ASIAN DEVELOPMENT BANK

RRP: KGZ 29149

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON

PROPOSED LOANS

AND A

TECHNICAL ASSISTANCE GRANT

TO THE

KYRGYZ REPUBLIC

FOR THE

CORPORATE GOVERNANCE AND

ENTERPRISE REFORM PROGRAM

August 1997

CURRENCY EQUIVALENTS

(as of 15 August 1997)

Currency Unit - Som

1SOM = $0.0579
$1 = SOM17.2778

The exchange rate of the som is determined by the National Bank of the Kyrgyz Republic under a managed float system. In this Report, the rate of $1.00 = SOM17, the rate prevailing during appraisal, has been used.

ABBREVIATIONS

CDC	–	Corporate Development Center
DESD	–	Department of Economic Sector Development
EBRD	–	European Bank for Reconstruction and Development
EF	–	Employment Fund
FDI	–	Foreign Direct Investment
FINSAC	–	Financial Sector Adjustment Credit
FSU	–	Former Soviet Union
GDP	–	Gross Domestic Product
IAS	–	International Accounting Standards
IMF	–	International Monetary Fund
JSC	–	Joint Stock Companies
KNEHC	–	Kyrgyz National Energy Holding Company
MLSP	–	Ministry of Labor and Social Protection
MOF	–	Ministry of Finance
NAK	–	National Aviation Company
NBKR	–	National Bank of the Kyrgyz Republic
NCSM	–	National Commission on Securities Markets
PESAC	–	Privatization and Enterprise Sector Adjustment Credit
PMO	–	Prime Minister's Office
SOE	–	State Owned Enterprise
SPF	–	State Property Fund
TA	–	Technical Assistance
UNDP	–	United Nations Development Programme
USAID	–	United States Agency for International Development

NOTES

(i) The fiscal year of the Government ends on 31 December.

(ii) In this Report, "$" refers to US dollars.

CONTENTS

LOAN AND PROGRAM SUMMARY

Borrower : Kyrgyz Republic

The Proposal : A Program to support corporate governance and enterprise reform, and a technical assistance (TA) loan to support the Program in the area of capacity building in corporate governance and insolvency proceedings.

The Program

Rationale : There is a pressing need to reform the policy and legal environment for the enterprise sector to strengthen competitiveness and to improve corporate governance of enterprises. These reforms will provide the incentives to adopt modern management practices and technology. They will thus contribute to improving the internal efficiency of enterprises and their long-term competitiveness in a dynamic market environment. The Program will complement the Government's macroeconomic stabilization and financial sector reforms that are supported by the International Monetary Fund and the World Bank, respectively.

Objective : The Program will improve the performance and efficiency of the enterprise sector so that it will be viable in a competitive market-based economy.

Scope : Improved efficiency is to be achieved through enterprise reforms that strengthen the incentives for better performance through improved corporate structure and governance in all enterprises, both public and private. The Program will develop and implement guidelines for best practice in corporate governance, including statutory mechanisms for their enforcement. All enterprises, public and private, will be cut off from subsidized loans from the budget, required to seek new financing on commercial terms without direct or indirect Government guarantees, and faced with competition to the extent possible. The Program will also expedite liquidation and restructuring to eliminate the deadweight of nonviable enterprises, promote the rapid redeployment of viable assets, and serve as an incentive for better management performance. The legal framework and implementation capabilities for insolvency procedures will be strengthened. The Program is unlikely to have any additional impact on unemployment. It will lead to recognition of the loss of employment that has already occurred and will address the related social costs of adjustment.

Classification: Economic Growth

Environmental Assessment : Category C. The environmental implications of the Program are minimal.

Bank Assistance

A. Program Loan

Loan Amount and Terms : A loan of SDR28,964,000 ($40 million equivalent) will be provided from the Bank's Special Funds resources to support a program of reforms in the enterprise sector. The loan will have a repayment period of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum.

Program Period and Tranching: The Program period will be three years. The loan will be released in two equal tranches. The first tranche will be made available upon loan effectiveness. The second tranche is expected to be released by May 1999, depending upon satisfactory implementation of the agreed conditions.

Executing Agency : The Department of Economic Sector Development

Procurement : In the case of goods commonly traded on international commodity markets, procurement will be undertaken in accordance with normal commercial procedures appropriate to the trade and acceptable to the Bank. Procurement of goods for which contracts are less than $5 million will be based on normal commercial practices for procurement by the private sector or Government procurement procedures acceptable to the Bank for procurement by the public sector. Each supply contract for eligible imports estimated to cost $5 million or more will be awarded through international competitive bidding procedures in accordance with the Bank's *Guidelines for Procurement*. Procurement of goods in excess of the international competitive bidding threshold will be subject to Bank review after award of the contract but prior to disbursement. Contracts valued at less than $5 million will be subject to post review by the Bank.

Disbursement: The proceeds of the loan are expected to be disbursed against a broad range of imports, subject to a negative list of items. The proceeds may be disbursed to finance eligible expenditures incurred within 180 days prior to loan effectiveness.

	Counterpart Funds :	Counterpart funds to be generated from the proceeds of the loan will provide budgetary support that will be used to help finance the costs of adjustment.
B.	**TA Loan**	
	Loan Amount and Terms :	A TA loan of SDR2,896,000 ($4 million equivalent) will be provided from the Bank's Special Funds resources for capacity building in corporate governance and insolvency procedures, and to implement a public information and education project to strengthen stakeholder commitment. The loan will have a repayment period of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum.
	Implementation Period :	The TA will be implemented over a period of 18 months.
	Executing Agency :	The Department of Economic Sector Development
	Consulting Services :	The TA loan will finance the provision of international consulting services for the advisory and training activities required for the development of corporate governance frameworks, and upgrading insolvency implementation capabilities of the judiciary and court system. It is estimated that about 67 person-months of international consulting services and about 176 person-months of domestic consulting services will be required. The consultants will be recruited in accordance with the Bank's *Guidelines on the Use of Consultants* and other arrangements satisfactory to the Bank for the engagement of domestic consultants.
	Procurement :	Procurement of goods and services to be funded out of the TA loan will be subject to the provisions of the Bank's *Guidelines for Procurement*. Generally this will mean that supply contracts for equipment or materials will be awarded on an international shopping basis, except in the case of minor items where off-the-shelf purchases will be permitted. Any civil works financed under the TA loan will be on a local competitive bidding basis.
C.	**TA Grant** :	Policy formulation and implementation capabilities will be strengthened by advisory TA in the amount of $800,000. The TA will be financed by the Bank on a grant basis from the Bank-funded TA program. It is estimated that about 21 person-months in international consulting services will be required. The

consultants will be engaged in accordance with the Bank's *Guidelines on the Use of Consultants*.

Risks and Safeguards :

The major risk to the successful implementation of the Program is that some groups may seek to undermine the content and timing of the reforms if they see themselves as being adversely affected. Groups that will have their power reduced or subject to greater accountability could resist the implementation of the Program. However, most employees of enterprises likely to be taken through bankruptcy are not now being paid and as unemployment benefits and retraining will be available, formal bankruptcy procedures will not face opposition from workers. Another important risk is that the Government may not be able to sustain macroeconomic stability. High and sustained budget deficits may raise inflation and real interest rates and contribute to increased uncertainty that will be detrimental to enterprise performance. Finally, the implementation of best practice corporate governance principles may proceed more slowly than anticipated. The risk of opposition by vested interests will be mitigated by the Government's strong commitment to the Program, and activities under the loan that will help to facilitate the understanding and cooperation of stakeholders. The macroeconomic risks will be mitigated by the Government's strong commitment to stabilization programs under the International Monetary Fund and World Bank auspices. The third risk will be mitigated by an ongoing Bank TA, as well as by further assistance to be provided through the TA loan.

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on (i) a proposed loan to the Kyrgyz Republic for the Corporate Governance and Enterprise Reform Program; and (ii) a proposed technical assistance (TA) loan to the Kyrgyz Republic for Capacity Building for Corporate Governance and Bankruptcy Procedures. The Report also describes a TA grant for Capacity Building in the Prime Minister's Office, and if the proposed loans are approved by the Board, I, acting under the authority delegated to me by the Board, shall approve the TA.

II. INTRODUCTION

2. The Bank's operations in the Kyrgyz Republic have focused on supporting the country's transition to a market-based economy. At the core of the transition process is a fundamental reorientation of enterprises and the incentives influencing their behavior, including the introduction of profitability as a guide for operational success and the incorporation of effective corporate governance mechanisms. In view of the clear need for crystallizing the incentive structure and achieving needed improvements in corporate governance, the Government has sought Bank assistance to support a program of reforms to improve the efficiency of the enterprise sector.

3. A Reconnaissance Mission for the proposed Program was undertaken in October 1996, and a Fact-finding Mission in November 1996. In December 1996, the Bank approved a small-scale TA to help the Government prepare and implement an important part of the Program.[1] An Appraisal Mission was fielded during 14-30 April 1997.[2] This report is based on the findings of the Bank missions, various Bank-funded studies pertaining to enterprise, trade, and other reforms;[3] and discussions with staff of the Prime Minister's Office (PMO); Ministry of Finance (MOF); State Property Fund (SPF); Ministry of Foreign Trade and Industry; National Bank of the Kyrgyz Republic (NBKR); Ministry of Justice; the National Commission on Securities Market (NCSM); World Bank; and other aid agencies. The Program Framework is in Appendix 1.

---

1 TA 2712-KGZ:*Preparation and Implementation of Guidelines on Best Practice in Corporate Governance*, for $100,000, approved on 13 December 1996.

2 The Mission consisted of J. Ahmed (Project Economist/Mission Leader); R. Boumphrey (Senior Economist); R. Clendon (Senior Counsel); H. Wang (Economist); R. Moreland (Consultant, Social Impact Assessment); and K. Krupka (Consultant, Corporate Governance Public Information and Education). This Mission was assisted by C. Lin (Consultant, Corporate Governance), and D. Morris (Consultant, Corporate Governance) who were in the field in connection with TA 2712-KGZ. The Mission was assisted also by A. Shea (Consultant/Legal Expert) relative to the legal framework, and by W. Schelzig (Programs Manager), and J.C. Alexander (Senior Programs Officer) who were in the field at the Mission's commencement. The Mission was joined in its final stages by R. Adhikari (Economist) and by P.M. Dickie (Director, Infrastructure, Energy and Finance Department, East).

3 Including TA No. 2297-KGZ:*Industry and Trade Sector Study*, for $600,000, approved on 3 February 1995. This advisory TA helped the Government analyze a range of issues pertaining to the competitiveness of manufacturing activities and the economic implications of proposals to join a customs union with Russia.

III. THE MACROECONOMIC CONTEXT

A. Development Objectives and Strategy

1. Systemic Transformation

4. The current period of transition for the Kyrgyz Republic has been difficult. With the breakup of the former Soviet Union (FSU), the economy was subject to massive shocks resulting from the termination of fiscal transfers from the FSU, a sharp deterioration in the terms of trade, and a drastic decline in the volume of trade. Since 1991 the Government with support from the Bank; the International Monetary Fund (IMF); and the World Bank, has undertaken a program of reforms aimed at macroeconomic stabilization and systemic reforms. The systemic reforms have covered a wide range of activities such as privatization; financial sector reforms; the elimination of controls in pricing, trade, and distribution; and the development of the legal system. The stabilization measures have contributed to arresting the hyperinflation of 1992 and 1993, leading to a decline in the annual inflation rate to manageable levels; liberalization of the exchange regime; and greater control over public expenditures. However, the country's independence was accompanied by a sharp contraction in output with gross domestic product (GDP) declining cumulatively by approximately 50 percent between 1990 and 1995. Over the same period, industrial output declined by almost 70 percent.

5. The economic difficulties have contributed to extreme hardship for the majority of the population. With the breakup of the FSU, lifetime employment for virtually all labor force participants has been rep (laced by widespread job insecurity. Although only 5 percent of the labor force was recorded as unemployed at the end of 1995, many more were estimated to lack work or to have only part-time employment. Spending on social insurance, social assistance, and social services such as health and education has declined sharply in real terms.

6. Prior to independence in August 1991, decisions concerning the Kyrgyz economy, which ranked among the poorest in the FSU, were made in Moscow.[1] Within the Soviet-style command economy, demand was determined by central planners in Moscow with production capacity being the key constraint to output expansion. The economy was highly dependent on trade with the rest of the FSU both for supplies of inputs and for markets for its outputs. A sizable net negative resource balance in the Kyrgyz economy was met through significant fiscal and material transfers from Moscow. Characteristic of the Soviet system, farms and firms were highly inefficient by international standards, protected by the inward-looking trade patterns of the FSU.

7. These initial conditions meant that at the time of independence the Kyrgyz economy was (i) highly vulnerable to exogenous shocks, (ii) dependent upon subsidies for Government fiscal operations, (iii) dependent upon transfers to balance the external account, (iv) lacking in institutions for monetary and fiscal control, and (v) based on enterprises that were intrinsically inefficient. The breakdown of the FSU then resulted in a collapse of output in the Kyrgyz economy as (i) external demand declined, (ii) FSU interrepublican trade and payments systems were disrupted, (iii) transfers from Moscow ceased and domestic production subsidies proved unsustainable, and (iv) there was a sharp deterioration in the terms of trade as the

---

[1] Industry in the Kyrgyz prereform economy was fairly narrowly based, comprising mainly textiles, clothing, and leather goods (27 percent of total industrial output); industrial engineering (25 percent); food processing (24 percent); electricity (4 percent); and mining (4 percent).

relative price structure moved into line with international levels. The terms of trade deteriorated by about 40 percent in 1994-1995.

8. As a result of these structural problems, after independence the Kyrgyz Republic experienced a severe depression. From 1990 to 1995, GDP declined by more than one half in real terms. All the major sectors (agriculture, industry, and services) suffered during the long depression. Industry, which accounted for 34 percent of GDP in 1990, experienced the sharpest fall in output, by an average of 28.7 percent per annum from 1991 to 1994 and by 12.4 percent in 1995.

2. Macroeconomic Stabilization Policies

9. With independence there was almost immediate cessation of budgetary support from Moscow that traditionally averaged between 11-12 percent of GDP. The budgetary position was further undermined by the output collapse that diminished the tax base and revenues. Despite these adverse circumstances, since 1993 the Government has tackled its fiscal crisis by implementing measures to boost revenues, while restricting and restructuring expenditures. While there have been signs of progress, the fiscal situation has remained extremely difficult, with the budget deficit widening to 9.5 percent of GDP in 1995.

10. On the expenditure side consumer subsidies have been nearly eliminated, wage increases in the public sector restricted, and the size of the civil service reduced. The Government has tried to minimize the impact of the fiscal crisis on social sector expenditure. In the 1996 budget, social protection and social sector spending amounted to 58 percent of total expenditures. However, given the contraction in GDP in the period 1991-1995, the level of real resources committed by the Government for social sector spending is less than the level before independence.

11. The Government has achieved signal success in reducing inflation. Hyperinflation characterized all countries using the Russian ruble in the years immediately following the collapse of the Soviet Union. In May 1993, the Government moved to develop the tools of monetary control with the introduction of the national currency (the som). In 1994, deposit and credit interest rates were liberalized, directed credits largely discontinued, and domestic bank financing of the budget deficit was sharply curtailed. The tight monetary stance succeeded in bringing inflation down to around 3 percent per month in the second half of 1994, or to about 87 percent annually by the year-end. The annual rate fell to 30 percent by the year-end in 1996. Interest rates have followed a similar downward path.

B. Medium Term Economic Prospects

12. Steps have been taken to reform the banking system through the liquidation of two insolvent state banks (Elbank and Agroprombank) in 1996 and the restructuring of two other troubled banks (Promstroibank and AKB Kyrgyzstan). The country has liberalized its trade system and realized current and capital account convertibility of the som. Because of improved macroeconomic management, IMF's Board approved its third annual Enhanced Structural Adjustment Facility arrangement with the Kyrgyz Government in March 1997.

13. The Kyrgyz economic prospects over the medium term appear promising (see Table 1). The progress made on macroeconomic stabilization and structural reform has laid a basis for the country's economic recovery and development. Real GDP is expected to grow by 4 to 5 percent annually from 1997 to 1999. The growth in GDP is likely to be driven by

continued growth of investment, particularly in the agriculture, energy, and mining sectors. While public investment is projected to increase with the expansion of the public investment program over the medium term, the ongoing stabilization efforts and structural reform are expected to promote private investment. Investment will continue to be financed by domestic savings and foreign funds. Domestic public savings are projected to increase as the consolidated fiscal deficit is reduced and the share of capital spending in public expenditures increases. Private savings are also expected to grow because of the continued decline in inflation and the financial sector reform.

Table 1: Medium-term Projections for Key Macroeconomic Indicators

Item	1996 actual	1997	1998	1999
Real GDP Growth (%)	5.6	7.0	5.0	5.5
Investment (% of GDP)[a]	14.0	19.0	20.0	21.0
Savings (% of GDP)[a]	2.0	3.0	5.0	7.0
Budget Deficit (% of GDP)	-5.9	-5.4	-3.7	-2.7
Inflation (%, annual average)	30.3	25.0	15.0	10.0
Current Account Deficit (% of GDP)[b]	-24.4	-13.6	-10.0	-9.0
Gross Official Reserves (months of imports)	1.7	2.8	2.8	2.9
External Debt (% of GDP)	35.2	57.0	62.0	67.0
External Debt-service Ratio (%)	12.2	10.0	13.0	11.0

a Excluding the Kumtor gold mining project.
b Including official transfers.
Sources: Kyrgyz authorities, IMF, and staff projections.

14. Inflation is projected to decline from 30 percent in 1996 to 10 percent in 1999. To reduce inflation, the Kyrgyz authorities are committed to maintaining the present tight monetary policy to control the growth of money supply and credit.

15. Unemployment and poverty issues will remain a concern over the medium term. Employment growth is expected to be sluggish at the initial stage of economic recovery, because firms generally make full use of their existing labor before hiring new workers. There are also large numbers of redundant workers in many farms and enterprises, especially in the social sectors, such as education and health. With the ongoing restructuring of enterprises and the deepening of social sector reforms, many of these redundant workers are expected to become unemployed. Thus, open unemployment and the proportion of the population living in poverty are likely to increase during 1997-1999.

16. While there have been important achievements in macroeconomic stabilization, a recently emerging concern has been the provision of loans to enterprises. While directed lending through the banking system has been eliminated, since 1993 the Government has provided substantial loans to enterprises (both public and privately owned) directly from the budget. These loans have been provided on soft terms and fully half of them are now in arrears. This issue needs to be tackled on an expeditious basis to prevent negative macroeconomic repercussions. An additional concern relates to the customs union with the Russian Federation, Kazakstan, and Belarus. Aligning its external trade and exchange system with that of the other

members may jeopardize the gains achieved over the past few years through trade and exchange liberalization.

17. Problems remain in the privatization of medium and large enterprises and in ensuring that newly developing markets are competitive in structure. For the new private small and medium enterprises serving the local market, the major obstacles will be gaining access to domestic capital for investment. For the medium and large enterprises[1] whose growth may need to be export-led, the task will be to attract FDI, to restructure activities in line with the country's comparative advantage, and to develop new foreign markets through greater international competitiveness. The ability of enterprises to develop market-based behavior, as well as the capacity of newly established market-based economic institutions to provide a policy environment conducive to such efforts, remains untested.

18. The conditions of extreme scarcity of savings and of foreign exchange earnings to finance the import of vital industrial inputs that will remain in the medium term mean that growth in factor productivity, rather than growth in quantity of inputs, has to be the principal source of economic growth. Thus, it is urgent that allocative efficiency in the economy as a whole and the internal efficiency of enterprises at the micro level are raised to ensure that economic growth is robust and sustainable.

IV. THE SECTOR

A. Background

19. The enterprise sector refers to all enterprises, public or private, regardless of size, that offer services that would be provided by a commercially oriented corporate sector in a market economy. Despite impressive success with privatization since 1991, the State retains an extensive role in the enterprise sector (see Table 2). Most of the enterprises fully privatized have been small, peripheral entities. The hard core of medium and large enterprises, which represent the backbone of the country's industrial system, remain either fully or predominantly state-owned.

B. Government's Initial Reform Strategy

1. The Corporatization and Privatization Process

20. Reducing the role of the state in the enterprise sector has been a major objective of the Government's program of transition to a market system. The primary instrument for achieving this strategy has been a policy of privatization, which has been implemented in three phases. Legislation governing the privatization of State-owned enterprises (SOEs) was passed in December 1991. A decree issued in January 1992 set out the program of privatization to be implemented by the newly created State Property Fund. The program covered about 10,000 SOEs.

---

[1] Classification of an enterprise as medium or large is based on number of workers, with the norm varying across sectors and branches. In general, however, medium refers to enterprises with 100 to 499 workers and large to those with 500 or more workers.

