integration with EEU will also provide a push to regional cooperation.

36. The findings of a diagnostic study sponsored by ADB and CAREC focusing on five existing free trade zones concluded that they had limited success because of gaps in planning and development. Free trade zones and industrial parks, if properly planned, executed, and managed, have the potential to break the vicious cycle of low productivity and narrow manufacturing base by providing domestic firms an incentive to become part of global value chains, attract foreign investment and technology, and reap economies of scale by agglomeration.⁴⁸ The comparative advantage of different regions in becoming part of global value chains needs to be identified, and these zones need to be provided with high-quality infrastructure and simple administrative procedures and regulations, including incentive packages based on clear criteria. Initially the country could become part of the regional and cross-border value chains taking advantage of EEU membership.

37. Cross-border cooperation is an essential element of the transport and energy security for the region. Regional interdependence in the past was dictated by the geographical allocation of resources and strategies used by central planners of the former Soviet Union to design and develop those resources.

⁴⁴ ADB. Kyrgyz Republic: Climate Resilience and Disaster Risk Reduction in Water Resources Management. Project Concept Paper <https://www.adb.org/projects/51081-002/main>

⁴⁵ ADB. 2010. *Central Asia Atlas of Natural Resources. Chapter on Kyrgyz Republic*. Manila.

⁴⁶ ADB. 2014. *Operationalizing Economic Corridors in Central Asia: A Case Study of Almaty-Bishkek Corridor*. Manila.

⁴⁷ Growing Together, Almaty-Bishkek Corridor Initiative Investment Framework (October 2016).

⁴⁸ CAREC. 2018. *Diagnostic Study and Strategic Framework for Free Economic Zones and Industrial Parks*. Manila.

III. IMPLICATIONS FOR ADB COUNTRY ENGAGEMENT

38. The government is formulating its long-term development strategy, 2018–2040 and recently approved its medium-term strategy for 2018–2022 (Unity, Trust, Creation). The foundations of these are in the framework of the National Sustainable Development Strategy, 2013–2017. The medium-term strategy's main goals are improving public administration so that the government serves the people well; creating an economic basis for the well-being of the people; developing the strategic sectors of the economy; developing human capital; addressing cross-cutting concerns (gender and environment); and prioritizing national development programs and projects (Taza Koom, development of regions, social protection schemes, reforms of law enforcement agencies, and maintaining peace and development). These broad objectives are aligned with ADB's Strategy 2030.⁴⁹

39. As the lead partner, ADB needs to take a medium-term perspective to support government efforts to achieve broad-based growth that is less susceptible to the adverse effects of exogenous shocks. Simultaneously, ADB's support needs to ensure that growth is more inclusive and contributes to more job creation domestically. Further, regional cooperation needs to be leveraged so that the economy of the Kyrgyz Republic can gain to the maximum extent possible from new trade opportunities. Within this broad framework, ADB's engagement will have to be closely aligned with (i) the government's development strategy, (ii) the broad thrust of ADB's Strategy 2030, (iii) ADB's comparative advantage, and (iv) lessons identified from past ADB operations as noted in the country partnership strategy final review for Kyrgyz Republic covering 2013–2017 with a clear focus on its recommendations.⁵⁰ ADB's interventions also need to complement efforts of other development partners. Since ADB's resources are limited and the needs of the country in financing its development strategy are large,⁵¹ ADB's engagement needs to focus on addressing some of the priority constraints.

40. ADB should factor in spatial dimensions in its planned strategic approach and program during 2018–2022. Much of the population (6.1 million in 2017) is concentrated in the Chui valley along the Kazakhstan border in the north and the Fergana valley in the south. The Tien Shan and Pamir mountains dominate the topography and divide the country into the northern zone (Bishkek, Talas, Chui, Issyk-Kul regions) and the southern zone (Jalal-Abad, Osh, Batken regions). Given their economic disparities, a programmatic approach focusing on a lagging region could be attempted with ADB support sequenced around new growth nodes.

41. Based on the national development priorities, ADB's comparative advantage, and ongoing operations, ADB could explore a country-focused and differentiated three-pronged approach in the CPS, 2018–2022 as follows:

(i) **Pathways for ADB to support growth and economic diversification.** ADB could continue to support infrastructure development in the energy and transport sectors. Its engagement in the energy sector should aim to gradually expand ADB's footprint on rehabilitation of the country's flagship hydropower plants. ADB's transport interventions would need to focus on cross-border roads that facilitate development of CAREC transport corridors and continue with the ongoing support for operations and maintenance of road projects and climate-proofing

⁴⁹ ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

⁵⁰ ADB. 2018. *Country Partnership Final Review: Kyrgyz Republic, 2013–2017*. Manila.

⁵¹ The resource requirements for financing in the country's medium-term development program, 2018–2022 are not specified. The program document does not indicate the potential financing sources. From the range of issues that the program aims to address, it can be inferred that the resource requirements will be large.

construction to ensure sustainability. ADB should assist the government with institutional reforms in the energy and transport sectors. ADB could also assist private sector development while continuing to improve the investment climate. In collaboration with the International Monetary Fund and other development partners, ADB could help strengthen the country's finance sector. ADB would need to consider support for government on identifying and promoting potential growth drivers. There is also a need to continue sustained programmatic approach for policy-based loans to improve economic diversification. These should be supplemented with knowledge support to identify new growth drivers.

(ii) **Pathways for ADB to improve access to public and social services.** To make growth more inclusive, sustained support is needed to improve the delivery of basic services such as water supply and sanitation services in selected areas, enhance employability of the population through skills development, and strengthen climate change resilience. ADB would need to continue to improve the education system so that workers can be absorbed in productive jobs in the formal sector. ADB investments could provide access and improve the quality of water supply to enhance health indicators. Urban development efforts would also need to be made to stimulate new growth centers. Particular effort should be made to improve governance and manage the adverse effects of climate change. ADB would need to build on the current approach of gender mainstreaming in the design and implementation of its projects. In addition, the program should include targeted interventions to empower women in areas such as social sectors (education and health), financial inclusion, and job creation. In line with the approach of ADB's Strategy 2030, interventions in the CPS period would need to focus on women's economic empowerment, gender equality in human development, reduced time poverty of women, increasing women's resilience to external shocks, and gender equality in decision-making.

(iii) **Pathways for ADB to leverage regional cooperation and integration.** ADB should catalyze solutions that enable the country to better leverage regional cooperation in its national development priorities. Under CAREC, ADB has experience in developing regional transportation links and accompanying logistics and promoting energy trade. These initiatives will be continued. ADB has taken the regional cooperation process forward through planning support for the ABEC. Under ABEC, ADB will pilot investment projects in Almaty, Bishkek, and the surrounding regions to improve coordination, increase regional specialization, and generate economies of scale for exports of services and food products. Cross-border agriculture value chains could be developed, and regional tourism promoted for private sector involvement using the PPP modality. In addition, ADB can continue to play a proactive role in assessing the impacts from integration of the Kyrgyz Republic into the EEU. Although the country acceded to the EEU in August 2015, it has yet to yield gains in diversification of industry and increased competitiveness in order to expand exports to a larger market. ADB could also support the planned financial sector integration within EEU.