Table 2: Enterprise Sector: Key Indicators

Indicators	1990	1996
State Share of Industrial Output (%)	94.4	44.1
State Share of Output in GDP (%)	50.5	20.7
Fixed Assets in State Sector as Share of Total Fixed Assets (%)	80.4	42.5
Capital Investment in SOE's (000' Soms in constant prices)	10,319.3	213.9
Direct Foreign Investment (million $)	185.1	98.2
Number of Loss Making SOEs	66.0	316.0
Number of Medium and Large SOEs Fully Privatized	—	660.0
Number of Private Loss-making Enterprises	—	439.0
Share of State Enterprise Sector in Total Credits and Loans (%)	87.5	53.3

— = magnitude zero; SOEs = State-owned enterprises.

Note: SOEs are defined here as enterprises that are either 100 percent state-owned or in which the state has more than 50 percent holdings, inclusive of enterprises under local governments but excluding collectives.

2. Phase I: 1992-1993

21. Privatization began with some 10,000 enterprises included in the program. During the first phase, a major portion of the small SOEs, primarily in trade (retail outlets) and services, was privatized largely through noncompetitive voucher and cash sales to managers and workers. This process was completed in the second phase of privatization (1994-1995) during which competitive voucher and cash auctions were introduced. By the year-end of 1994, about 4,700 such small enterprises had been converted into fully private ownership.

22. A different and more gradual strategy of privatization was adopted toward medium and large SOEs. For these enterprises, the first step toward privatization was their corporatization, i.e., their conversion into corporate forms with legal identity, predominantly in the form of joint-stock companies (JSCs), as a means of clarifying property rights. Noncompetitive sales of minority stakes were made to workers and collectives, but the state, through the State Property Fund, retained majority holdings. There was no serious effort made at this stage to break up the larger enterprises with monopolistic powers.

23. The result of this process was that much of the initial privatization brought about little real change in enterprise management and operations. The previous management remained in control, while, under the "closed" form of shareholding commonly adopted, employees were required to surrender their shares to the collective on leaving the enterprise. No progress was made in the sale of the 25 percent of shares that had been reserved for the State for auction to the general public using "special means of payment" (coupons). Competition between privatized companies was also curtailed by the tendency of companies to remain linked to apex associations at district and national levels. To address these deficiencies, the Government passed a new Privatization Law in late 1993 and intensified the privatization.

3. Phase II: 1994-1995

24. The second phase of privatization saw a broadening of the scope of privatization as well as significant changes in the methods employed. The privatization of small SOEs was completed through competitive voucher and cash auctions. The State's shares in enterprises

privatized during Phase I were also divested through voucher auctions to individuals and investment funds. However, the main focus of privatization efforts was directed at about 1,300 medium and large SOEs in the industry and commercial sector and subsector, where the process of corporatization and conversion into JSCs was accelerated. Of these, 836 SOEs were included in the 1994-95 Privatization Program. Twenty-four major loss-makers within this group of 836 were placed under a special Enterprise Restructuring and Resolution Agency (ERRA) both as a means of "quarantining" and of developing models that could be replicated.[1]

25. The basic approach to privatization was to be a combination of free distribution to workers and management, and competitive coupon and cash auctions (mass privatization). Initially, the intention was to provide 5 percent of shares as a free distribution to workers and management; not less than 25 percent to be divested through voucher auctions; and sale of the remaining 70 percent either through competitive private bids with bid prices and business plan proposals as evaluation criteria, or through direct sale to target strategic investors. In reality, the blend and relative proportions of shares to be privatized differed according to the strategic importance and viability of the enterprise being privatized. In early 1995, a variant of "core investor sale" was adopted whereby bidders were not required to submit business plans and bid price became the sole criterion for sale.

26. The group of 836 medium and large SOEs targeted during this phase of the privatization program passed through the voucher auction stage by the end of 1995. In 434 enterprises, state shares were fully divested as well.

4. Phase III: 1996-1997

27. By the end of 1996 about 1,000 of the targeted 1,300 medium and large SOEs had gone through voucher auction. Of these the state had fully divested its shares in about 660 enterprises. The present agenda is to complete the voucher auction of the remaining 300 enterprises in the mass privatization scheme and divest the remaining state shares in about 640 enterprises. In addition, it is planned to start the privatization of 11 large monopolies, including utilities, with a view to attracting foreign investment. Finally, the Government will also be considering the disposition of some 4,000 additional SOEs that were not included in the mass privatization program. During the present phase of privatization efforts, enterprises are engaged in the process of divesting social assets such as schools and medical facilities. More than 300 nonviable SOEs will be liquidated or otherwise disposed of.

28. The best indicators of the true extent of privatization, which put the figures quoted above in the proper perspective, are (i) the share of the state in the ownership of fixed assets and in output of the national economy; and (ii) relative share in fixed assets put in the national economy.[2] Data for the first three quarters of 1996 show that public sector enterprises (defined as enterprises that are either fully 100 percent state-owned or in which the State has over 50 percent holdings; inclusive of enterprises under local governments but excluding collectives) account for 44 percent of total industrial output and about 21 percent of the GDP. Their fixed assets (SOM2.8 billion at current prices) represent 43 percent of the total in the economy. They continue to claim the largest share of financial resources: 53 percent of total

---

1 Funded under a World Bank Privatization and Enterprise Sector Adjustment Credit approved in 1992 for $60 million.

2 The use of these two sets of statistics provides an indication of the concentration of state ownership of the public sector in strategic or large enterprises, and hence their market power in the national economy.

loans and credit in the economy have been given to them, and they have received SOM108 million in budgetary subsidies in the first three quarters of 1996.

C. Constraints and Issues

1. Weaknesses in Enterprise Performance

29. The performance of the enterprise sector has been weak due to the severe economic recession of the past few years. But as economic conditions improve, significant impediments remain both at the policy and micro levels. Unless removed, they will limit the capability of the enterprise sector to exploit opportunities opened up by the economic recovery. While the reform program has had considerable success, the objective of establishing a competitive market-based system necessary to sustainable and stable growth has yet to be achieved. In particular, a number of systemic weaknesses remain in the enterprise sector that are impairing its ability to develop the desired supply response.

30. The poor performance of the enterprise sector is indicated by the slump in output and profitability. While these are in part caused by the recessionary conditions in the economy, a significant proportion of enterprises are not viable under market-based conditions. According to the third quarter of 1996 data, there were 316 loss-making public sector enterprises, compared with 66 in 1990. In addition, there were 439 loss-making private enterprises. The total losses of public sector enterprises amounted to SOM349 million, or about three quarters of the total enterprise losses in the national economy in the first three quarters of 1996.

2. Factors Affecting Enterprise Performance

31. The performance of enterprises, whether SOEs or private, depend on internal and external incentives that operate upon them. The legal structure of a modern corporation includes separate identity (corporatization); professional management; and transferability of shares. These, together with the dynamics of the relationship between owners (shareholders); the supervisory board; and the executives of the firm define the internal incentives operating on the firm. The legal form and internal incentives are not sufficient to induce efficiency, and certain external incentives must be in place to ensure sustainable efficiency. Firm managers in advanced market economies face a wide range of external constraints (incentives), economic and legal, in executing their duties. The economic constraints include product market competition; the desire to avoid bankruptcy (takeover); discipline exerted by capital markets on managers of firms that need to raise funds externally; labor market competition when jobs (especially managerial) are contestable; etc. Legal constraints arise from government regulations and laws of judiciary responsibility. The interplay of internal and external incentives—the broad definition of corporate governance—causes managers to act in accordance with the goals of efficiency and profitability set by owners. The absence of any of the internal or external incentives can seriously undermine performance.

32. One of the most important external factors in the performance of both public and private enterprises is the presence of competition. Competitive pressures are only effective in the face of financial discipline, i.e., if enterprises are cut off from budgetary allocations or other forms of subsidies, and if commercial banks are only willing to lend on commercial terms. Equity and debt markets also have a role to play in enforcing effective governance. Diluting the Government's ownership through sale of shares to a strategic investor and to other equity holders improves corporate governance in a number of ways. The introduction of a private sector strategic investor can be a major inducement to greater efficiency through a closer

alignment of risk bearing with control. The strategic investor can bring specialized management skills that improve performance. The presence of the strategic investor and other equity holders—banks, pension or investment funds—on supervisory boards can play an important role in exerting discipline on management by demanding information flows evaluating management performance. Adequate information flows essential for monitoring management performance will only be forthcoming if an effective system of enterprise accounts and audit is in place. A healthy financial sector, including banks, investment funds, and other financial institutions, able to play an independent role in evaluating and monitoring enterprises that seek credit or equity infusions is a vital ingredient to enforcing corporate governance and enterprise efficiency.

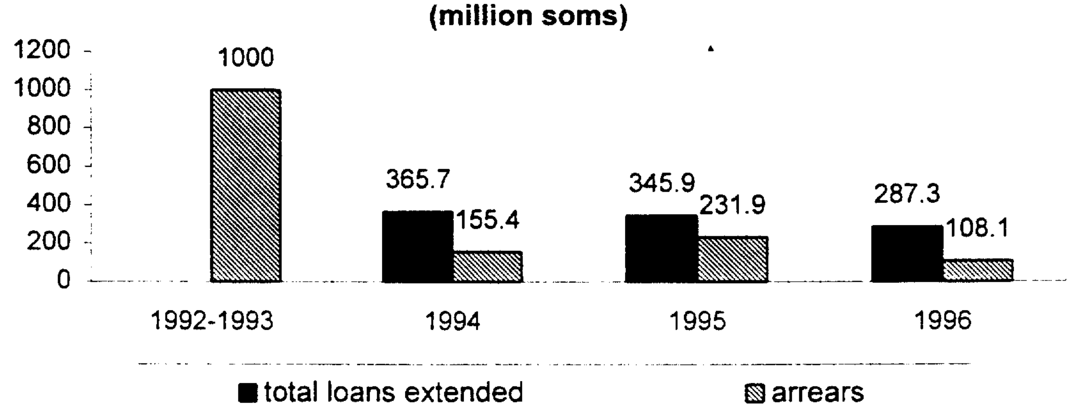
3. Enterprise Performance: External Factors

33. Although important progress has been made in establishing the policy and institutional environment within which enterprises can function effectively and competitively, key incentives and laws have yet to be effectively enforced if they are to act as external incentives and impose greater discipline both within enterprises and in interenterprise transactions.

a. Subsidies and Imposition of Financial Discipline on Enterprises

34. For the period 1992-1993, the outstanding arrears of enterprises receiving loans through the banking system stood at about SOM1 billion (see Figure 1). This represented a quasi-fiscal deficit and a bad loan on the books of NBKR. Its absorption was accomplished by its conversion and placement with NBKR in December 1996 of a 25-year Government bond paying 5 percent. While directed lending through the banking system has been eliminated, between 1993 and 1996 enterprises (both private and public) have been provided with a cumulative SOM1 billion of loans directly from the budget. These loans have been provided at nominal rates of interest (about 10 percent) far below rates of inflation or current market rates of interest. In addition to the large subsidy element in these loans, many of them have effectively been grants as they have not been repaid. Currently, the arrears on the loans given in 1993-1996 stand at SOM500 million.

Figure 1. Budgetary Loans Extended and Their Arrears (million soms)



Note: The figure for 1992-93 represents arrears on loans channeled through the banking system.
Source: Ministry of Finance

35. Budgetary assistance of this type needs to be curtailed for a number of reasons. First, unrequited transfers will place an intolerable burden on the budget, which could result in destabilizing macroeconomic developments through large fiscal deficits and an inflationary spiral adversely affecting economic growth. Second, rather than assisting enterprises to adjust, budgetary transfers and subsidies provide them with incentives to continue their past inefficient behavior. Such enterprises are likely to demand further assistance from the budget. This has the additional result of undermining any mechanism of control that other claimants (e.g., the banks) might have. Third, providing budgetary loans goes beyond the function of a government agency, such as the Ministry of Finance (MOF), which is not equipped to evaluate the credit risk involved in such lending.

b. Insufficiently Competitive Markets

36. The existence of competitive and distortion-free input and product markets that provide appropriate signals for allocating resources is essential to induce the efficiency and the viability of enterprises. The absence of a dynamic domestic private sector sharply constrains effective competitive pressures. Significant policy gains in these areas will need to be safeguarded as the private sector emerges through the growth process. It will be equally important to safeguard policy gains in respect of trade liberalization, which has resulted in a low and uniform tariff with few quantitative restrictions. Combined with free entry/exit in domestic markets, trade liberalization can be expected to force SOEs to focus on costs, efficiency, and marketing by introducing competition and diluting monopoly power they might have had. A major policy concern is the adjustment path to a customs union with neighboring countries that have greater trade distortions.

c. Legal Framework: Insolvency Procedures

37. The Kyrgyz Republic is in the process of comprehensive legal reform as it moves from a centrally planned economy to free market principles. Laws have been drafted in virtually all areas of commercial endeavor and the Civil Code has been adapted to accommodate them. Many of the new laws are being or have already been revised to reflect recent experience. The Civil Code constitutes the framework for the operation of all other laws.

38. One of the most critical issues facing the Kyrgyz Republic at the present time is the large number of loss-making enterprises, both in the public sector and in the emerging private sector. An essential incentive to encourage the owners and management of enterprises to work efficiently to maximize profits is the threat of liquidation if they do not do so. Liquidation is not only a spur to efficiency but provides the necessary guarantee to those who deal with and lend to enterprises that, in the event of default, the claims of the creditors will be dealt with promptly and fairly. The assets of a liquidated enterprise, which were used inefficiently, are transferred through the liquidation process to those who may use them more efficiently, and this is of benefit to the whole economy. For liquidation to provide these benefits, there needs to be an appropriate law of bankruptcy.

39. The existing Law on Bankruptcy dating from 1994 now needs to be modified in light of the new Civil Code and to take account of lessons learned to date. A number of issues have arisen in practice that require clarification. A Working Group established by the Government and containing both local and international experts has produced a draft of appropriate amendments to the Law on Bankruptcy. Once the new Law has been passed, it will be necessary to revise the General Instructions on Bankruptcy to implement the more general provisions of the Law.

40. The role of the courts is crucial to the proper functioning of corporate governance and to the efficient operation of liquidation procedures. The major deficiency in the Kyrgyz Republic at the present time lies less in the legislation than in the enforcement of such legislation through the courts. The best laws on corporate governance or liquidation will not operate unless the judiciary has the capacity to make them operate efficiently. This is not the case in the country at the present time. Liquidation cases involving insolvent enterprises are heard in the Arbitrazh courts which deal with all cases to which an enterprise or other non-natural person accorded legal personality is a party. With the exception of the Supreme Arbitrazh court in Bishkek, these courts are at present understaffed. Court buildings are inadequate and lack facilities such as good legal libraries or even basic collections of legislation, or word-processing and communication facilities. In some oblasts, the courts are forced to meet in inadequate rented accommodation. The judges additionally have not received sufficient training in the basic principles of commercial legislation: in corporate law, financial law, and the law relating to insolvency.

d. Access to Finance, Skills, and Technology

41. There is a clear awareness in the Government of the need to develop a financial market to finance enterprises. The skills, institutions, and instruments necessary for such a market, however, will take time to develop. The underdeveloped financial market is also a major impediment to the financing of technological renovations in newly privatized enterprises. The insolvency of the previous state banking system and the current fragility of the newly established commercial banks have eroded public confidence in the banking system. However, important progress has been made in stabilizing the banking system through the provision of the Financial Sector Adjustment Credit (FINSAC) from the World Bank. Under this $45 million credit, the World Bank is assisting the Government to close down unviable banks, restore the banking system to viability, and introduce a comprehensive system of prudential regulation and supervision.

42. While a functioning stock exchange exists, securities and equities markets are still underdeveloped. A project funded by the United States Agency for International Development (USAID) is currently underway to accelerate the listing of eligible companies on the stock exchange. A number of investment funds have been established to deal in privatization coupons. However less than 40 percent of all coupons issued are being held by these investment funds. Pension funds and insurance companies play only a marginal role in the economy currently. Moreover, securities companies and other nonbank financial institutions currently are not subject to good governance mechanisms that allow for transparency in their operations. This has resulted in the lack of public confidence in many of these institutions. This is of some concern as the supply of securities will increase as the conversion of companies into joint-stock companies continues through the corporatization process. In particular, as some of the key SOEs are brought forward for privatization, a greater utilization of privatization coupons and their coursing through investment funds is expected to take place. The development of a regulatory framework for nonbank financial institutions is essential and is being supported under the World Bank's FINSAC credit. A draft law on insurance companies has been prepared by the Government, draft amendments to the Civil Code in the area of leasing are being prepared by NBKR, and a law on nonstate pension funds is also being drafted with assistance from USAID.

43. The Government is seeking to tap foreign capital to support the enterprise sector. FDI can play a key role in the recovery of the Kyrgyz economy by bringing capital, technology, management skills, and access to export markets. While the Government wishes to encourage FDI, the policy environment needs further strengthening. One problem is the

duplication of efforts across and within ministries. This has resulted in blurred and overlapping responsibilities.

e. Accounting Standards

44. The system of accounting standards and reporting requirements for enterprises is still in an embryonic stage. This has meant that the monitoring and transparency of an enterprise's operations remain problematic as reporting requirements are not enforced and the capacity of such enforcement remains weak. Accurate and timely financial information is of vital importance to enterprise reforms. Without financial information, especially product cost, cash flow, and profitability data, managers are unable to do their jobs. Likewise, boards of directors, shareholders' councils and the shareholders themselves are unable to gauge management's success or to know which investment strategy may be best. Outside lenders and investors need reliable financial information too to assess the viability and attractiveness of enterprises before investing their own capital in the enterprise as debt or equity.

4. Internal Factors: Weak Corporate Governance

a. Corporate Governance

45. Corporate governance, narrowly defined, is concerned with ensuring that an enterprise, and the bundle of assets that constitutes the enterprise, is managed in the best interests of the owners. The problem of corporate governance arises when the owners themselves are not directly engaged in the management of the enterprise and delegate managerial authority. Owners have less information (financial, technical, and operational) about the enterprise than managers who may run the enterprise in their own interests rather than those of the owners. Even when managers do not deliberately set out to undermine the interests of owners, they may be taking strategic decisions impacting on the enterprise's asset value, profitability, and performance for which they do not bear the ultimate residual risk. In other words, managers enjoy control over use of the enterprise's assets without having to bear the full consequence of or responsibility for their decisions.

46. An efficient system of corporate governance is therefore one that allows owners to govern how an enterprise is managed or operated in their best interests. This can be achieved through a minimal set of precautions and safeguards comprising

(i) effective monitoring by shareholders of management behavior, decisions, and the enterprise's performance through regular reporting, usually verified by an external, independent audit based on rigorous international accounting standards of comprehensive operational, financial, and accounting information that provides transparency;

(ii) an optimal incentive structure of rewards, and penalties, for managers to manage the enterprise in the best interests of the owners, designed to maximize the coincidence and compatibility of their interests with those of the owners; and

(iii) a clear and enforceable system of decision making and managerial organization (shareholders' council or annual general meeting of shareholders, board of directors, and, in the German model, supervisory

boards) that delineates the duties, rights, and responsibilities of management, owners, and stockholders.

47. The corporatization and privatization process has largely failed to establish effective corporate governance structures, mainly due to the failure to clarify and define the rights and responsibilities of owners, stakeholders, and management. The fundamental weakness in enterprise governance in the Kyrgyz economy has not been resolved by the corporatization and privatization programs. In fact, in many instances the governance problem has become even more serious and defective.

48. The problems of governance are magnified in SOEs as they are owned by everyone and by no one in particular. The State (the owner) has less direct information than SOE managers, and therefore encounters problems in monitoring and controlling SOEs' behavior to ensure that they operate in the public interest. The SOE management has control over resources but does not bear the residual risks, i.e., the profits or losses after all contractual obligations have been met. As losses are borne by the public at large (through the budget), risk and control are not appropriately aligned. Furthermore, with ineffective mechanisms for bankruptcy, SOEs operate in an environment lacking financial discipline and without strong incentives to improve efficiency.

49. The conversion of SOEs into JSCs and other market-based corporate forms has aimed at severing the direct link between the Government and productive entities as a means of enhancing the operational (managerial) and financial autonomy of enterprises and the orientation of their activities toward market-based commercial principles. This process, however, has resulted in even weaker monitoring of enterprises, and even less transparency than under the previous command planning system. Corporate control is now more fully invested with enterprise management, yet in so far as the State retains total or majority shares in these companies, the residual risk is still being borne by the State (the public) and not by those in control of the enterprise.

50. In most of the larger SOEs and corporatized enterprises where the State retains majority stakes, the links with the Government and other administrative authorities remain strong. Under the dual control structure typical of the German system and adopted in most transition economies, both public and private enterprises have a supervisory board (of shareholders) and a management board. In almost all of the SOEs, State representation is also found on the management board. Nor is there any representation of independent directors on the supervisory board. Thus, neither the operational autonomy of management nor the commercial principles of operation have been clarified or established for SOEs, and they remain vulnerable to arbitrary political interventions. No effective mechanisms appear to be installed for monitoring the efficiency of their operations (aside from planned targets on quantitative/physical output norms, as in the case of the fully state-owned natural monopolies) or for ensuring that these SOEs operate in the public interest.

51. The corporate governance of the fully privatized enterprises and those where the State holds a minority stake is equally weak. In principle, the new owners of these enterprises now bear the residual risk as well as control responsibilities. However, with limited competitive pressure and the absence of threat of insolvency proceedings, there are no rigorous external incentives or pressures for the owners to operate responsibly and efficiently. This situation undermines the interests of stakeholders (workers, creditors, supplies, customers, etc.). The lack of transparency and of effective corporate governance structures in these privatized enterprises also allows management and majority shareholders to operate against the interests

of minority shareholders. In many cases, newly privatized firms are characterized by irresponsible behavior of owners (e.g., failure to pay wages and creditors, and to comply with statutory registration and auditing requirements), and management unwilling or unable to operate on a commercial, market-oriented basis. Many privatized firms operate in an "anything goes" atmosphere. The new owners were used to operating within the structure of a command planning system in which they executed orders issued from above. Not only are they weak in entrepreneurship and commercially-oriented management skills in a market environment, but their assumption of ownership of assets as an essentially free transfer to them has meant that little or no risk need to be borne if they perform their ownership and management functions poorly. A typical example of weak corporate governance in a privatized enterprise is described in Supplementary Appendix A.

52. Under these conditions, there is a danger that privatization might become an end in itself rather than serve as a means for creating a dynamic, competitive, and efficient economy. At best, assets are divested at massive discounts to incompetent owners and managers. At worst, the failure of the privatization process in invigorating the economy could generate a political backlash over time. It is therefore vital that the privatization process proper —the divestiture of state assets—be complemented by concomitant efforts to improve the policy environment and to strengthen the functioning of enterprises through improved governance mechanisms. Unless more effective corporate governance structures are adopted, the pressure to institute market-oriented management techniques and business practices will remain weak at the micro level, while the creation of new policy and regulatory environment at the macro level will continue to be problematic.

b. Summary of Constraints

53. In common with other transition economies, the corporatization and privatization process in the Kyrgyz Republic has resulted in a number of features that are unfavorable for effective corporate governance. The most important of these features may be summarized as follows:

(i) The voucher (mass distribution) process of privatization has led to a system of widely dispersed small shareholders who are unable to monitor the performance of firms or to influence (because of their individual small shareholding) the governance of the enterprises.

(ii) The practice of awarding minority (e.g. 30 to 35 percent) but sizable blocks of shares to existing management and workers has led to insider control by management and workers who not only lack the modern management skills necessary for operations in a market environment, but who also refuse to disclose adequate information about the firm's operation to outside investors.

(iii) A system of subsidies to enterprises is undermining financial discipline and acting as a constraint to enterprise efficiency.

(iv) Product market competition is currently too weak to impose sufficient discipline for promoting efficiency.

(v) The financial market is underdeveloped, and there is a severe capital shortage in the economy in general.

(vi) The overall legal framework and national accounting regulations are still being developed, and are not being rigorously enforced, to perform their roles as external disciplinary mechanisms in enforcing improved corporate governance.

54. Not only is the capital structure of enterprises detrimental to effective corporate governance in the Kyrgyz Republic (i.e., either too dispersed among too many small outside shareholders, or concentrated in the hands of insiders who lack the skills and incentive for restructuring and who effectively exercise nearly complete control at the expense of other shareholders), but owners themselves do not yet know how to exercise their functions and rights.

D. Government Objective and Strategy

55. The Government's objective for enterprise reform is to facilitate the development of a modern and competitive enterprise sector while providing adequate protection for the rights of investors and workers. The Government's strategy for the 1997-1999 period is to broaden enterprise reforms to the extent that by the end of the period

(i) a sound basis for effective corporate governance will have been established;

(ii) an appropriate legal and regulatory framework for the sector will be in place;

(iii) enterprise subsidies will have been substantially reduced; and

(iv) a modern banking system will have begun to emerge capable of financing enterprises.

56. A significant number of enterprises will remain under state control, at least in the short term. The Government is introducing measures to strengthen the governance of SOEs by separating their management from their parent agencies and line ministries through their conversion into JSCs reporting to boards of directors. At the same time, the remaining large conglomerates will be broken up and converted into JSCs at the level of their constituent enterprises.

57. Despite the scale of the problems it faces, the Kyrgyz economy has good prospects that a revitalized enterprise sector will be well placed to realize. With World Bank assistance, a banking system based on commercial principles and a sound prudential regulatory framework is expected to emerge over the next two years to provide financing on commercial terms to viable projects. Relatively cheap skilled labor, rich natural resources, and a reasonable infrastructure will be the main basis for further growth. There is considerable potential for developing natural resources through exploitation of minerals, especially gold, expansion of hydroelectric capacity to meet demands in Central Asia, oil and gas exploration and development, and raising of agricultural yields through improved irrigation and agronomic practices. Moreover, a detailed Bank study has shown that a wide range of manufacturing

activities are likely to be competitive.[1] The Government is aware that a critical prerequisite for success is further reform to remove existing distortions undermining the performance of enterprises. Well-functioning enterprises and a market-based system of incentives are crucial to the growth and development of the Kyrgyz economy.

E. External Assistance to the Sector

1. Structural Reforms

58. The TA provided by USAID has played a crucial role in devising and implementing the mass privatization schemes through the various voucher and auction methods. This process will be completed by June 1997 when the vouchers expire. USAID's TA has also played a key role in drafting the laws that provide the legal framework for a market economy. This has included assistance to draft or revise laws defining the regulatory framework for the energy sector, insolvency procedures, company law, etc.

59. The World Bank has supported privatization and restructuring of enterprises through the Privatization and Enterprise Sector Adjustment Credit (PESAC), approved in October 1994. The $60 million credit provided budgetary support to the Government linked to the implementation of its phased privatization and restructuring programs described earlier (the preparation of detailed plans for privatization was funded by USAID). PESAC's focus was the restructuring and liquidation of 24 large, loss-making public enterprises under a special care and maintenance program executed by the newly established Enterprise Restructuring and Resolution Agency. Under this program, 17 enterprises have been restructured in some measure, and 7 identified for liquidation, although none has yet been liquidated. Some 15,000 people were laid off. The gross cost of the restructuring component was SOM250 million. About $12 million was spent on severance payments and on wage arrears of the displaced labor force. The program ended in 1996.

60. In June 1995 the World Bank approved the Agriculture Privatization and Enterprise Adjustment Credit of $45 million, which continued the support for the privatization and enterprise reform program and expanded it to the agriculture sector. The credit assisted the Government to develop land markets, demonopolize and privatize State-owned conglomerates in the agriculture and food processing sectors, and eliminate remaining price and trade controls in these sectors. Important assistance to the privatization of the agriculture sector has also been provided by the Bank.[2]

61. Under the $45 million FINSAC provided by the World Bank in 1996, NBKR has undertaken a comprehensive restructuring of the banking system. Of the nine banks with negative net worth, including four State-owned banks, four were put under direct supervision. Two of the State-owned banks have been liquidated (Elbank and Agroprombank) and the remaining two are being restructured. The restructuring involves the recapitalization of the two banks through private means. One of the two banks being restructured, Promstroi, has substantially improved its performance and has surpassed the performance criteria set for

---

1 TA No. 2297-KGZ: *Industry and Trade Sector Study* , for $600,000, approved on 3 February 1995. Broad areas for potential development were identified using the analytical tools of export similarity analysis, linkage analysis, and factor content analysis; 28 activities were identified by more than one of the above techniques. These 28 areas include tea, nonalcoholic beverages, textiles, hand tools, bicycles, footwear, iron and steel products, luggage, refractory and ceramic goods, fruit and vegetable processing, hosiery and knitted goods, paints, agricultural machinery, metal castings, etc.

2 Loan No. 1407-KGZ (SF):*Agriculture Sector Program*, for $40 million, approved on 23 November 1993.

release of the second tranche. A debt resolution agency was created to expedite the collection or write-off of nonperforming loans and a temporary rural credit agency was established to replace the liquidated Agroprombank. A new Chart of Accounts for Banks based on international accounting standards (IAS) has been introduced and is being enforced in all commercial banks. Legislation has been enacted that strengthen NBKR's regulatory authority over commercial banks. NBKR is successfully enforcing the new prudential guidelines that include minimum capital adequacy requirements, single borrower and insider lending limits, and reserve and liquidity requirements. Efforts are underway to create an effective regulatory and legal environment for the development of nonbank financial institutions. The newly enacted Banking Law, and the charter for banks developed by NBKR provide a sound basis for effective corporate governance in commercial banks. This will strengthen the role banks can play in exercising and monitoring corporate governance functions over enterprises that borrow from them.

62. The World Bank's Public Sector Resource Management Adjustment Credit for $44 million was approved in March 1997 to reform intergovernmental relations and the budget process. The revised tax sharing arrangements envisaged under the Credit will ease pressures on the budget by discouraging local governments from making spending commitments not supported by their revenues. The possibilities for incurring arrears will be lessened by linking budgetary projections to macroeconomic projections, and specifying binding expenditure allocations for ministries and local governments. The government is also expected to develop a plan relative to divestiture of its social assets.

63. In 1997, USAID is expected to provide about $2 million for the further development of a system of enterprise accounts consistent with the IAS. Assistance will be provided to some 300 enterprises to assist them adopt the new accounting standards.

2. Aid Coordination

64. While the World Bank and USAID projects have succeeded in helping privatize a major proportion of state assets, only limited progress has been made in enterprise governance. In this context, the role of Bank assistance is to strengthen the incentives and institutions for the improved governance of enterprises, which has been neglected to date. Progress achieved in liberalizing and creating new product and factor markets, stabilizing financial markets, and establishing a legal and regulatory framework sets the essential preconditions for governance reforms.

65. The Bank has coordinated closely with other funding bodies, in particular with the World Bank, IMF, and USAID. This included a two-day series of coordination meetings in Washington with the World Bank, immediately following the Fact-finding Mission in November 1996. The World Bank and the Bank are in agreement that the proposed Program is complementary both to the reforms already accomplished, and those underway under the auspices of the World Bank's FINSAC in the financial sector. The Program's focus on corporate governance of enterprises is viewed as meshing well with the World Bank's assistance for strengthening banks through the introduction of prudential supervision, regulation and safety, and soundness provisions.

66. Close coordination has been achieved with IMF and the World Bank regarding the Program's focus on imposing financial discipline on enterprises. A similar level of coordination has been achieved with USAID regarding a variety of projects being supported by them, in particular, those related to reform of the legal framework for bankruptcy. USAID's

training program for the judiciary will complement the specialized training programs envisaged under the Program. While USAID will provide training in general legal procedures to judges and lawyers, the Bank will focus on specialist training in bankruptcy procedures for judges in the court of Arbitrazh. The Bank has also closely coordinated with USAID for the development of a system of enterprise accounts that is expected to improve enterprise governance through increasing the transparency of enterprise operations. Finally, the Bank coordinated closely with the European Union relative to a range of issues including the partial privatization of the major utilities.

F. The Bank's Operations and Strategy in the Sector

67. No previous Bank program has focused explicitly on reforms to improve corporate governance. However, enterprise reform, broadly defined, has become increasingly important as an objective pursued under the Bank's policy-lending modality. The Gujarat Public Sector Resource Management Program approved in December 1996 for $250 million gave crucial importance to enterprise reform in the context of improving the efficiency of the public sector. Within this broader objective, the program addresses enterprise reform in a systematic manner, primarily through corporatization and divestment of SOEs.

68. Enterprise reform has typically been one of the objectives pursued under industry sector program loans, most notably in Pakistan and Bangladesh.[1] The chief lesson learned from these loans has been the extreme difficulty of undertaking such reforms in the absence of very strong commitment from the Government. The success of reforms is dependent on the policy decisiveness of the Government and on coordination between relevant Government agencies. Front-loading of difficult reform issues, especially those relating to legislative changes, is critical and an important indicator of Government commitment. In addition, it is essential to force a level playing field on SOEs by subjecting them to domestic and international competition, and by ensuring that they no longer have access to subsidies to make up their losses. In recognition of these concerns, the proposed Program places a heavy emphasis on placing SOEs on the same legal and commercial footing as private enterprises. The program has a major provision for TA to strengthen critical institutional capabilities that will support its core objectives. Finally, the program front-loads all legislative changes.

69. The lessons from Bank experience are consistent with reform experience in Eastern Europe, New Zealand, and Asian countries such as the People's Republic of China. The latter experience has been examined by a Bank TA.[2] The lessons derived from this broader assessment are that the ownership imperative and the alignment of risk with control are central to the issue of enterprise performance and corporate governance. A cross-country review of alternative governance mechanisms was carried out by the Bank and is summarized in Supplementary Appendix B.[3]

70. Experience with enterprise reform in a number of countries shows that substantial gains in SOE performance can result from imposing on them the incentive framework of a modern corporation. This research also shows that the problem of governance, the alignment of risk and control, applies also to all corporations, private or public, where the

---

1 Loan 891-BAN:*Industrial Program*, for $65 million, approved on 31 July 1988; Loan 1147-BAN:*Second Industrial Program*, for $125 million, approved on 17 December 1991; and Loan 932-PAK:*Industrial Program*, for $100 million, approved on 13 December 1988.

2 TA No. 1924-PRC:*Public Enterprise Governance Reform*, for $600,000, approved on 3 August 1993.

3 TA No. 2712-KGZ:*Preparation and Implementation of Guidelines on Best Practices in Corporate Governance*, for $100,000, approved on 13 December 1996.

dispersion in ownership and difficulties in monitoring the performance of mangers makes it difficult to ensure that managers are pursuing the best interests of owners.

V. THE PROGRAM

A. Rationale

71. An effective corporate governance structure allows owners and stakeholders to ensure that those entrusted with management do so in the best interests of the owners and stakeholders. The incentive to attain efficiency, within an effective corporate governance structure, in turn compels the adoption of advanced management practices and technology to remain competitive.

72. An effective system of corporate governance must ensure an adequate supply of corporate finance, in appropriate form and at competitive rates, to fund all commercially viable business opportunities open to the company in the light of its technology, skills, and experience. Suppliers of finance will either require equity stakes within an ownership structure that fully protects their rights and returns; or in the case of debt finance, reasonable assurance that the company will be run in a way that maximizes the prospect of the loan being financed and repaid on time. In each case this requires that an effective governance system be in place. Viable competitive enterprises need good management, appropriate technology and skills, and access to adequate finance. All three are in short supply in the economy, but all three are potentially available together via international collaboration. This will not normally be forthcoming unless the governance system is sound.

73. The process and methods of mass privatization in the Kyrgyz Republic have resulted in a structure and dispersion of ownership that are detrimental to effective corporate governance. Share ownership of enterprises is widely dispersed. At the same time, however, the allocation of a significant minority of shareholding to the management and workers of an enterprise has led to an insider-dominated system of control that has seriously constrained the ability of outside investors to inject capital to rejuvenate enterprises. These drawbacks in fully and partially privatized enterprises in the country exist despite the compulsory adoption in joint-stock companies with more than 50 shareholders of a two-tier structure of corporate control, involving the establishment of a supervisory council to monitor the behavior and performance of the executive (management) board. The adoption of the German-type two-tier system was intended to ensure effective and sound corporate governance. But the reality in the Kyrgyz Republic is that the two-tier system has only been formally and superficially adopted while actual corporate governance arrangements and practices provide neither protection for owners nor incentives for management to operate the enterprise as efficiently as possible. Weaknesses in enforcing legislation has also meant that the threat of bankruptcy is not credible, further undermining financial discipline.

74. In both public and privatized enterprises, lack of financial discipline and shortcomings in incentive structures have accommodated the retention of managerial and operational practices of the previous command system. Until a more effective corporate governance system is adopted, the impulse to implement modern market-oriented management techniques, business and accounting practices, and internal reorganization of firms will remain weak. The privatization program is aimed at transferring control of assets and resources to the private sector as a means of enhancing entrepreneurship and economic dynamism; this needs

to be complemented by the development of institutions and rules that provide an effective corporate governance structure so as to promote the most productive and efficient uses of these assets and resources.

75. The absence of a specific focus on improving corporate governance is a critical void in the reform process that the proposed Program addresses. Despite success with the privatization program and the development of a legal framework for a market economy, there is widespread concern that the corporatization and privatization process has transferred ownership and control of productive assets to those without an adequate understanding of financial, legal, and corporate responsibility and accountability over the use of assets. Governance in SOEs is equally weak, and it is, therefore, important to adopt effective market-based corporate governance structures in both public sector enterprises undergoing restructuring and in newly privatized enterprises.

76. The Program's contribution to improved corporate governance in the country will have significant synergy and multiplier effects given the existing and planned range of support in other areas of enterprise development and market transition provided by other multilateral and bilateral agencies. Substantial ongoing and planned assistance by the World Bank and EBRD to strengthen the banking system and to develop sound financial markets would be complemented and reinforced by improved enterprise governance that facilitates more efficient corporate financing through greater transparency and monitoring. Similarly, support provided by the World Bank, USAID, EBRD, and the Bank for the country's privatization program and the enforcement of bankruptcy laws would yield more substantive and positive results if assets transferred to new owners and management are more effectively and responsibly controlled under improved governance structures.

B. Objective and Scope

77. The Program's objective is to improve the performance and efficiency of the enterprise sector so that it can be viable in a competitive, market-based economy. Improved efficiency is to be achieved through enterprise reforms that strengthen the incentives for better performance through improved corporate structure and governance in all enterprises, both public and private. The Program will develop and implement guidelines for best practice in corporate governance, including statutory mechanisms for their enforcement. All enterprises, public and private, will be cut off from subsidized loans from the budget, required to seek new financing on commercial terms without direct or indirect Government guarantees, and faced with competition to the extent possible. The Program will also expedite liquidation and restructuring to eliminate the deadweight of nonviable enterprises, promote the rapid redeployment of viable assets, and serve as an incentive for better management performance. The legal framework and implementation capabilities for insolvency procedures will be strengthened. Finally, the Program will address the expected social costs of adjustment. The Program as a whole is set out in the form of a Development Policy Letter in Appendix 2, and the Policy Matrix in Appendix 3. Parallel to and in support of the Program, TA will be provided, consisting of a loan for capacity building in corporate governance and insolvency procedures, and a grant for strengthening the capacity of the PMO.

C. Policy Framework and Actions

1. Promotion of Enterprise Efficiency Through Improved Corporate Governance

a. Extension of Enterprise Reforms into Key Areas of Full State Ownership

78. Enterprise reforms will be introduced into the key areas remaining under 100 percent State ownership: energy, telecommunications, and transport (aviation). In these areas, the Program will separate ownership and management functions. Those SOEs still operating as Government departments will be corporatized on an expeditious basis to facilitate their commercial orientation and improve economic efficiency. In this connection, the Government will create State-owned JSCs for the telecommunications industry—Kyrgyztelecoms—and airlines. Activities in the gas sector undertaken in Government departments will be merged and reorganized into one company, Kyrgyzgasmunaizat.

79. The National Aviation Company (NAK), the Kyrgyztelecoms company, Kyrgyzgasmunaizat, and the state electric power company—formerly the Kyrgyz National Energy Holding Company, now called Kyrgyzenergo—will implement a set of governance reforms designed to achieve the clarification of ownership rights, the incorporation and exercise of these rights through supervisory boards, appointment of management with appropriate delegation of authority from the supervisory boards, and the realignment of risk and control through the introduction of stakeholders and strategic investors through partial divestment of Government ownership.

b. Divestment Through Coupon Privatization

80. Consistent with the Government's objectives for privatization, each of the SOEs noted above will begin the voucher auction phase of the privatization program. This will lead to greater utilization of privatization coupons currently being held by the public and potentially encourage their channeling through investment funds that can be expected to play a stronger role in the corporate governance of these enterprises. This process has now been satisfactorily concluded, all four entities have been formally corporatized and have undergone partial privatization through voucher auction.

c. Institutionalizing Best Practice in Corporate Governance

81. Through a combination of policy reforms and capacity building the Program will establish appropriate corporate governance structures in the Kyrgyz Republic. A handbook on best practice in corporate governance for Kyrgyz enterprises is being prepared with Bank assistance.[1] The handbook, which explains the objectives and principles of effective corporate governance and contains a model Company Charter, is designed to significantly strengthen corporate governance by providing detailed rules in five key areas: (i) shareholders' rights and responsibilities; (ii) procedures for the convening of annual general and extraordinary meetings of shareholders, and the conduct and voting procedures at such meetings; (iii) the membership, duties, and responsibilities of the supervisory board (board of directors); (iv) the membership, duties, and responsibilities of the management board (executive body); and (v) the

[1] TA No. 2712-KGZ:*Preparation and Implementation of Guidelines on Best Practice in Corporate Governance*, for $100,000, approved on 13 December 1996.

establishment and functions of an independent registrar of shares and a shareholders' audit committee.

82. Implementation of the best practices in corporate governance, as described in the handbook, is a fundamental target of the Program. The Company Charter and the associated Articles of Association, represent the principal internal mechanism for effective corporate governance. Thus, a key objective of the Program is the adoption by a predetermined group of enterprises of the model Company Charter as contained in the Handbook. The enterprises that would be required to adopt the model Company Charter, or its essential provisions, are the JSCs with more than 50 shareholders who are required under present legislation to establish a two-tier system (comprising a board of directors and an executive body).

d. Instruments for Legal Adoption

83. The model Company Charter has been drafted to be consistent with the Civil Code and the Law on Economic Partnerships and Associations of the Kyrgyz Republic. Prior to Board presentation, the Government is to issue the necessary decrees and take whatever other legal steps that may be necessary to (i) confirm the model Company Charter as a minimum standard; (ii) make its adoption mandatory for certain types of JSCs; and (iii) task various Government bodies, such as MOF, SPF, the Ministry of Foreign Trade and Industry, the Ministry of Justice, the National Commission on Securities Markets and the Government Procurement Agency, with its implementation within their respective areas of jurisdiction. A decree fulfilling these objectives was issued on 26 July 1997 (Government Decree 433).

84. Compliance with best practice in corporate governance, and the implementation of the model Company Charter, will be enforced through the following mechanisms:

(i) **Public Sector Enterprises**. The model Company Charter will be directly adopted by all state-owned or majority state-owned enterprises, including the major public sector monopolies as an essential component of their respective corporatization, unbundling, and privatization programs.

(ii) **Equity Market (Registration)**. All JSCs registering with the State Securities Agency are required to adopt the model Company Charter; companies already registered will be required to adopt the model Company Charter within a period of nine months following the enactment of the appropriate legal mechanism.

(iii) **Equity Market (Licensing of Nonbank Financial Institutions)**. All nonbank financial institutions, such as investment funds, insurance companies, pension funds, etc., will be required to adopt the model Company Charter as a precondition for obtaining a license to operate; companies already registered will be required to adopt the model Company Charter within a period of nine months following the enactment of the appropriate legal mechanisms.

(iv) **Equity Market (Listing Requirements)**. The adoption of the model Company Charter will be a precondition for listing in the Kyrgyz Stock Exchange; for companies already listed and actively trading on the stock

exchange, adoption of the model Company Charter will be a precondition for new share issues.

(v) **Debt Market**. The NBKR will recommend to all commercial banks that the adoption of good corporate governance and the model Company Charter by borrowing enterprises be taken into account during the loan screening and credit-rating process.

(vi) **Prequalification for Government Contracts and International Assistance.** Companies seeking to tender for government contracts will need to have adopted the model Company Charter to be eligible for such contracts and assistance.

e. Strengthening Institutional Capacity

85. To strengthen the institutional capacity to facilitate and monitor the implementation of corporate governance, the Government will establish a Corporate Development Center (CDC) under the Program, utilizing the TA loan for this purpose. The CDC will be an interdepartmental unit under the PMO. The CDC will help strengthen the enforcement and monitoring capabilities of Government agencies tasked with implementing the best practice in corporate governance. It will provide advisory services to enterprises on the implementation of the model Company Charter, develop questionnaires and diagnostics to evaluate the effectiveness and problems of actual corporate governance structures and practices in enterprises operating under the model Charter, and refine and update the model Company Charter in line with the changing policy and institutional environment in the country.

86. Through the CDC, the Government will provide a corporate governance training program aimed at developing expertise in implementing and monitoring effective corporate governance at relevant Government and State bodies; banks; nonbank financial institutions, such as investment funds; and universities. Through the CDC the Government will also implement a management development training program aimed at introducing modern management systems and techniques at selected leading public and private sector enterprises operating under new corporate governance structures, to improve their competitiveness and efficiency.

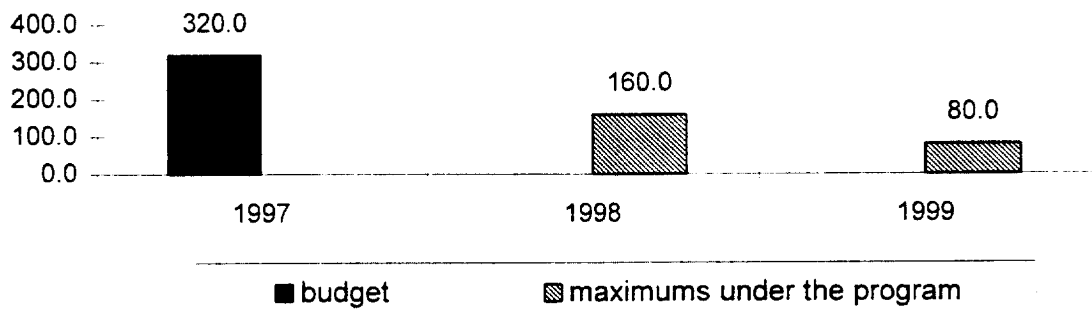
87. Finally, the CDC will implement a nationwide public information and education program to develop awareness among shareholders, enterprise officials, and the general public about the objectives and principles of good corporate governance, as well as the rights and responsibilities of shareholders and enterprise officials.

2. Imposition of Financial Discipline on Enterprises

88. The Program will phase out budgetary subsidies to strengthen financial discipline. In response to budgetary limitations and the need to ensure that enterprises face appropriate financial discipline, the Government has progressively reduced the direct assistance provided to enterprises. Direct credits have been terminated. However, a number of enterprises facing short-term financial constraints have been provided with loans from the budget. Under the Program, this facility will be initially rationalized by cutting off loans to enterprises in arrears, an action that has already been taken. The amounts to be provided to enterprises from the budget would be reduced in 1998 to SOM160 million or 50 percent of the amount be provided in 1997 (see Figure 2). This would constitute a condition for release of the second tranche. It has been agreed that in each successive year, these loans will be halved

again. In addition, the Government will apply to these loans an interest rate equal to the expected annual rate of inflation plus a service charge. The Government is also vigorously pursuing debt recovery. It has recovered SOM44 million of arrears to the budget in 1997 already, or just under 10 percent of the cumulative arrears to the budget since 1994. The Program objectives relative to imposition of financial discipline are fully supported by IMF and will play an important role in promoting macroeconomic stability.

Figure 2. Budgetary Loans to All Enterprises: 1997 and Projected Under the Program (million soms)



Source: Ministry of Finance

89. Financial discipline will be reinforced through an NBKR directive that will instruct commercial banks that no Government guarantees will be forthcoming for their lending to enterprises and that such lending will have to be on commercial terms.

3. Promotion of Competition and Strengthening of the Enabling Environment for FDI

90. The Program will seek the assurance of competitive markets through the entry of private firms as a major inducement to SOEs to improve efficiency. Prices have been liberalized in the Kyrgyz Republic and there is free entry by the private sector in most economic activities. The low tariff and open trade policy regime contributes to competition and efficiency in the domestic market. It is vital that the efficiency gains from these reforms are not lost through disruptions to the conducive trade policy regime. In this regard, the Government will ensure that during the Program period no new quantitative restrictions will be imposed on trade. Also, tariffs will not be raised during the Program period except in accordance with antidumping considerations.

91. The FDI policy environment is to be improved under the Program by enacting the new Law on Foreign Investment and establishing an agency for promoting and supporting FDI as a "one-stop entry shop." The new Law is expected to be enacted in September 1997.

4. Strengthening of the Legal Framework and Enforcement of Bankruptcies

92. An important component of the Program will be to strengthen the legal framework for, and capabilities to implement, insolvency procedures. A new Law on Bankruptcy has been presented to Parliament. An associated set of draft General Instructions has been prepared and will require modifications to bring it into line with the new Law (the instructions guide judicial

decisions on legal interpretation). Other measures will be taken to strengthen the capacity of the judicial system. These measures will include the appointment of more judges to the Arbitrazh courts. The courts will be provided with appropriate legal materials and with equipment to assist them in carrying out their functions. A selected number of judges will be given appropriate training in the fields of corporate, financial, and insolvency legislation. This will also include training in such associated fields as the valuation of assets and basic accounting techniques, including the understanding of corporate balance sheets.

93. The following actions will be undertaken under the Program:

(i) By the end of September 1997, a new Law on Bankruptcy, substantially in the form produced by the Working Group on Bankruptcy, will be enacted. The enactment of the new Law constitutes a condition for loan effectivity.

(ii) Within six months of the adoption by the Parliament of the new Law on Bankruptcy, a revised version of the General Instructions will be approved by the Government.

(iii) The capacity of the judges in the Arbitrazh courts to enforce good corporate governance and appropriate liquidation procedures will be strengthened by (a) appointing more judges so that 20 of the current 31 vacancies are filled by 1 May 1998 at the latest, (b) improving the conditions under which the judges work by providing the judges with appropriate legislative materials and equipment, (c) rehabilitating court buildings, and (d) providing specialized training to the judges.

(iv) By the end of September 1997 the Government will establish a Working Group on the Enforcement of Legal Rights to review the problems of enforcement of judicial decisions. The Working Group will report its findings to the Government by the end of December 1997, and this report is to be circulated to members of the People's and Arbitrazh courts, and the Constitutional Court for comment. The final report to be produced by 1 February 1998 is to make recommendations for legislative changes to improve the position.

94. The Government agreed that from the proposed technical assistance loan it will allocate funds to address the above issues, and in particular:

(i) revision of the General Instructions on Bankruptcy;
(ii) strengthening of the capacity of the judges of the Arbitrazh courts by the provision of training, legislative materials, and some equipment (mainly computers);
(iii) improving the conditions under which the Arbitrazh judges work through rehabilitating court facilities; and
(iv) strengthening capacity of the State Property Fund for out-of-court liquidation of nonviable SOEs.

5. Introduction of Enterprise Accounting Systems

95. The Program will support the development and promotion of national accounting standards in conformity with the IAS. The Central Asian Accounting Reform Project sponsored by USAID has recommended the establishment of an appropriate body to develop and approve accounting methodology and standards, promulgate instruction, provide training, and license professional accounting and auditing activities. A working group of local and international accounting and auditing experts has developed a list of accounting standards, modeled on the IAS and adapted to local practices and conditions. Under the Program, as an interim measure, the Government has established a department under MOF that is authorized to undertake the above mentioned functions. With USAID assistance, the Government will assist enterprises to adopt the sanctioned accounting standards. Some 300 enterprises are being targeted and the Government will ensure that at least 80 of these targeted enterprises adopt the new accounting standards as a condition for release of the second tranche.

D. Social and Environmental Issues

1. Social Issues

96. The transformation of the Kyrgyz economy and related enterprise reform has, and will continue to have, a major effect on employment and on the provision of social services by enterprises. Many SOEs have not paid wages for extended periods, and is generally acknowledged that SOEs are greatly overstaffed. As enterprise reform continues, viable enterprises will have to become more competitive. The effect of this will be to shed surplus workers. Nonviable enterprises will be closed and their workers released into the market.

97. Growing long-term unemployment is a specific feature of the labor market, and is new to the country. In 1995, more than 50,000 workers were laid off. An even larger number have resigned voluntarily. New entrants continue to join the workforce. New job placements are found by less than half of those freed into the labor market. Unemployment figures are unrealistically low. In October 1996, only 78,600 workers, or 4.8 percent of the labor force of 1.6 million, were registered as unemployed, an increase of 56 percent over the 1995 level. The Ministry of Labor and Social Protection (MLSP) officials estimate unofficial unemployment at twice that figure, which still seems to be inconsistent with economic reality. The National Statistics Department projects unemployment of 7.9 percent in the near future, with 80 percent coming from the public sector.

98. A Poverty Impact Assessment to evaluate the likely adverse impact of the Program on vulnerable groups was carried out (for details, see Appendix 4). It is in practice not possible to successfully disentangle the impact of any one adjustment Program from that of the transition process in general or from the impact of adjustment packages supported by other aid agencies. In any case, the very significant transition costs are the result of the inappropriate policy legacy of the past. The Program is designed to minimize the adjustment costs during transition. The Poverty assessment revealed that the Program is unlikely to have a significant additional impact on unemployment. The major impact was identified as the recognition of the loss of employment that has already occurred. This is likely to affect more than 300 nonviable and essentially nonoperating SOEs. For schematic purposes, the recognition of loss of unemployment can be linked to the strengthening of the capacity to carry out out-of-court liquidations and in-court bankruptcy procedures for failing enterprises. In addition the Program period is likely to coincide with the contraction of large SOEs. In total, the Program will involve the recognition of employment loss for some 75,000 workers during the Program period. The

costs of the various retrenchment packages and training programs will be in the order of $20 million. The major positive impacts will be higher incomes and improved income security for employees retained at more successful enterprises and greater supplies of goods and services to consumers.

99. Measures will be required in both the short and long term to ameliorate the negative impact on employment of the transition process. The greatest need for short-term action is income support for those who are retrenched. In the long term, action will be needed to create job opportunities to enable the retrenched to reenter the workforce.

100. Administrative structures and mechanisms to ameliorate the short-term negative impact of unemployment are available. MLSP administers the Employment Fund (EF) to deliver unemployment benefits. However, there are weaknesses in the system for assisting the unemployed and especially the newly unemployed. First, there are difficulties in identifying and registering those eligible for unemployment benefits. Second, there are operational difficulties in delivering benefits to those eligible. Third, there are difficulties in providing the funds needed to make payments to all those registered. The financial difficulties of the EF will be aggravated as the number of recipients grows, especially if the MLSP's current efforts to improve identification and registration of the unemployed are successful.

101. Technical assistance to the Social Fund from the European Union is establishing a computer-based accounting system that will significantly improve the operations of both the Social Fund and the EF in relation to identifying and registering those eligible to receive benefits, and in monitoring financial flows. The World Bank is proposing to assist MLSP to improve delivery mechanisms through policy and administrative reforms attached to its Social Sector Adjustment Credit (SDR19 million) now under preparation for approval in early 1998. Targeting for unemployment benefits will be improved including tighter eligibility criteria for unemployment benefits.

102. While these reforms will support operational and financial sustainability for the EF, interim measures will be required to ensure that it has the capacity to assist those negatively affected. Under the Program, the Government will ensure that adequate funds are made available from the budget to meet its obligations to recipients of unemployment benefits until the EF achieves financial sustainability.

103. A deficit of SOM30 million is expected in the EF in 1997. This level of funding will be required annually to maintain the current level of service. The unemployment recognized by the Program will result in additional costs of unemployment benefits and retraining. In this connection, it has been agreed that the Government would ensure SOM70 million will be provided through the Social Fund to the EF in 1998, as a condition for second tranche release. It has been further agreed that during the remaining Program period, i.e., in 1999 and 2000, the Government will provide budget funds to the Social Fund to cover the gap between the EF's collections and revenues plus an additional SOM20 million to mitigate the adverse social impact of transition.

104. MLSP has a range of programs to create paid and self-employment that will, in the long term, assist those retrenched. The United Nations Development Programme (UNDP) and Germany are assisting MLSP to enhance these programs and further assistance is expected from the World Bank. In particular, the World Bank's support will be directed at active labor market policies to assist unemployed youth, those affected in rural areas, and women. The development of employment and training opportunities for women is expected to involve

support for a women's employment and training investment fund and the provision of microcredits.

105. The Program does not involve gender issues in any significant way.

2. Environmental Issues

106. The Program has been classified as Category C by the Bank's environmental classification system. Its environmental impact is expected to be minimal.

VI. THE PROPOSED LOAN

A. Amount of Loan and Source of Funds

107. It is proposed that the Bank provide a loan of SDR28,964,000 ($40 million equivalent) from the Special Funds resources to support policy reform in the enterprise sector.

B. Interest, Maturity, and Utilization Period

108. The Borrower will be the Kyrgyz Republic, and the loan will carry an annual service charge of 1 percent. It will have a repayment period of 40 years, including a grace period of 10 years.

109. The loan is expected to be used over a period of 36 months from the date of loan effectiveness. Its proceeds may be used to finance eligible imports incurred within 180 days prior to the date of effectiveness.

110. The loan will be released in two equal tranches. The first tranche will be made available upon loan effectiveness. The second tranche is expected to be released by May 1999, but this will be dependent upon satisfactory implementation of the Government's enterprise reform program, in particular fulfillment of all conditions for release of the second tranche, as specified in the Policy Matrix (see Appendix 3).

C. Implementation Arrangements

111. The Department of Economic Sector Development (DESD) in the PMO will be the Executing Agency for the Program loan, and will be responsible for the effective administration and disbursement of the loan proceeds and the proper maintenance of records.

112. DESD will provide quarterly reports on the progress of the Program. These will indicate, among other things, progress made, problems encountered, remedial action taken during the previous six months, and proposed Program activity and expected progress during the following six months.

113. A steering committee will be established to oversee the implementation of the Program. The committee will be chaired by the Prime Minister and will comprise the minister of Finance, minister of Foreign Trade and Industry, minister of Justice, chairperson of SPF, chairperson of NBKR, chairperson of the National Commission for Securities Markets, and the chairperson of the Supreme Court of Arbitrazh. This steering committee will meet at least once

every three months to ensure that the proposed reforms are undertaken in line with the agreed timetable. A division within DESD will be formed for the day-to-day supervision of the Program's progress.

D. Procurement and Disbursement

114. Disbursements from the loan will be based on a negative list of imports (see Appendix 5). In the case of goods commonly traded on international commodity markets, procurement undertaken in accordance with normal commercial procedures appropriate to the trade will be regarded as acceptable to the Bank. Procurement of goods for which contracts are less than \$5 million will be based on normal commercial practices for procurement by the private sector or Government procurement procedures acceptable to the Bank for procurement by the public sector. Each supply contract for eligible imports estimated to cost \$5 million or more will be awarded through international competitive bidding procedures in accordance with the Bank's *Guidelines for Procurement*. Procurement of goods in excess of the international competitive bidding threshold will be subject to Bank review after award of the contract but prior to disbursement. Contracts valued at less than \$5 million will be subject to a post review by the Bank. In the event that appropriate procedures have not been followed, the Bank reserves the right to withhold the disbursement of funds or to seek reimbursement. Proceeds of the loan will be withdrawn in accordance with the Bank's standard disbursement procedures.

E. Counterpart Funds

115. The counterpart funds to be generated from the proceeds of the Program loan will provide budgetary support that will be used to help finance the costs of adjustment. In particular, the Government will provide SOM70 million from the Social Fund to the EF in 1998, and during each of the remaining years of the Program period will provide SOM20 million in addition to the amount required to meet the deficit between the EF's collections and expenditures.

F. Monitoring and Tranching

116. The Bank will, in cooperation with DESD, carry out periodic reviews of progress in the implementation of the Program, and will assess the impact of the Program on the enterprise and other sectors of the economy. The Government will keep the Bank informed of the outcome of the policy discussions with other multilateral and bilateral aid agencies that have implications for implementation of the Program, and will provide the Bank with an opportunity to comment on any resulting policy proposals.

117. In addition to the quarterly progress reports, DESD will submit a Program completion report to the Bank within six months of the release of the second tranche. This report will evaluate the implementation of the policy reform measures under the Program, their impact on the economy and the enterprise sector, lessons learned during the Program period, and further reforms and assistance needed for the development of the sector.

118. There are 19 actions in the Policy Matrix in Appendix 3, that are required to be completed prior to Board consideration; all have been substantially completed. Amendments to the Law on Foreign Investments have passed by the Parliament. Certain aspects of these amendments are being further reviewed and will be completed in September 1997. Enactment of the new Law on Bankruptcy constitutes a condition for loan effectivity. The Law has been

passed on its first reading; its second reading and enactment are expected in September 1997. For release of the second tranche, the following seven actions are required:

(i) Implement best practice corporate governance structures in key state enterprises: Kyrgyzenergo, NAK, Kyrgyztelecoms, and Kyrgyzgasmunaizat to implement corporate governance structures including (a) company charters; (b) appropriate supervisory and management structures; and (c) monitoring/reporting requirements in compliance with the handbook on best practice in corporate governance (1.C.3).

(ii) Complete the public education and information project to disseminate best practice in corporate governance (I.E.3).

(iii) Complete the management development training project (1.E.5).

(iv) Reduce loans in the 1998 budget to commercial enterprises to SOM160 million, i.e., 50 percent of the 1997 budget figure (II.A.3).

(v) Complete training for judges of the Arbitrazh Courts; other court personnel; and valuers, receivers, and liquidators (IV.B.2.).

(vi) Assist 80 of the 300 enterprises targeted by the accountancy project to adopt new accounting standards (V.A.4).

(vii) Submit a provision for the 1998 budget to ensure SOM70 million to be directed through the Social Fund to be allocated to the EF for unemployment benefits and retraining for persons affected by the Program (VI.4).

119. An additional 16 monitorable actions will be taken during the Program. Most of these actions represent important steps toward achieving the objectives designated as conditions for the release of the second tranche.

G. Accounts and Audits

120. Unless otherwise agreed during loan negotiations, an imprest account will be established into which the proceeds of the Program loan will be deposited. The conditions relating to this account would be specified by the Bank during loan negotiations.

VII. THE PROPOSED TECHNICAL ASSISTANCE

A. TA Loan for Capacity Building in Corporate Governance and Insolvency Procedures

121. In addition to the Program loan and in support of the Program, it is proposed that the Bank provide a TA loan of SDR2,896,000 ($4 million equivalent) from its Special Funds resources for capacity building in corporate governance and insolvency procedures. As for the Program loan, the Borrower of the TA loan will be the Kyrgyz Republic, and the loan will carry

an annual service charge of 1 percent and have a repayment period of 40 years, including a grace period of 10 years. The TA loan is expected to be used over a period of 18 months.

122. The Government has initiated discussions with UNDP for $1 million in grant assistance and should that grant assistance materialize, the Government would like to reduce the TA loan from the Bank accordingly. The Bank will provide umbrella financing for this amount and when confirmation from UNDP has been received, and terms of reference and competitive selection of international consultants based upon technical merits have been agreed, the Bank will cancel the corresponding amount from the TA loan. The Government and the Bank agree that the UNDP assistance would have to be firmly committed not later than 31 December 1997 for it to be utilized effectively under the Program.

123. The TA loan will have the following components: (i) strengthening monitoring and implementation capacity for improved corporate governance structures, inclusive of a management development training for senior- and middle-level executives of SOEs and privatized enterprises, and a public information and education project to disseminate best practice in corporate governance; and (ii) strengthening of the legal framework to ensure effective implementation of insolvency procedures. It is expected that a total of 67 person-months of international consulting services and 176 person-months of domestic consulting services will be required. All consultants will be recruited in accordance with the Bank's *Guidelines on the Use of Consultants* and other arrangements satisfactory to the Board for the engagement of domestic consultants. The objectives, terms of reference, and detailed cost estimates are in Appendix 6 and Supplementary Appendix C.

124. Procurement of goods and services to be funded from the TA loan will be subject to the provisions of the Bank's *Guidelines for Procurement*. Generally this will mean that supply contracts for equipment or materials will be awarded on an international shopping basis, except in the case of minor items where off-the-shelf purchases will be permitted. Any civil works financed under the TA loan will be on either a local competitive bidding or force account basis.

B. TA Grant for Strengthening the Capacity of the PMO

125. The Government has requested a TA grant of $800,000 for strengthening the capacity of the PMO to analyze, formulate, coordinate, and implement economic reform policies. The PMO coordinates the work of other ministries and is the ultimate authority responsible for preparing position and policy papers for the Government's decision. In particular, a need has been felt to strengthen PMO's capabilities in respect of preparing short- and medium-term macroeconomic assessments and projections, and the analysis of international trade issues and industrial developments. A team of two international consultants will be recruited, consisting of a macroeconomist and international trade and industrial economics expert to provide 18 person-months and 3 person-months of consulting services respectively. The consultants will be recruited in accordance with the *Bank's Guidelines on the Use of Consultants*. They will implement a course of training in analytical and quantitative methods, assist the Government in preparing short- and medium-term economic projections, and provide advice on a range of economic policy issues requiring the attention of the PMO. The objective, terms of reference, and detailed cost estimates are in Appendix 7. The experts will be attached to the staff of the Prime Minister. The TA grant will be financed by the Bank from the Bank-funded TA Program.

VIII. PROGRAM BENEFITS AND RISKS

A. Benefits

126. The Program will strengthen the Kyrgyz Republic's continued efforts to establish a market-based economy. Experience has shown that liberalization measures alone may not promote market-oriented behavior in an economy with the serious institutional rigidities typical of a command system. The Program, while deepening the Government's ongoing reform measures, is designed to bring about changes in the governance of enterprises that currently dominate the economy. The Program will support the reform and strengthening of the legal and policy environment for operations in the enterprise sector, and promote the development of institutions for corporate governance required to underpin a market-based economy. It is expected that the combination of policy reform and development of institutions will set in place a market-oriented structure of incentives at the enterprise level. To this end, the Program is designed to help improve the efficiency and prudence of decision making in enterprises, and instill greater financial discipline on enterprise operations. The improved incentive structure at the enterprise level will lead to better performance by the sector, and will result in a more efficient mobilization and allocation of scarce resources—financial, managerial, and material—within the overall economy. This will facilitate structural adjustment and contribute to efficient economic growth.

B. Risks

127. The major risk to the successful implementation of the Program is that some groups may seek to undermine the content and timing of the reforms if they see themselves as being adversely affected. However most employees of enterprises likely to be taken through bankruptcy are now not being paid, and as unemployment benefits and retraining will be available, formal bankruptcy procedures will likely face less opposition from workers. However, other groups that will have their powers reduced or subject to greater accountability could resist the implementation of the Program. Another important risk is that the Government may not be able to sustain macroeconomic stability. High budget deficits may raise inflation and real interest rates, and contribute to increased uncertainty that will be detrimental to enterprise performance. Finally, the implementation of best practice corporate governance principles may proceed more slowly than anticipated.

128. The risk of opposition to reforms will be mitigated by the Government's strong commitment to the Program, and activities under the loan that will facilitate the understanding and cooperation of other stakeholders. The second risk will be mitigated by the Government's strong commitment to stabilization programs under IMF and World Bank auspices. The third risk will be mitigated by the ongoing TA that assists the Government in developing and implementing best practice corporate governance principles, as well as by further assistance to be provided for this purpose under the TA loan attached to the Program.

IX. ASSURANCES

129. Other than the tranching conditions stated earlier, the Government has assured the Bank that (i) the policies adopted and actions taken prior to the date of the Loan Agreement, as described in the Development Policy Letter (Appendix 2), will continue in effect

for the duration of the Program period; and (ii) it would promptly adopt the other policies and take the other actions included in the Program as specified in the Development Policy Letter and/or Loan Agreement and ensure that such policies and actions continue in effect for the duration of the Program period.

X. RECOMMENDATION

130. I am satisfied that the proposed loans for the Corporate Governance and Enterprise Reform Program would comply with the Articles of Agreement of the Bank and recommend that the Board approve:

(i) the loan in various currencies equivalent to Special Drawing Rights 28,964,000 ($40 million equivalent) to the Kyrgyz Republic for the Corporate Governance and Enterprise Reform Program, with a service charge at the rate of 1 percent per annum and with an amortization period of 40 years, including a grace period of 10 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Program Loan Agreement presented to the Board; and

(ii) the TA loan in various currencies equivalent to Special Drawing Rights 2,896,000 ($4 million equivalent) to the Kyrgyz Republic for Capacity Building in Corporate Governance and Insolvency Procedures under the Program with a service charge at the rate of 1 percent per annum and with an amortization period of 40 years, including a grace period of 10 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Technical Assistance Loan Agreement presented to the Board.

MITSUO SATO
President

25 August 1997

APPENDIXES

SUPPLEMENTARY APPENDIXES
(Available on Request)

KGZ: CORPORATE GOVERNANCE AND ENTERPRISE REFORM PROGRAM LOAN PROGRAM FRAMEWORK

Design Summary	Program Outputs	Monitoring Mechanisms	Risks/Assumptions
1. GOAL • To promote economic growth • Mitigate transition costs	• Sustained growth of the economy and of the enterprise sector as indicated by increase in the rate of growth of GDP and gross value added, and in enterprise profitability • Maintenance of adequate levels of consumption	• Economic reports	• Groups that will have their powers reduced or subjected to accountability could resist implementation of the Program. • Government may not be able to sustain macroeconomic stability. • Implementation of best practice corporate governance may proceed more slowly than anticipated. • Bad weather may adversely affect agriculture and the economy's growth.
2. OBJECTIVE • To improve the performance and efficiency of the enterprise sector so that it can be viable in a competitive economy 2.1 To increase the number of enterprises implementing and practicing improved corporate governance arrangements	• Increased institutional capacity of government departments to implement, monitor and enforce compliance of enterprises with best practice in corporate governance as embodied in the mandatory model Company Charter, as indicated by (i) improved collection, collation and recording of information on registration and corporate governance structures of companies; (ii) improved computer-based company registration database system and sharing of information among relevant government departments; and (iii) improved skills of government officials to evaluate corporate governance structures of companies and examine extent of compliance with corporate governance decrees.	• Progress reports • Databases of various government departments • Company records and registration data • Evaluation reports prepared by Corporate Development Center (CDC) and government departments	• Sustained commitment by government for enterprise reforms • Government to facilitate inter-departmental coordination and cooperation • Credibility and enforcement of sanctions against companies failing to register and comply with the model Company Charter

Design Summary	Program Outputs	Monitoring Mechanisms	Risks/Assumptions
	• Improved corporate governance practices among enterprises, as indicated by: (i) 100% of public majority state-owned enterprises (with more than 50 shareholders), under jurisdiction of SPF, to have complied with the model Company Charter; (ii) 60% of all JSCs to have complied with the model Company Charter; (iii) participation of company officials in corporate governance training programs undertaken by CDC; and (iv) dissemination of corporate governance implementation reference manuals by CDC.		
2.2 To increase enterprise management skills and enterprise management training capacity	• Minimum of 125 enterprise management staff trained in modern management systems, marketing and product development • Increased local capacity in management development training, as indicated by (i) minimum of 20 local trainers trained; (ii) training programs executed by local trainers; and (iii) training materials tailored to local needs.	• Attendance record and questionnaires • Evaluation report on training programs and on execution of training programs by local trainers	• Time and cost constraints on enterprises
	• Adoption of corporate governance best practices by at least 60% of target JSCs	• Government registration records	• Maintenance of and access to records
2.3 To develop and strengthen public awareness of the principles and objectives of good corporate governance, and of shareholders rights and responsibilities in particular	• Increased awareness of good corporate governance practices among opinion leaders and general population	• Qualitative research • Media monitoring • Response rates to CDC help line, consulting services	• Other aspects of corporate governance are implemented as planned.
2.4 To improve the legal framework covering insolvent enterprises	• Implementation of Bankruptcy Law and training of Judges	• Project progress reports • Consultant reports	• Parliamentary delay possible; unacceptable changes to draft
2.5 To develop mechanisms to monitor and assess the impact of ongoing macroeconomic, industrial and trade policy reforms, including enterprise reforms	• Capacity of the Department of Economic Development and Finance (DEDF) in the Prime Minister's Office strengthened to initiate, manage, monitor, and assess the impact of policy reforms	• Project progress reports	
3. **PROGRAM COMPONENTS**			
3.1 Enterprise efficiency promoted through corporate governance	• Model Company Charter embodying best practice in corporate governance to be developed and made	• NBKR has issued regulations recommending commercial	• Time and cost constraints on enterprises

Design Summary	Program Outputs	Monitoring Mechanisms	Risks/Assumptions
	mandatory for all JSCs with more than 50 shareholders	banks to include compliance with the model Company Charter as part of the normal credit approval process. • Government Decree 433 of July 26, 1997 mandates: (i) appropriate licensing authorities to require nonbank institutions to adopt model Company Charter specified in Handbook as a condition for licensing; (ii) joint stock companies registering with the National Commission on Securities to be required to adopt the model Company Charter of the Handbook; and (iii) joint stock companies with more than 50 shareholders must adopt Company Charter specified in the Handbook to prequalify for Government procurement contracts.	
	• By June 1998, complete implementation of corporate governance structures of Kyrgyzenergo, Kyrgyztelecoms, NAK, and Kyrgyzgasmunaizat in accordance with the model Company Charter	• Project progress reports	
3.2 Financial discipline imposed on enterprises	• Throughout the program, budget loans to commercial enterprises reduced annually by 50% of the previous year's value, starting at the 1997 figure of SOM320 M	• Project progress reports • Ministry of Finance	
3.3 Domestic and international competition promoted and enabling environment for FDI strengthened	• Throughout the program, no new quantitative restrictions are imposed on international trade • Throughout the program, no tariffs on imports to be raised except in accordance with WTO anti-dumping provisions	• Project progress reports	
3.4 Legal framework for insolvency strengthened and its enforcement ensured	• New Bankruptcy Law enacted prior to loan effectivity • By April 1998, 20 of 31 vacancies in Arbitrazh Court filled		• Parliamentary support for reform proposals • Insufficient number of suitable candidates
3.5 Transparency in financial accounting and reporting promoted	• By December 1997, a program to assist 300 enterprises to adopt national accounting standards implemented		• Support from USAID for the successful training of local accounting firms.

Design Summary	Program Outputs	Monitoring Mechanisms	Risks/Assumptions
3.6 Transition costs mitigated	• By March 1999, at least 80 of the enterprises targeted by the above program assisted in adopting new accounting standards • By November 1997, Social Fund to introduce accounting and reporting systems in accordance with internationally accepted accounting standards • By December 1998/99, budgetary allocation provided to the SF for allocation to the EF: SOM20 million for training and SOM30 million for unemployment benefits		• Government commitment to reforms
3.7 TA Loan: Implementation of Corporate Governance Structures and Bankruptcy Procedures			
3.7.1 Capacity building in the implementation and enforcement of Best Practice in Corporate Governance	• Corporate Development Center (CDC) established	• Progress reports	
3.7.1.1 Corporate governance monitoring, implementation and enforcement capacity of government departments improved	• Monitoring system and computer-based database on company registration and corporate governance structures developed • 60 government officials trained to evaluate corporate governance compliance • Enforcement of registration and corporate governance compliance • Model accounting and financial reporting systems developed	• Evaluation reports • Progress reports	• Inter-departmental coordination and cooperation • Weak enforcement by government and lack of credibility of sanctions
3.7.1.2 Enterprise management skills and development training capacity improved	• Training of 20 trainers and 125 enterprise managers in management skills	• Project progress reports • Evaluation reports	
3.7.1.3 Public Information and education implemented			
(i) Conduct qualitative research	• 20 focus groups established	• Research reports	
(ii) Operate CDC Information Bureau	• Bureau established on schedule • Help line established and promoted • One information network post established in each oblast	• Project progress reports • Distribution and information request logs	• Other CDC initiatives implemented fully
(iii) Targeted outreach to enterprises	• Reach minimum of 800 enterprises with informational materials • At least 50 enterprise meetings conducted	• Project progress reports • Distribution logs	
(iv) Direct outreach to public	• At least 11 public meetings/ events conducted • At least five ally organizations developed and mobilized • Use of schools module in at least 30 institutions developed, promoted, and monitored	• Project progress reports	• Interest of groups stimulated • Interest of schools stimulated
(v) Media relations improved	• At least 12 media events held	• Project progress reports	• Full government support and

Design Summary	Program Outputs	Monitoring Mechanisms	Risks/Assumptions
	• At least 15 press releases issued • At least eight special television or radio program features aired • Q&A column to appear at least 24 times • At least 200 press kits produced and distributed		designation of spokesperson
(vi) Information materials produced and distributed	• At least 50,000 copies of informational leaflets, glossaries and other materials produced and distributed • Print and video materials to support training programs produced and distributed	• Project progress reports • Distribution logs	
(vii) Sustainability of campaign ensured	• CDC promoted as source for corporate governance information and counsel • At least two private agencies or NGOs enlisted and promoted as shareholders rights promoters	• Project progress reports • Focus group research	• Sustained group's interest and willingness to participate
3.7.2 Reformed and improved legislation and procedures relating to bankruptcy, and in related institutional strengthening of the judiciary and State Property Fund			
3.7.2.1 General Instructions on Insolvency improved	• Changes to Civil Code relating to Bankruptcy, in form substantially approved by the Working Group • New Law on Bankruptcy consistent with changed Civil Code, in form substantially approved by the Working Group • Revised version of General Instructions for Bankruptcy consistent with new Law and Civil Code • Working group established to review enforcement of judicial decisions and to make recommendations	• Project progress reports • Consultant reports	
3.7.2.2 Capacity of the judiciary to implement insolvency laws improved	• Seminars for judges, 20 of whom are to specialize in bankruptcy procedures to be held in Bishkek and Osh • Seminars for insolvency practitioners, 20 of whom are to receive special training to be held in Bishkek and Osh • Practical handbook on insolvency prepared • Plan for sustainability of training and institutionalization of training programs especially through SPF prepared Judges trained in use of computers and e-mail and in use of Toktom computerized legal information system and other information retrieval systems	• Project progress reports • Consultant reports	• Inability/ unwillingness of sufficient number of judges to attend training courses • Inability to find unacceptable candidates as judges
3.7.2.3 Assistance to the State Property Fund	• Training function for judges and others continued • assistance in the conduct of liquidations and reorganizations		

Design Summary	Program Outputs	Monitoring Mechanisms	Risks/Assumptions
	• assistance in the continuing process of revision of regulations • continuing development of appropriate practices and procedures		
3.7.2.4 Support to the Working Group on Law Enforcement	• Report to be presented to Government by end-December 1997		
3.8 TA: Strengthening the Economic Policy Making and Monitoring Capabilities of the Prime Minister's office			
3.8.1 Computer-based economic information system established	• National income and related economic data collected and collated • Computer-based quarterly and annual economic forecasting model developed and tested		
3.8.2 Assistance in planning and formulation and management of policies provided	• Forecasts of expected outcomes of various policy options provided • Training of staff conducted • Preparation of regular reports on economic activity initiated		
4. PROGRAM ACTIVITIES	INPUTS		
4.1 Guidelines on corporate governance in strategic and large SOEs implemented			
4.2 Financial discipline imposed on enterprises			
4.3 Domestic and international competition promoted and enabling environment for FDI strengthened			
4.4 Legal framework for insolvency strengthened and its enforcement ensured			
4.5 Transparency in financial accounting and reporting promoted			
4.6 Transition costs mitigated	• SOM20 million for training, SOM30 million for unemployment benefits in 1998 budget • $4 million		
4.7 TA Loan			
4.7.1 Capacity building in the implementation and enforcement of Best Practice in Corporate Governance	• Total cost of $1.7 million • CDC will have an office manager and administrative and secretarial support staff of 5 people • 1 full-time corporate governance specialist as Chief Consultant		

Design Summary	Program Inputs	Monitoring Mechanisms	Risks/Assumptions
	• Government will meet pay the salaries of the 7 government officials seconded to the CDC • TA will meet the costs of the international consultants, salaries of local administrative/secretarial support staff; electronic equipment; operating expenses • Total cost of $2.3 million		
4.7.1.1 Corporate governance monitoring, implementation and enforcement capacity of government departments	• 5 full-time professionals with expertise in corporate governance, corporate law, company organization, accounting systems and financial reporting systems • 2 part-time international specialists/ consultants in corporate governance		
4.7.1.2 Management development training	• 1 supporting and 1 professional staff each with expertise in Business Management and Public Relations, respectively • 2 part-time international business management specialists/ consultants		
4.7.1.3 Public information and education campaign	• Total cost of $600,000		
(i) Conduct qualitative research as well as focus groups and individual interviews	• $20,000 • 2 weeks of short-term international consultant • 2 months of long-term domestic consultant	• Research reports • Project progress reports	
(ii) Operate CDC Information Bureau as source for all materials, outreach, help line, regional information network	• $16,000 • 1 month of short-term international consultant • 6 months of long-term domestic consultant	• Project progress reports • Distribution logs • Help line logs	
(iii) Targeted outreach to enterprises	• $16,500 • 1.5 months of short-term international consultant • 7 months of long-term domestic consultant	• Project progress reports	• Continued government support • Sustained interest of enterprises
(iv) Direct outreach to public	• $17,600 • 1.5 months of short-term international consultant • 7 months of long-term domestic consultant	• Project progress reports • Focus groups • Volume of calls/inquiries to CDC Information Bureau	
(v) Media Relations	• $51,000 • 1 month of short-term international consultant • 6 months of long-term domestic consultant	• Project progress reports • Distribution logs	• Distribution network established
(vi) Promoting sustainability of campaign	• 1.5 months of short-term international consultant • 8 months of long-term domestic consultant	• Project progress reports	• Sustained interest of local private groups
4.7.2 Reformed and improved legislation and procedures relating to bankruptcy, and institutional strengthening of the judiciary and State Property Fund	• Total cost of $1.7 million		

Design Summary	Program Inputs	Monitoring Mechanisms	Risks/Assumptions
4.7.2.1 General Instructions on Insolvency improved	• 1 consultant with Russian language skills who is familiar with the existing laws and regulations relating to insolvency as well as international law and practice		
4.7.2.2 Capacity of the judiciary to implement insolvency laws improved	• Consultants with Russian language skills and familiar with existing laws and regulations relating to insolvency as well as international law and practice • Modest financial support for training participants • Consultants will further support judges over a further period of 2 years through e-mail		
4.7.2.3 Assistance to the State Property Fund	• 1 international consultant for a total of 6 months spread over a longer period • 3 domestic consultants over a period of 18 months		
4.7.2.4 Support to the Working Group on Law Enforcement	• Support will be given by domestic of international consultants employed in respect of the revisions to the General Instructions on Insolvency and by the consultant working with the State Property Fund		
4.8 TA: Support for PMO	• Total cost of $830,000 • 18 months international consultant: Macroeconomist • 3 months international consultant: International Trade and Industrial Economics Expert		
4.8.1 Computer-based economic information system established	• office equipment	• Monthly reports • Final report	
4.8.2 Assistance in planning and formulation and management of policies provided	• office equipment • translation services	• Monthly reports • Final report	

JSC - Joint Stock Company
MOF - Ministry of Finance
SOE - State-Owned Enterprise
SPF - State Property Fund

КЫРГЫЗ РЕСПУБЛИКАСЫНЫН ПРЕМЬЕР-МИНИСТРИ

ПРЕМЬЕР-МИНИСТР КЫРГЫЗСКОЙ РЕСПУБЛИКИ

БИШКЕК ш., ӨКМӨТ ҮЙҮ

г. БИШКЕК, ДОМ ПРАВИТЕЛЬСТВА

«___» ____________ 199 ж. г.

№ 004068

Жооп кайтарууда биздин № жана дата көрсөтүлсүн
При ответе обязательно ссылайтесь на наш № и дату

DEVELOPMENT POLICY LETTER

31 July, 1997

Mr. Mitsuo Sato
President
Asian Development Bank
ADB Avenue
Manila
Philippines

Dear Mr. President,

1. The Kyrgyz Republic began the effort to stabilize and structurally transform its economy in 1991. The stabilization objectives have been pursued under successive World Bank and International Monetary Fund (IMF) arrangements. Despite the magnitude of the external shock since 1991, and policy slippage resulting from inexperience with the new indirect instruments of macroeconomic control, the Republic's stabilization efforts have been more successful than almost all the states of the former Soviet Union. The hyperinflation experienced in 1992 and 1993 has been brought under control, and the annual rate of inflation expected in 1997 is now about 17 percent, down from a peak of about 100 percent in 1993. For the first time since 1991, positive economic growth was recorded in 1996.

2. The structural reforms have had three broad, interrelated objectives. The first objective is to change the role of the State by reducing its participation in the ownership and financing of enterprises while strengthening its policy and regulatory role. The second objective is to create new markets by liberalizing prices and trade. The third objective is to develop a new dynamic private sector, and promote privatization and the restructuring of former State-owned enterprises. A wide range of complementary reforms, both across and within sectors, have been undertaken in pursuit of these objectives.

3. To create an enabling environment for a market-based economy, basic legislation has been passed, and the Government is implementing an action program of legal and regulatory reforms that secures property rights, removes entry and exit barriers, and removes hindrances to business operations. Markets have been liberalized, price controls abolished in most cases, and the system of obligatory state orders and supply contracts eliminated.

4. A major objective of the Government has been to transfer ownership of State- owned-enterprises to the private sector as rapidly and efficiently as possible. By the end of 1996, more than 50 percent of State assets had been privatized. Since 1994, the privatization process has been conducted on a more competitive basis.

5. **The Program.** Mr. President, the Corporate Governance and Enterprise Reform Program forms a core component of the Government's continuing reform strategy to modernize the economy and complete its systemic transformation.

6. **Strengthening Corporate Governance.** The Government's goal for enterprise reform is to facilitate the development of a modern and competitive enterprise economy while providing adequate protection for the rights of shareholders, and investors. A fundamental objective of the Program is to develop sound corporate governance structures under which the rights and obligations of owners (whether public or private), managers, and stakeholders are clearly defined and enforced. An effective system of corporate governance must ensure an adequate supply of corporate finance, in appropriate form and at competitive rates, to fund all commercially viable business opportunities open to the company in the light of its technology, skills, and experience. Suppliers of finance will either require equity stakes within an ownership structure that fully protects their rights and returns; or in the case of debt finance, reasonable assurance that the company will be run in a way that maximizes the prospect of the loan being financed and repaid on time. In each case this requires that an effective governance system be in place.

7. Viable competitive enterprises need good management, appropriate technology and skill, and access to adequate finance. All three are in short supply in the economy, but all three are potentially available together via international collaboration. This will not normally be forthcoming unless the governance system is sound, but at the same time governance arrangements must allow for and incorporate the presence of strategic foreign investors on fair and dependable terms.

8. In view of the above, the Program will establish, codify, and institutionalize sound corporate governance practices leading to greater transparency and more efficient monitoring of enterprises in both the public and private sectors. While a significant number of enterprises will remain under state control, at least in the short term, the Government is introducing measures to strengthen the governance of these enterprises through their corporatization and conversion into joint stock companies (JSCs) enjoying operational autonomy. At the same time, the remaining large conglomerates will be broken up and converted into JSCs at the level of their constituent enterprises. These reforms will be introduced and consolidated in the core areas of state ownership in energy, telecommunications, and transport that are the remaining sectors in which the state retains 100 percent ownership. In these sectors, State-owned enterprises (SOEs) are to be corporatized and placed on the same legal and commercial footing as private firms.

9. A Handbook on "Best Practice in Corporate Governance for Kyrgyz Enterprises" has been prepared under a Bank-financed TA. The Handbook explains the objectives and principles of effective corporate governance. It also contains a model company charter designed to significantly strengthen corporate governance by providing detailed rules in five key areas: (a) shareholders rights and responsibilities; (b) procedures for the convening of annual general and extraordinary meetings of shareholders, and the conduct and voting procedures at such meeting; (c) the membership, duties, and responsibilities of the Supervisory Board (Board of Directors); (d) the membership, duties,

and responsibilities of the Management Board (Executive Body); and (e) the establishment and functions of an Independent Registrar of Shares and a Shareholders' Audit Committee.

10. The enterprises that are required to adopt the model Company Charter, or its minimum essential provisions, are the joint-stock companies with more than 50 shareholders who are required under present legislation to establish a two-tier system (comprising a Board of Directors and an Executive Body of decision making). Compliance with the Best Practice in Corporate Governance, and the implementation of the model Company Charter developed under Bank TA , will be enforced under the Program through

(i) **Public-sector enterprises.** Direct adoption of the specimen Company Charter by all state-owned or majority state-owned enterprises, and in particular by the major public sector monopolies Kyrgyz National Energy Holding Company (KNEHC) and the Kyrgyz Aviation Company, as an essential component of their respective corporatization and privatization programs;

(ii) **Equity Market (Registration).** All joint-stock companies registering with the State Securities Agency will be required to adopt the model Company Charter; companies already registered will be required to adopt the model Company Charter within a nine-month period;

(iii) **Equity Market (Licensing of Nonbank Financial Institutions).** All nonbank financial institutions, such as investment funds, insurance companies, pension funds, etc., will be required to adopt the Company Charter as a precondition for obtaining a license to operate; companies already registered will be required to adopt the model Company Charter within a nine-month period;

(iv) **Equity Market (Listing Requirements).** The adoption of the model Company Charter will be a precondition for listing in the Kyrgyz Stock Exchange; for companies already listed and actively trading on the stock exchange, adoption of the model Company Charter will be a precondition for new share issues;

(v) **Debt Market.** The National Bank of Kyrgyz Republic will make recommendations to all commercial banks that the corporate governance structures, and more specifically their adoption (or nonadoption, as the case may be) of the model Company Charter, of borrowing enterprises be examined during the loan-screening and credit-rating process;

(vi) **Prequalification for Government and International Assistance and Contracts.** Companies seeking either (a) to tender for Government contracts, or (b) assistance (in the form of technical assistance and credit) from bilateral and multilateral agencies under Government agreements, will need to have adopted the model Company Charter to be eligible for such contracts and assistance.

11. In this connection my Government has issued a Decree on 26 July 1997 (a) confirming the model Company Charter as a minimum standard; (b) making its adoption mandatory for joint-stock companies, with more than 50 shareholders; and (c)

tasking various Government and State bodies (such as Ministry of Finance, the State Property Fund, the Ministry of Foreign Trade and Industry, the Ministry of Justice, the National Commission on Securities Market, and the Government Procurement Agency) with its implementation within their respective areas of jurisdiction.

12. Mr. President, it will be essential to strengthen institutional capabilities to ensure that the improved corporate governance structures take hold in the economy and that they are properly understood and enforced. For this purpose the Government expects to utilize a TA loan provided by the bank. This objective of the TA loan will be building up the capacity of local institutions in the Kyrgyz Republic to implement and enforce the best practice in Corporate Governance through the establishment of a Corporate Development Center, which will perform the following functions:

(i) assistance to Government departments tasked with implementing and enforcing the implementation of the normative model Company Charter;

(ii) assistance to enterprises in implementing the normative model Company Charter, as required by legislation, and in helping them to operate and abide by the provisions of the Charter in a practical and concrete way beyond the formal adoption of the Charter;

(iii) assistance to shareholders and enterprise officials to inform them of—to ensure that they fulfill—their rights and obligations under the Charter, including advice and support for them on legal and other means of enforcing compliance with the Charter in cases of violations;

(iv) provide a corporate governance training program, aimed at developing expertise in implementing and monitoring effective corporate governance, at relevant Government and State bodies, banks, nonbank financial institutions (such as investment funds), universities, etc.;

(v) implementing a management development training program, aimed at introducing modern management systems and techniques at selected leading public and private sector enterprises. operating under new corporate governance structures, to accelerate their competitiveness and efficiency; and

(vi) implementing a public information and education program to develop awareness among shareholders, enterprise officials, and the general public about the objectives and principles of good corporate governance as well as the rights and responsibilities of shareholders and enterprise officials.

13. **Improving Financial Discipline.** In response to budgetary limitations and the need to ensure that enterprises face appropriate financial discipline, the Government has progressively reduced the direct assistance provided to enterprises. Directed credits have been terminated, and central bank loans to enterprises eliminated. However, a number of enterprises, facing short-term financial constraints, have been provided with loans from the budget. Under the Program, this facility will be initially rationalized by cutting off loans to enterprises with arrears, an action that has already been taken. The Government will implement an action plan for further rationalizing of this scheme. In this connection, the amounts to be provided to enterprises from this facility will be reduced in

1998 to Som160 million, or 50 percent of the Som 320 million to be provided in 1997. Furthermore, in each successive year these loans will be reduced by 50 percent of the previous years budget allocation. Additionally, the Government will apply to these loans an interest rate equal to the expected annual rate of inflation plus a service charge.

14. **Assurance of Competitive Markets.** Economic efficiency and the viability of enterprises depend on the existence of competitive and distortion-free input and product markets that provide appropriate market signals for allocating resources. In this connection the Government will continue to ensure competition in markets through entry of private firms as a major inducement to SOEs to improve efficiency. Price controls have been liberalized in the Kyrgyz Republic, and there is free entry by the private sector in most economic activities. The low tariff and open trade policy regime contributes to competition and efficiency in the economy. To maintain this conducive environment, the Government will ensure that no new quantitative restrictions are introduced. It will also ensure that import tariffs are not raised during the Program period, except where justified by World Trade Organization (WTO) antidumping provisions.

15. Foreign direct investment (FDI) can play a key role in the recovery of the Kyrgyz economy by bringing capital, technology, management skills, and access to export markets. While the Government wishes to encourage FDI, the policy environment needs further strengthening. One problem is the duplication of efforts across and within ministries. This has resulted in blurred and overlapping responsibilities. The FDI policy environment has been improved, a new Law on Foreign Investment has been enacted, and a "one-stop entry shop" for attracting foreign direct investment established.

16. **Strengthening Bankruptcy Procedures.** An important component of the Program will be to strengthen the legal framework for, and capabilities to implement, insolvency procedures. This is an essential prerequisite to rationalizing and restructuring enterprises. Rationalization of plant, equipment, and labor is needed to redress the fundamental distortions that are the legacy of the previous centralized economic system and to produce viable enterprises through the process of restructuring. Occasionally entire enterprises may be restructured. Often, only parts of former enterprises are viable and must be separated in order to survive. However, in many cases, there is little hope of restructuring. In such cases, the enterprise must be closed, and its assets released into the market. The process of insolvency acts as an effective mechanism to clear away nonviable enterprises and to free up the marketfor more effective producers and employers. Assets of these nonperforming or underperforming enterprises (fixed assets, inventory, raw materials, and accounts receivable), as well as human resources, are then released into the market to be reallocated to potentially more productive uses.

17. The adoption of the new Bankruptcy Law under the Program (in substantially the form developed by the Working Group on Bankruptcy) and its implementation will allow the reallocation of underutilized assets to sectors and activities in which they may be more productive. These steps will help to give courts an independent role as adjudicators of commercial disputes and enforcers of commercial laws. The new Law will give greater priority to secured lenders in settling claims. It is expected that this will provide banks and other financial institutions the opportunity to play a more proactive role in monitoring enterprise performance and in shaping restructuring decisions.

18. A major constraint to the efficient functioning of the judicial system is the insufficent number of qualified Arbitrazh judges. Court buildings are often inadequate and lack facilities such as good legal libraries or even basic collections of legislation, or word-

processing and communication facilities. In some oblasts, the courts are forced to meet in inadequate rented accommodation. The judges also require additional training in the basic principles of commercial legislation: in corporate law, financial law, and the law relating to bankruptcy.

19. Under the Program, measures will be taken to strengthen the capacity of the judges to enforce good corporate governance and appropriate liquidation procedures. These measures will include the appointment of more judges, which will be done in a manner so that the best candidates can be found and given proper basic training. Additionally, the court facilities will be rehabilitated, and the courts provided with appropriate legal materials and with equipment to assist them in carrying out their functions. The judges—or a selected number of them—will be given appropriate training in the fields of corporate, financial, and insolvency legislation. This will also include some training in such associated fields as the valuation of assets and basic accounting techniques, including the understanding of corporate balance sheets.

20. The Government will furthermore review the difficulties that the courts have in enforcing judgments and provide concrete measures for legislation or other means to overcome these difficulties.

21. **Enterprise Accounting**. To reinforce corporate governance, mechanisms for internal and external monitoring of enterprise performance are being introduced and strengthened. The Program will support the development and promotion of national accounting standards in substantial conformity with International Accounting Standards (IAS). Accurate and timely financial information is of vital importance to enterprise reforms. Without financial information (especially product cost, cash flow, and profitability data), managers are unable to do their jobs. Likewise, boards of directors, shareholders' councils, and shareholders are unable to gauge management's success or to know which investment strategy may be best. Outside lenders and investors need reliable financial information, too, to assess the viability and attractiveness of enterprises before investing their own capital in the enterprise as debt or equity.

22. The major social impact of the Program is expected to be the recognition of the loss of employment and income security. The major positive impacts will be higher incomes and improved income security. Measures will be required to provide income support for those who are retrenched. In the long term, action will be needed to create income opportunities to enable the retrenched to re-enter the workforce.

23. Administrative structures and mechanisms to ameliorate the short-term negative impact of unemployment are well established. The Ministry of Labor and Social Protection administers the Employment Fund to deliver unemployment benefits. However, there are weaknesses in the system for assisting the unemployed and especially the newly unemployed. First, there are difficulties in identifying and registering those eligible for unemployment benefits. Second, there are operational difficulties in delivering these benefits to those eligible. Third, there are difficulties in providing the funds needed to make payments to all those registered. The financial difficulties of the Employment Fund will continue to grow as the number of recipients grows, especially if the current efforts of the Ministry of Labor and Social Protection to improve identification and registration of the unemployed are successful.

24. While the Government is implementing a number of reforms that will lead toward financial sustainability for the Employment Fund, interim measures will be required

to ensure that it has the capacity to assist those negatively affected. Under the Program the Government will ensure that adequate funds are provided to the Social Fund for allocation to the Employment Fund to meet its expenditures relative to the payment of unemployment benefits and provision of training schemes for displaced workers.

25. The Employment Fund expects a deficit of Som 30 million in 1997. This level of additional funding will be required annually to maintain its current level of service. It is expected that the Program could result in recognizing unemployment that would require the additional cost of unemployment benefits and retraining. As these costs are substantial, the Government will ensure that a total of Som 70 million would be provided through the Social Fund to the Employment Fund in 1998. Similarly, during the remaining Program period the Government will annually provide budget funds to the Social Fund to cover the gap between the Employment Fund's collection and revenues plus an additional Som 20 million to mitigate the adverse social impact of the transition process. The Social Fund will provide to the Bank separate accounts for receipts on collections and budget subventions, and payments on behalf of and to the Employment Fund.

26. Mr. President, the Kyrgyz Republic has undertaken reforms in the face of especially difficult initial conditions including the sudden cessation of aid from the Soviet Union, the disintegration of the Council for Mutual Economic Assistance (CMEA), and a collapse of its trade. In the light of these initial conditions the Kyrgyz Republic's achievements are impressive. While the country has a long way to go, it has made important progress in its stabilization and structural reform program. Significant gains have occurred in the areas of price and trade liberalization, exchange market reform, legal reform, and privatization. The Kyrgyz Republic is now in full compliance with IMF's ESAF program, and IMF has approved the third annual arrangement under the program. In 1996 there was real GDP growth for the first time since 1991. However, in view of the deep-rooted structural weaknesses in the economy, the potential for renewed inflation, and the difficult balance-of-payments position, the Republic's economic outlook remains fragile.

27. The structural reforms and institution building envisaged under the Corporate Governance and Enterprise Reform Program will serve to make major improvements in the environment needed for a market-oriented economy. It will, however, take considerable time before the resulting economic activity can offset the adverse impact of the five-year economic and fiscal crisis from which the Kyrgyz Republic is recovering.

Yours sincerely,

Apas Djumagulov
Prime Minister

POLICY MATRIX

Overall Objective: To improve the performance and efficiency of the enterprise sector so that it can be viable in a competitive market-based economy.

Objective	Action Planned	Actions to be Completed Prior to Board Consideration	Actions to be Taken Prior to Release of Second Tranche	Other Actions to be Taken During the Program
I. Promote Enterprise Efficiency Through Improved Corporate Governance				
I.A. Extend enterprise reforms to the key areas in which the State retains 100 percent ownership.	I.A.1. Government activities in gas sector undertaken in Government departments to be merged and reorganized into Kyrgyzgasmunaizat.	Done		
	I.A.2. National Aviation Company (NAK), Kyrgyztelecoms, and Kyrgyzgasmunaizat to be corporatized and registered as joint-stock companies.	Done		
	I.A.3. Implement the coupon (i.e. partial) privatization of the Kyrgyzenergo Company, NAK, Kyrgyztelecoms, and Kyrgyzgasmunaizat before expiry of coupons on 30 June 1997.	Done		
I.B. Codify Guidelines on Best Practice in Corporate Governance.	I.B.1. Through Government decree, establish Working Group on Corporate Governance consisting of representatives from the Prime Minister's Office; State Property Fund; the Ministry of Finance; National Bank of Kyrgyz Republic (NBKR); National Commission on Securities (NCS);and Ministry of Foreign Trade and Industry.	Done		
	I.B.2. Prepare draft Guidelines on Best Practice in Corporate Governance on the basis of (i) review of international best practice; and (ii) evaluation of practices existing in public and private enterprises, and financial institutions in the Kyrgyz Republic.	Done		
	I.B.3. Finalize draft Guidelines as Handbook on Best Practice in Corporate Governance.	Done		
	I.B.4. Adopt the Handbook on Best Practice on Corporate Governance, including the model Company Charter incorporated in it, and the mechanisms for its legal adoption through a Government decree.	Done		
I.C. Implement Guidelines on Corporate Governance in Strategic and Large State-owned enterprises (SOEs).	I.C.1. Kyrgyzenergo and the corporatized Kyrgyztelecoms, NAK, and Kyrgyzgasmunaizat to provide corporate statements to the Bank indicating areas of compliance with the Company Charter and identify the remaining areas of noncompliance (if any).			October 1997

Note: Conditions for release of second tranche are shown in **bold type**.

	I.C.2.	Kyrgyzenergo and the corporatized Kyrgyztelecoms, NAK, and Kyrgyzgasmunaizat enterprises to submit time-bound plans for instituting changes in their corporate structures and governance mechanisms so as to bring them into compliance with the Handbook.			December 1997
	I.C.3.	**In accordance with legislation Kyrgyzenergo and the corporatized Kyrgyztelecoms, NAK, and Kyrgyzgasmunaizat to complete implementation of corporate governance structures including (i) company charters, (ii) appropriate supervisory and management structures (iii) monitoring and reporting requirements in compliance with Handbook on Best Practice in Corporate Governance.**		**June 1998**	
I D. Enforce the Implementation of Best Practice in Corporate Governance in the enterprise sector.	I.D.1.	Enforce corporate governance on all joint stock companies with more than 50 shareholders: (i) NBKR to issue regulations recommending commercial banks to require borrowers' compliance with the model Company Charter as part of the normal credit approval process. (ii) Appropriate licensing authorities to require nonbank financial institutions (investment funds, insurance companies, pension funds, etc.) to adopt model Company Charter specified in Handbook as a condition for licensing; companies already registered will be required to reregister within nine months of the Government decree adopting the Handbook and the model Company Charter. (iii) Joint stock companies registering with the National Commission on Securities to be required to adopt the Company Charter of the Handbook; companies already registered will be required to reregister within nine months of the Government decree adopting the Handbook and the model Company Charter. (iv) Government to issue Decree or regulation that joint-stock enterprises with more than 50 shareholders must adopt Company Charter specified in the Handbook of Best Practice Corporate Governance to prequalify for Government procurement contracts.	Done		
I.E. Promote the implementation and dissemination of Best Practice Corporate Governance Principles to stakeholders.	I.E.1.	In accordance with agreements with the Bank regarding staffing and functions, establish a Corporate Development Center (CDC), an interdepartmental unit reporting to the PMO, to promote the implementation of the Best Practice in Corporate Governance.			December 1997
	I.E.2.	Under the CDC, and in consultation with the Bank, initiate a public information and education campaign to disseminate the Handbook on Best Practice in Corporate Governance and explain the basic principles, content, structure, and practice of corporate governance. Train domestic consultants to carry out public information and education functions.			January 1998
	I.E.3.	**Complete the public information and education campaign.**		**February 1999**	

Note: Conditions for release of second tranche are shown in **bold type**.

	I.E.4.	Under the CDC, and in consultation with the Bank, initiate training Program in management and corporate governance principles for senior and middle-level executives of enterprises. Train trainers and develop training materials and manuals.			July 1998
	I.E.5.	**Complete implementation of management development training program.**		**February 1999**	
II. Impose Financial Discipline on Enterprises					
II.A. Phase out budgetary subsidies and introduce market-based financing mechanism for enterprises.	II.A.1.	Government to provide the Bank with annual reports detailing budgetary allocations, loans, and subsidies made to enterprises.			Throughout the Program
	II.A.2.	Issue statement in budget that no new budget loans will be made to any commercial enterprises with loan arrears to the budget.	Done		
	II.A.3.	**Reduce new budget loans to commercial enterprises in 1998 to not more than SOM160 million (i.e., 50% of the 1997 figure SOM320 million).**		**December 1997/1998**	
	II.A.4.	Reduce new budget loans to commercial enterprises to not more than SOM80 million, i.e, by 50% of the previous year's value, SOM160 million.			December 1998
	II.A.5.	Reduce budget loans to commercial enterprises by 50% of the previous years.			Throughout the Program
	II.A.6.	NBKR to issue directive that it will not undertake to guarantee liabilities on loans extended to enterprises by commercial banks and that commercial bank lending to enterprises should be on commercial terms.	September 1997		
III. Promote Domestic and International Competition and Strengthen the Enabling Environment for Foreign Direct Investment					
	III.1	Liberalize prices in product and input markets.	Done		
	III.2.	Remove barriers to entry/exit in relation to the provision of goods and services.	Done		
	III.3.	Enact the amendments to the Law on Foreign Investments.	September 1997		
	III.4.	Establish and staff an agency for promoting and supporting foreign direct investment as a "one-stop entry shop."	September 1997		
	III.5.	Ensure no new quantitative restrictions are imposed on international trade.			Throughout the Program
	III.6.	No tariffs on imports to be raised except in accordance with WTO antidumping provisions.			Throughout the Program

Note: Conditions for release of second tranche are shown in **bold type**.

IV. Strengthen the Legal Framework for Insolvency and Ensure its Enforcement					
IV.A. Strengthen legal framework.	IV.A.1.	Enact the new Insolvency Law substantially in the form developed by the Working Group on Bankruptcy.		September 1997[1]	
	IV.A.2.	Arbitrazh Court to nominate judges to at least 20 of 31 vacancies.	Done		
	IV.A.3.	Fill at least 20 of the 31 judicial vacancies in Arbitrazh Court.			April 1998
	IV.A.4.	In consultation with the Bank finalize General Instructions for Implementing Insolvency Procedures to conform with the revised Insolvency Law.			February 1998
IV.B Develop implementation capabilities for insolvency proceedings.	IV.B.1.	In accordance with training plans to be agreed with the Bank, and consistent with the finalized General Instructions for implementing insolvency procedures, commence a training program for (i) judges in the Arbitrazh Court; (ii) other relevant court and Government personnel; (iii) valuers, receivers, liquidators, and other insolvency professionals.			May 1998
	IV.B.2.	**Complete the judicial training program.**		**May 1999**	
V. Promote Transparency in Financial Accounting and Reporting to Ensure More Effective Monitoring and Control of Enterprises.					
V.A. Implement national accounting standards.	V.A.1.	Create a department in the Ministry of Finance responsible for developing national accounting standards in a accordance with international accounting standards (but not touching upon accounting standards and procedures for financial institutions licensed by NBKR and within NBKR's jurisdiction).	Done		
	V.A.2.	Adopt accounting standards developed by the CAAR Working Group.	Done		
	V.A.3.	Implement a program to assist 300 enterprises to adopt these standards.			December 1997
	V.A.4.	**Assist at least 80 of the enterprises targeted by the above program in adopting new accounting standards.**		**March 1999**	
VI. Mitigate Transition Costs					
	VI.1.	Rationalize existing programs to assist retrenched workers by (i) discontinuing charging costs to previous employers; and (ii) removing the requirement of definite job offer to qualify for retraining.	Done		

Note: Conditions for release of second tranche are shown in **bold type**.

1 Condition for loan effectivity.

	VI.2.	The Social Fund (SF) is to establish separate accounts for the Employment Fund (EF).	Done		
	VI.3.	SF is to introduce accounting and reporting systems in accordance with internationally accepted accounting standards.			November 1997
	VI.4.	**Submit a provision for the 1998 budget to ensure expenditure of SOM70 million to the SF to be allocated to the EF to meet its expected shortfall between collections and expenditures as well as to cover part of the expected adjustment costs. Budget to allocate SOM 30 million for unemployment benefits and SOM 40 million for retraining.**		**December 1997**	
	VI.5.	Provide budgetary allocation to the SF for allocation to the EF—SOM20 million for training and SOM30 million for unemployment benefits.			December 1998/1999

Note: Conditions for release of second tranche are shown in **bold type**.

POVERTY IMPACT ASSESSMENT

A. Outcomes of the Program

1. Actions and Outcomes

1. The Social assessment revealed that the Program is unlikely to have a significant additional impact on unemployment. The major impact was identified as the recognition of the loss of employment that has already occurred. This is likely to affect more than 300 nonviable and essentially non-operating SOEs. For schematic purposes, the recognition of loss of unemployment can be linked to the strengthening of the capacity to carry out out-of-court liquidation and in-court bankruptcy procedures for failing enterprises. In addition the Program period is likely to coincide with the contraction of large SOEs. In total, the Program will involve the recognition of employment loss for some 75,000 workers during the Program period. The costs of the various retrenchment packages and training programs will be in the order of $20 million. The major positive impacts will be higher incomes and improved income security for employees retained at more successful enterprises and greater supplies of goods and services to consumers.

2. Employment Outcomes

2. It is expected that in each year of the Program, about 100 nonviable SOEs will be enabled to be liquidated. Most of these enterprises will be liquidated through the out-of-court liquidation under SPF auspices. The revised bankruptcy law and improved procedures for its application will help to deter insolvency. Managers, with the threat of the bankruptcy sanction, will improve their operating performance and learn to deal with the problems of impending insolvency by negotiation with creditors and by internal action; both will help limit the number of bankruptcy petitions taken to court for decision. The SOEs that face liquidation/bankruptcy have an average nominal employment of about 300; assuming 50 percent of the employment level is illusory gives a total unemployment impact of 15,000 of which 20 percent is assumed to be short-term unemployment, i.e., 3,000 per year. The total unemployment impact on nonviable SOEs during the Program period is expected to be 45,000, of which 9,000 will be short-term and 36,000 the long-term impact.

3. Based on a number of simplifying assumptions (see Supplementary Appendix...) it is estimated that there will be about 27,000 retrenchments in other enterprises. A reasonable assessment is that retrenchment would occur in equal numbers (9,200) in each of three years, starting in 1999. Of the retrenchees, 20 percent (5,500) are considered short-term and 80 percent (22,000) long-term unemployed, according to the known experience of previous reemployment of those displaced.

3. Contraction of Large SOEs

a. Actions and Outcomes

4. Four large SOEs will be the subject of the Program's attention to improve corporate governance, as a pilot exercise to be extended throughout the corporate world. The enterprises are Kyrgyzenergo; the National Aviation Company (NAK); Kyrgyztelecoms; and Kyrgyzgasmunaizat. These enterprises will be corporatized and rationalized in structure. They

will go through the coupon privatization process and will be prepared for varying degrees of unbundling of operations and privatization with a view to attracting foreign investment.

b. Employment Outcomes

5. The major short-term social outcomes on the four enterprises during the Program period would be reduced employment. Whether retrenchments should be attributed to the program, to the commercial interests and imperatives of the enterprise, to the general restructuring of the economy, or to other factors is unclear. The timing of retrenchments is also unclear. Decisions on the final structure of ownership, management, and employment for the enterprises are rightly the province of their management and board representatives. These decisions are some considerable time away.

6. Employment at the four large SOEs is 21,500. It is estimated that the total employment impact of reform at the four enterprises would be 10,800 jobs lost. Department of Employment Services data show the number of retrenchees registering for assistance between 1991 and 1996 as about 72,000, of whom about 13,000 were recorded as obtaining employment. If those gaining employment are considered as short-term unemployed, then about 20 percent of retrenchees are short term. Applying this proportion to the 10,800 retrenchees estimated for the four enterprises divides them into 2,200 short- and 8,600 long-term unemployed.

c. Prices

7. Prices for energy (electricity and gas), telecommunications, and air transport would almost certainly rise in the short term as the semiprivatized enterprises sought a commercial focus for their operations. Price increases and their timing would depend on corporate objectives, costs, and returns, and can not be predicted. The incidence of increased prices on individual groups would depend on management decisions on pricing policies. The poorest in the community would be affected most by energy price rises, most importantly that of electricity. Prices of all goods and services produced by the enterprises would fall and the quality of their supply would rise in the long term, as investment in new capital, improved management practices, and a more commercial orientation were introduced. Improved energy supplies, at lower prices, would be especially beneficial to the poor.

B. Amelioration of Negative Impacts

1. Short-term Financial Costs

a. Unemployment Impact

8. It is estimated that short-term unemployment accompanying the program will total 16,700 people, of whom 2,200 will be related to contraction of large SOEs and 14,500 in connection with recognition of unemployment in nonviable SOEs. All of the former is assumed to occur in 1998. Of the latter, unemployment in SOEs is expected to be begin in 1998 and be equally distributed throughout the Program period; in other enterprises, it is expected to be distributed in equal parts over three years from 1999 to 2001.

9. Retrenched employees are entitled to payment by their employers equivalent to about three months' wages. The separation payment also includes payment of wage arrears that are assumed to average one month per employee. With the average monthly wage assumed to be SOM750, the total cost of the retrenchment package, that is borne by the employer is SOM3,000. This is a one-time payment.

b. Unemployment Benefit

10. UB is paid at the rate of SOM130 per month, with each recipient limited to six payments per year. Thus, each retrenchee who is short-term unemployed and registers will receive a maximum of SOM780 in UB. It is highly unlikely that all retrenchees accompanying the CGERP actions will register and claim UB. The Experience of the Department of Employment Services has been that only about 23 percent of those for UB receive it (Part B). Nevertheless, the estimates of costs here assume that UB is delivered to all of the 7,700 expected short-term unemployed for a full six months each.

c. Technical Training

11. It is not possible, from available data, to relate the numbers of people receiving technical training to the number subsequently being employed. The Department of Employment Services now provides training courses to about 7,000 people each year, so that about 7 percent of the unemployed receive this service. It is conservatively assumed that 50 percent of retrenchees who are short-term unemployed are provided with technical training. The Department of Employment Services estimates the cost of this training as SOM1,000 per trainee.

d. Total Cost

12. The total cost of ameliorating short-term negative social impacts for the four years from 1998 to 2001 and under the foregoing assumptions, is estimated at SOM33.0 million. While CGERP is for the period 1998 to 2000 only, the extra year (2001) is included in the estimates so that the total cost of ameliorating all short-term impact is shown. Of the total cost of SOM33.0 million, about SOM23.1 million will be borne by employers for retrenchment packages and SOM9.9 million by the Employment Fund, through the Department of Employment Services, for UB and training courses.

2. Long-term Financial Costs

a. Unemployment Impact

13. Long-term unemployment accompanying the program is estimated to total 66,600 people, of whom 8,600 will be for contraction in the large SOEs and 58,000 in connection with nonviable SOEs.

b. Retrenchment Packages

14. Each of the retrenchees becoming long-term unemployed is entitled to a one-time separation package similar to that calculated for those becoming short-term unemployed, of an estimated SOM3,000. Again, this is borne by the employer.

c. Unemployment Benefit

15. UB is assumed to be paid to all of the estimated 66,800 long-term unemployed. As for the short-term unemployed, this almost certainly represents a great overestimation. It is assumed here that 10 percent of the long-term unemployed initially registering to receive UB cease to receive it in the next year, due to their obtaining employment, ceasing to register, passing away, or reaching retirement age and receiving a pension. Each of the long-term unemployed is assumed to receive the allowable annual maximum of SOM780 in UB.

d. Technical Training

16. While it is difficult to estimate the numbers of long-term unemployed people who will want technical training, a suitably high figure (50 percent of those becoming long-term unemployed) is adopted here, to reflect the aim of getting as many retrenched people as possible back into the workforce. The cost of this training is SOM1,000 per trainee.

e. Business Training

17. The same uncertainties attend estimating demand for business training as for that of technical training. The Department of Employment Services now provides business training courses to about 1,800 people each year, less than 2 percent of the unemployed. It is conservatively assumed here, again with the aim of maximizing reentry of retrenchees to the workforce, that 10 percent of retrenchees who are long-term unemployed are provided with business training. The Department of Employment Services estimates the cost of this training as SOM3,000 per trainee.

f. Total Cost

18. The total cost of ameliorating long-term negative social impacts for the four years from 1998 to 2001 and under the foregoing assumptions, is estimated at Som366.6 million. While CGERP is for the period 1998 to 2000 only, the costs in the following year are included in the estimates, to show the total costs of ameliorating long-term impacts until they stabilize, when only UB is paid. For the year 2002, the annual cost of UB to the long-term unemployed accompanying CGERP is estimated, as UB only, at SOM37.9 million. This will fall annually as the number of recipients falls.

19. Of the total cost of SOM171.1 million to the end of 2001, about SOM91.8 million will be borne by employers for retrenchment packages and SOM79.3 million by the Employment Fund for UB and training courses.

3. Ameliorative Measures Required

a. Unemployment

20. The essential measures to ameliorate adverse short-term impacts are the payment of retrenchment packages, supply of UB, and the provision of training courses to assist retrenchees to reenter the workforce. In the longer term, UB will be required for those unable to obtain new employment. These measures are included in the estimates of costs. The Employment Fund, which will be the conduit for delivery of UB, has an underlying deficit of

SOM26 million. The Employment Fund will be called upon to provide additional assistance for UB payments and training. Provision of these services will require additional spending (and therefore, funding) totaling SOM188.2 million between 1998 and 2001, i.e., for the period before the Employment Fund's commitment stabilizes as only UB to the long-term unemployed. Annual additional funding required by the Government of Kyrgyz Republic and the Employment Fund is shown here:

	(SOM Million)			
Employment Fund	**1998**	**1999**	**2000**	**2001**
UB	20,124	25,729	39,567	41,134
Training	19,080	17,884	17,884	6,784
Subtotal	39,204	43,613	57,451	47,918

21. The calculated needs of the Employment Fund are additional to the approximately SOM30 million required annually to overcome its underlying deficit.

C. Conclusion

22. The Program period of CGERP will be accompanied by the recognition of the unemployment of about 75,000 people. The prospects of those people gaining employment in the foreseeable future are related to the sustainability of the economic upturn. The resurgence in growth, and prospects for its broad-based continuance are the developments that are likely to be the most effective in reducing unemployment through the creation of new jobs. Policy reform that provides a more conducive business environment is an essential precondition to job creation and the desired reduction in unemployment. In addition, two other kinds of support are required to sustain the transition. The first is budgetary support that will allow consumption levels to be maintained while the necessary structural changes to incentives and to the economy are underway. The Program makes an important contribution to this. The second involves the provision of assistance and training to assist the retrenched to reenter the labor force .

23. The Department of Employment Services is currently attempting to solve the problem of unemployment by technical and business training, with support from a variety of foreign assistance. Significant further assistance is expected in this regard from the World Bank's SOSAC that will develop a policy framework and a strategy, and provide technical and managerial expertise and access to funds to assist those most adversely affected by the transition process. In the interim, existing mechanisms for training will be funded by budgetary allocations made under the Program.

24. Movements in prices during the Program period will be, on balance, favourable and widespread, as enterprises become more efficient. There will be some short-term increases as enterprises are reformed, before the favorable impact of new capital investment and better management. Relative to electricity prices, the Government will ensure that low income groups will be assisted through a temporary lifeline subsidy program.[1]

---

1 As stipulated under Loan 1443-KGZ: *Power and District Heating Rehabilitation Project*, for $30 million, approved on June 1996.

INELIGIBLE ITEMS

1. The proceeds of the proposed Program loan may be used to finance the foreign currency expenditures in respect of the reasonable cost of imported goods (excluding any duties or taxes) required during the implementation of the Program. All imported goods financed from the proposed loan must be produced in, and procured from, the Bank's member countries.

2. Notwithstanding the provisions of paragraph 1 above, no withdrawal may be made in respect of

(i) expenditures for goods included in the following groups or subgroups of the United Nations Standard International Trade Classification, Revision 3;

Group	Subgroup	Description of Items
112	–	Alcoholic beverages
121	–	Tobacco, unmanufactured; tobacco refuse
122	–	Tobacco, manufactured (whether or not containing tobacco substitutes)
525	–	Radioactive and associated materials
667	–	Pearls; precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors and parts thereof; fuel elements (cartridges); nonirradiated for nuclear reactors
897	897.3	Jewelry of gold, silver, or platinum group metals (except watches and watch cases); goldsmiths' wares or goldsmiths' wares (including set gems)
971	–	Gold, nonmonetary (excluding gold ores and concentrates)

(ii) expenditures for goods intended for a military or paramilitary purpose or for luxury consumption;

(iii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in Class 1a or 1b, respectively, of the World Health

Organization's Classification of Pesticides by Hazard and Guidelines to Classification;

(iv) expenditures for goods supplied or to be supplied under any contract that a national or international financing institution or any other financial agency has financed or agreed to finance, including any contract financed or to be financed under any loan from the Bank; and

(v) expenditures incurred more than 180 days prior to the date of effectiveness of the loan.

TECHNICAL ASSISTANCE LOAN: IMPLEMENTATION OF CORPORATE GOVERNANCE STRUCTURES AND BANKRUPTCY PROCEDURES

A. Objectives and Scope

1. The objective of the TA is to promote the efficient functioning of enterprises in the Kyrgyz Republic through (i) the implementation of Best Practice in Corporate Governance by establishing a Corporate Development Center (CDC) aimed at building up institutional capacity in adopting and enforcing improved corporate governance structures and practices, including a public information and education program to enhance greater awareness among shareholders, enterprise officials, and stakeholders of their rights and responsibilities; and (ii) reform and improvement of legislation and procedures relating to bankruptcy, and in related institutional strengthening of the judiciary and the State Property Fund.

1. Corporate Governance

2. Institutional capacity building in the implementation and enforcement of Best Practice in Corporate Governance by the CDC in the TA will involve

(i) strengthening the capacity of Government departments to enforce, and monitor the extent of, the implementation of the normative model Company Charter;

(ii) strengthening the capacity of enterprises to adopt the Charter and to operate according to the spirit and the letter of the Charter through assistance in reorganizing the internal decision-making structures and in installing the necessary audit, share registration, information, and monitoring systems;

(iii) promoting a more active role in corporate governance by shareholders and enterprise officers through a greater awareness of their rights and responsibilities, as well as of the legal and other means for enforcing provisions of the Charter protecting their rights.

3. The CDC will include concomitant efforts to strengthen the capacity of management to exercise their duties and function more effectively through a management development training program, aimed at developing the skills of management of enterprises to maximize the efficiency and profitability of enterprises operating within an improved corporate governance structure. The management development training component will also incorporate training of government officials and enterprises in the implementation and enforcement of best practice in corporate governance.

4. Over the longer term, the most powerful mechanism for enforcing good corporate governance will be the assertion by shareholders, enterprise officials, and stakeholders of their rights enshrined in the company charter. This self-enforcement is either through a more active role in the governance of an enterprise, or through legal and other actions to force compliance in cases of violations. To build up the capacity for such self-enforcement by owners and stakeholders, the TA will also develop and strengthen public awareness of the principles and objectives of good corporate governance, and of shareholders rights and responsibilities in

particular. This will involve a public relations effort to establish awareness, on a national level, the importance and benefits of adopting improved corporate governance, as well as model systems and modalities for their practical implementation.

5. To enhance synergy, cost-effectiveness, interdepartmental coordination, and logistical efficiency in the execution and management of its various components, the TA will be implemented through a single full-service organization providing technical support, advisory services, training, and public information. Under the TA, the Government will establish a Corporate Development Center (CDC) to implement the various components of the Project.

6. The CDC will be an interdepartmental nonprofit organization under the Prime Minister's Office (PMO).

7. The CDC's Terms of Reference will be to: (i) help build up institutional capacity in implementing the normative model Company Charter through the three tracks of activities described above; (ii) engage in management development training; and (iii) promote awareness of the objectives and principles of effective corporate governance more widely in the economy and among the general public through a public information and education program.

8. The CDC will comprise five units of operations, as follows:

(i) **Government Implementation Enforcement Capacity Unit.** This unit will be responsible for liaising with and providing support to relevant Government departments in matters concerning implementation of the normative model Company Charter and monitoring the extent of implementation among enterprises over which the relevant Government departments have jurisdiction. This unit will comprise one head of the unit and one professional.

(ii) **Enterprise Implementation Capacity Unit.** A unit responsible for assisting enterprises in implementing the normative model Company Charter. This unit will comprise a head of unit and four professionals with expertise in corporate governance, corporate law, company organization, accounting systems, and financial reporting.

(iii) **Enforcement Capacity Unit.** This unit will provide advisory service to shareholders and enterprise officials on their rights and responsibilities under the normative model Company Charter. It will also offer assistance to shareholders and enterprise in enforcing compliance, through referral to legal and other means, in cases of violations of the Charter.

(iv) **Management Development Training Unit.** This unit will execute the training program in modern management systems and methods. It will also support the work of the units (items (i) to (iii) above) in the CDC concerned with corporate governance implementation and enforcement by providing training through seminars and workshops.

(v) **Public Information and Education and Resource Unit.** This unit will be responsible for the program to disseminate information about the objectives

and principles of corporate governance in general, and about the rights and responsibilities of shareholders and enterprise officials in particular. It will also act as a resource unit to organize seminars and workshops, and develop training manuals and guidebooks, to support the activities of the other four units within the CDC.

2. Staffing and Broad Terms of Reference of CDC

9. The core staff of the CDC will comprise 11 full-time professionals. Each of the units will have a head of Unit responsible for managing activities within their areas of responsibility. The work of the Government Implementation, Enterprise Implementation, and Enforcement Capacity units will draw upon a joint team of five professionals with expertise in corporate governance, corporate law, company organization, accounting systems, and financial reporting systems. The Management Development Training and the Public Information units will have one supporting professional staff each with expertise in Business Management and Public Relations respectively.

10. Of the 11 full-time professional staff, 7 will be seconded from Government departments involved in corporate governance implementation and enforcement. These will include the National Commission on Securities Market, the Ministry of Foreign Trade and Industry, the State Property Fund, the Ministry of Finance, the National Bank of Kyrgyzstan, the Ministry of Justice, and the PMO. The other four professionals will be recruited from outside Government and would be specialists in corporate law, accounting and finance, management, and a resource unit manager. The CDC will have an office manager and administrative and secretarial support staff of five people.

11. The work of the full-time professionals in the CDC will be assisted by a team of one full-time and five part-time foreign consultants providing 37 person-months of inputs over an 18-month period. The foreign consultants will comprise three teams: (i) Corporate Governance Team of two specialists in corporate governance (one with experience in transition economies, the other in industrial economics) and one each in corporate law and in accounting/corporate finance; (ii) Management Development Training Team of two business management specialists in fields of company organization, strategic and business planning, and marketing; and (iii) Public Information and Education (PIE) Team of a specialist in public relations and mass communications.

12. The full-time corporate governance specialist would serve as the chief consultant responsible for the overall execution and management of the TA. The consultant will act as the Adviser to the Center's director and to the TA's Steering Committee in the PMO, as well as acting as the main liaison and channel of communication between the Bank and the Center, the consultants and the Steering Committee on all general matters relating to the execution of the TA. The chief consultant and the part-time foreign corporate governance specialists would assist in the following tasks: (i) formulating detailed Terms of References (TORs) and workplans for the CDC and its constituent units; (ii) providing advisory services to Government departments and enterprises on the implementation of the normative model Company Charter, and on monitoring the extent of its implementation; (iii) developing questionnaires and diagnostics to evaluate the effectiveness and problems of actual corporate governance structures and practices in enterprises operating under the normative model Charter; (iv) refining and updating a model Company Charter in line with the changing policy and institutional environment in the Kyrgyz Republic; (v) developing specialized Company Charters, consistent with the normative model Company Charter and legislation, for major public sector natural monopolies tailored to specific industrial

characteristics; (vi) designing training activities and manuals in corporate governance; and (vii) coordinating and managing the work of the foreign consultants in corporate law, accounting, and finance.

13. The two foreign consultants in corporate law, and accounting/corporate finance will assist the two corporate governance experts in all areas of the latter's activities. They would also be tasked with providing specialist advice, training, and developing training materials in their respective areas of expertise for the training both in corporate governance and in management development.

14. The two management specialists will develop and execute training programs for company executives and public officials (modalities, training materials). They will also assist the Corporate Governance Team in providing advisory services to Government departments, enterprises, shareholders, and enterprise officials.

15. The foreign consultant in public relations and mass communications will develop, initiate, and execute a dissemination and public information program on corporate governance. The consultant will also support the corporate governance and management development training teams in developing training materials and in running training workshops and seminars.

16. A major task for all the foreign consultants will be to transfer skills to their local counterparts through training and collaborative work.

17. The CDC will, whenever necessary, recruit part-time professionals on short-term contracts from local universities, management consultancy, accounting, and law firms to fulfil specific assignments. This would be funded by consultancy assignments.

18. The Government will (i) meet the salary costs of the seven Government officials seconded to the CDC; and (ii) provide office space and basic office equipment (furniture, telephones) to house the CDC.

19. The TA will (i) meet the costs (fees, per diem, and travel) of the foreign consultants; (ii) the salaries of the local administrative/secretarial support staff; (iii) electronic equipment (computer and peripherals, fax machines, photocopiers, etc.) for the office; and (iv) operating expenses of the CDC.

20. The CDC will initiate and provide advisory services in other areas, such as corporate finance, asset and fund management, pensions and insurance, international trade, and finance, etc., if and when the demand for such services develop. Funding for these activities will be sought from bilateral and multilateral development agencies in the forms of technical assistance grants and loans. As such, the CDC will act as an institutional vehicle for originating, developing, and executing projects that will help the development of the corporate sector in the Kyrgyz Republic.

21. Upon the completion of the TA (18 months), the Government will have the option of either incorporating the CDC into a Government department, or converting it into a private sector operation by selling it to (local or foreign) financial institutions, law or accounting firms, or management consultancies.

3. Bankruptcy Implementation

22. The TA will assist the Government to improve the conditions for restructuring insolvent enterprises, whether in the state or private sector. It will have four main elements: (i) revision of the General Instructions for Insolvency, in the light of the new Law on Bankruptcy and the Civil Code; (ii) improvement of the capability of the judiciary, liquidators, lawyers, and accountants to effectively implement the laws and procedures relative to insolvency proceedings; (iii) support for the Government in the form of participation of a consultant in a proposed governmental Working Group that will review the general enforceability of judicial decisions in Kyrgyzstan; (iv) support for the State Property Fund in the form of provision of lawyers and financial analysts to work in the field of insolvency over a period of 18 months.

23. **Improvement of general instructions on insolvency.** Following the passage of the new Law and amendments to the Civil Code, it will be necessary to make a fundamental review of the existing Instructions to ensure that they are consistent with this new or amended legislation. The new Law foresees that there will be only two sets of Instructions, rather than the four that presently exist: these will be the General Instructions, and to the extent that separate Instructions are required, a set for banks (banks will be covered by the General Instructions unless specially provided otherwise.) In particular, the Instructions should aim to review and expand upon the out-of-court procedures for insolvency and reorganization, since these have much potential in the Kyrgyz circumstances. An individual consultant with Russian language skills, who is familiar with the existing laws and regulations in Kyrgyzstan relating to insolvency as well as international law and practice, will prepare revised General Instructions.

24. **Improvement of the capacity of the judiciary and others to effectively implement the insolvency laws.** This element of the TA will primarily comprise training through seminars and the provision of materials in the form of seminar studies and a handbook. Consultants with Russian language skills and familiar with the existing laws and regulations in Kyrgyz relating to insolvency as well as international law and practice, will prepare and conduct seminars to be conducted over a total of six weeks, (spread out over a longer period), for multiple parties, including a group of selected judges (approximately 15-20). Liquidators will be particularly trained in out-of-court procedures.

25. The seminar will be based on the revised Law of Bankruptcy and the Civil Code that is to be adopted before the date of commencement of the seminars, and on the Revised set of General Instructions on Bankruptcy, that must also be adopted by that date.

26. The emphasis of the seminars will be on the understanding of underlying concepts and the integration of concepts of insolvency law with corporate law and economic practice. These seminars will be designed to provide a forum for active discussion and analysis of

(i) the concept of a legal person and of limited liability or unlimited liability, having regard to the different forms of enterprises (state or private, partnership or company) envisaged by the Civil Code, and the effect of insolvency proceedings upon the legal person and its owners and creditors;

(ii) the different legal procedures envisaged by the Law on Bankruptcy, including the rationale for and circumstances in which temporary

liquidators or liquidators can be appointed; proceedings in court (but also emphasizing procedures that can take place without the participation of the court); sanction (a reorganization process); and amicable settlement, and the use of insolvency procedures as a means of reorganization of enterprises; including

(a) purchase of assets in an insolvency (methods and valuations); and

(b) funding of insolvent firms and the activities of the liquidator;

(iii) the interests of each of the parties and agencies involved in insolvency proceedings (employees, management, owners: lenders and other creditors whether secured or unsecured, including suppliers of goods and services, and depositors in banks; Government and local authorities; lawyers, liquidators, and judges);

(iv) the economic aims and benefits of insolvency and the consequences for creditors, insolvent companies, and the Republic, if appropriate decisions are delayed or not taken, as well as alternatives to liquidation (mergers and acquisitions, restructuring, etc.);

(v) the priorities in insolvency and the special treatment given to secured creditors, together with an analysis of the legal and practical problems of taking security and the liquidator's duty to attack security on legal grounds where possible;

(vi) the liquidator's rights, powers, and duties, and in particular the liquidator's duty of independence and the prevention of abuses in insolvent enterprises and by liquidators; and

(vii) certain basic accounting principles and techniques, including the ability to understand and analyze a company's balance sheet and to determine the true extent of its assets and liabilities, and methods used to disguise these, as well as methods used by dishonest management to extract value from the company.

27. The seminars will be held in two cities: Bishkek, the capital, and Osh, the second largest city, in the south. Attendees will be given some very modest financial support for the expenses of attending. Seminars should involve case studies as well as lectures and discussions.

28. One of the tasks of the consultants in preparing material for the seminar will be to ensure that the material is in such a form that it can subsequently be used by judges and insolvency practitioners as a handbook of policy and procedures for the conduct of insolvency cases. Consultants will support judges over a further period of two years through e-mail systems.

29. **Assistance for the State Property Fund**. The department of liquidations and reorganization in the SPF already has a training function, and also undertakes liquidations and reorganizations. It is ideally placed to continue the training function for judges and others. It will require additional assistance, in the form of an international consultant (either a lawyer familiar with accounting or an accountant familiar with legal principles) for a total of six months spread over a longer period. The consultant will advise the SPF and train and supervise domestic consultants (two lawyers and one accountant/financial analyst) who will then work with the SPF over a period of 18 months. The domestic consultants, employed as individuals or through firms, will (i) advise the SPF on the development of appropriate practices and procedures; (ii) assist with the continuing process of revision of regulations; (iii) conduct or assist with the conduct of liquidations and reorganizations; and (iv) carry out ongoing training of others within the SPF, in other Government departments, and in the judiciary. The domestic consultants will also participate in the proposed seminar program.

30. **Support to the Working Group on Law Enforcement.** Support to the Working Group to be established by the Government will be given by the consultants (domestic or international) employed in respect of the revisions to the General Instructions on insolvency and by the consultant working with the State Property Fund.

4. Broad Terms of Reference

31. A small team of international and domestic consultants will be recruited for the TA and engaged under the Bank's *Guidelines on the Use of Consultants*, using a simplified technical proposal. An individual consultant will be recruited, to (i) revise the General Instructions, and also associated activities, namely (ii) participate in the proposed Working Group on enforcement of legal rights, and (iii) work on the training seminars with the other international consultants. One other consultant (a lawyer), will be recruited as an individual or through a law firm or academic institution to be responsible for (i) all organizational and other matters in respect of the proposed seminars; and (ii) the production of a handbook for judges. This consultant will be responsible for this part of the TA but will work closely with the already appointed individual consultant who has revised the General Instructions, learning from that experience. A further international consultant, a lawyer with financial skills or an accountant with legal skills, will be appointed to assist the State Property Fund and to train domestic lawyers and accountants working with the SPF and recruited under the TA. Detailed terms of reference are in Supplementary Appendix C.

32. The international consultants appointed in relation to the seminars will select and involve in the seminars local lawyers, employed through a firm or as individuals, who speak fluent Russian (as native speakers) and who have a good knowledge of all relevant legislation and practices. The international consultant appointed in relation to the SPF assistance will assist with the selection of domestic consultants. International consultants will start their services (i) in relation to the assistance to the SPF, within three or four months of the implementation of the TA Loan; (ii) in relation to the revision of the General Instructions and associated activities within two or at most three months of the passing of the amended Law on Bankruptcy that is expected to be by the third quarter of 1997 or (if later) within two or three months of the implementation of the TA Loan; (iii) in relation to the training seminars, within one month of completion of the revision to the General Instructions, that is expected to be in March 1998. The projected completion date of the TA is February 1999 (except for certain follow-up activities via e-mail, which will last for a further year).

B. Cost Estimates

33. The total cost of the TA loan will be $4 million consisting of $2.3 million for corporate governance implementation, including the public information and education project, and $1.7 million for the bankruptcy implementation (see Table 1). The TA will involve the use of 67 months of international consulting services and 176 months of domestic consultant services. All international consultants will be recruited in accordance with the Bank's *Guidelines on the Use of Consultants* and other arrangements satisfactory to the Bank for engagement of domestic consultants.

C. Executing Agency

34. The Department of Economic Sector Development (DESD) in the Prime Minister's Office will be the Executing Agency for the entire TA Loan. The agencies that will benefit from and have the responsibility to ensure completion of other parts of the TA will be the following: (i) in relation to the revision of the General Instructions, the legal office of the Government; (ii) in relation to the training seminars, the Arbitrazh court; and (iii) in relation to the assistance to the SPF, the SPF itself.

STRENGTHENING CORPORATE GOVERNANCE IMPLEMENTATION AND BANKRUPTCY PROCEDURES

Table 1: SUMMARY OF COST ESTIMATES AND FINANCING PLANS

Item	Foreign Exchange	Local Currency	Total Cost
I. Bank Financing			
1. Consulting Services			
Corporate Governance and Management	1,012,000	143,000.00	1,155,000
Public Information and Education	188,000	96,000	284,000
Bankruptcy Implementation	625,000	178,000	803,000
2. Civil Works / Court Rehabilitation	—	357,000	357,000
3. Computers, Equipment and Materials			
Corporate Governance and Management	181,000	—	181,000
Public Information and Education	13,000	85,000	98,000
Bankruptcy Implementation	277,000	—	277,000
4. Unallocated/Miscellaneous[a]	500,000	345,000	845,000
Total	2,796,000	1,204,000	4,000,000
II. Government Financing			
1. Counterpart Staff	—	40,000	40,000
2. Office/Administrative Support	—	40,000	40,000
3. Others	—	100,000	100,000
4. Contingencies	—	20,000	20,000
Total	—	200,000	200,000
Grand Total (I + II)			4,200,000

— = magnitude zero

[a] Inclusive of interest during construction.

TECHNICAL ASSISTANCE: STRENGTHENING THE ECONOMIC POLICY MAKING AND MONITORING CAPABILITIES OF THE PRIME MINISTER'S OFFICE

A. Background and Rationale

1. The PMO coordinates the work of other ministries and is the ultimate authority responsible for preparing position and policy papers for the Government's decision. It also prepares short- and medium-term macroeconomic assessments and projections.

2. The PMO needs to have the capacity, including trained staff and the appropriate institutional arrangements, to provide timely, consistent, and high quality advice on macroeconomic, monetary, financial sector, and trade and industry matters to the Government. At present, its limited staff resources, poor access to databases, and inadequate model-building and forecasting capabilities sharply constrain its ability to carry out its mandated tasks.

B. The Technical Assistance

1. Objective

3. The objective of the TA is to strengthen the capacity of the Minister's Office to initiate, manage, monitor, and assess the impact of policy reforms in the Kyrgyz Republic.

2. Scope

4. The TA will assist PMO develop mechanisms to monitor and assess the impact of ongoing macroeconomic, industrial, and trade policy reforms. The TA will also help PMO to coordinate and assess the impact of the Corporate Governance and Enterprise Effort Program (CGERP) and the related Technical Assistance Loan.

5. A team of two international consultants will be recruited to implement a course of training in analytical and quantitative methods, develop a model for macroeconomic projections, and provide advice on a range of economic policy issues requiring the attention of the PMO.

6. Currently, databases within PMO are of limited quality, and about 50 percent of the consultants' time will be spent in setting up suitable databases for monitoring the impact of macroeconomic and other policy reforms of the Government. The consultants will also provide staff of PMO as well as other Government agencies with instruction in the use of the database and its future development so that future projects and polices can be monitored. In the interest of economy and efficiency, the services of these consultants will also cover, if necessary, the requirements of Bank operations being carried out under the TA loan provided to support the CGERP.

7. The consultants recruited under the TA will

   (i) establish a computer-based economic information system for economic policy formulation and the monitoring and assessment of policy outcomes, including

(a) collection and collation of national income and related economic data;

(b) developing a computer-based quarterly and annual economic forecasting model of the Kyrgyz economy to test the identity structures and consistency of national and sectoral accounts; this model should also describe and explain the relationships between major policy and instrumental variables and the dynamics in the macroeconomy; and

(c) providing forecasts of expected outcomes of various policy options;

(ii) assist in the planning and formulation and management of economic policies falling under the preview of PMO, including those related to the CGERP;

(iii) assess the impact of policy reforms on sectoral growth, international trade, and employment;

(iv) provide training and policy functions in

(a) collection and updating of an economic information system;

(b) macroeconomic policymaking utilizing the information system and the economic forecasting model; and

(c) trade and industrial policymaking and impact monitoring;

(v) initiate the preparation of regular reports on economic activity to include indicators of private sector performance and other variables important to economic policy-making in PMO; the report will incorporate relevant data form NBKR, the National Statistics Commission, Ministry of Finance, National Commission on Securities Markets, Ministry of Foreign Trade and Industry, etc.; and

(vi) coordinate with other Government agencies involving

(a) developing mechanisms to monitor the progress of the policy reforms of the Government;

(b) designing coordination mechanisms between relevant Government agencies responsible for implementing policy reforms; and

(c) reviewing of institutional arrangements within the PMO to identify, in terms of human resources and equipment, its requirements if it is to carry out its responsibilities effectively.

C. Cost Estimates and Financing Plan

8. The total cost is estimated at $830,000 equivalent of which $740,000 is the foreign exchange cost (see Table 1). The Bank will finance $800,000 to the entire foreign exchange component and $60,000 equivalent of the local currency cost equivalent on a grant basis. The Government will finance the remaining local currency costs of $30,000 for the counterpart staff, office facilities, and support services.

D. Implementation Arrangements

9. The PMO will be the Executing Agency for the TA. Consultants recruited under the TA will be placed on the staff of the Prime Minister. The TA will be implemented over a period of 18 months.

10. There will be 21 months of international consulting services provided under the TA. A team of two consultants will be recruited consisting of a macroeconomist, and international trade and industrial economics expert providing 18 and 3 person-months of consulting services respectively. The macroeconomist will be the team leader. The consultants will be recruited in accordance with the Bank's *Guidelines on the Use of Consultants.*

11. Both the macroeconomist and the trade and industrial economics experts will have experience in transition economies, and possess strong quantitative and model-building skills.

12. An inception report will be provided by the consultant(s) to the Executing Agency and to the Bank within one month of the commencement of services. The team leader will provide the Bank with monthly reports on the progress in the Project and on key policy developments. A draft final report outlining activities undertaken, and training completed will be presented to the Bank and the EA 12 months after commencement of the Project. A final report incorporating the comments received from the Bank and the Government will be presented at the end of the Project.

Table 1: COST ESTIMATES AND FINANCING PLAN
($)

Item	Foreign Exchange	Local Currency	Total Cost
A. Bank Financing (Bank-funded TA Program)			
1. Consultants			
a. Remuneration			
i. International Consultants	420,000	—	420,000
b. Per Diem			
i. International Consultants	80,000	—	80,000
c. Travel			
i. International Consultants	30,000	—	30,000
2. Report Preparation	10,000	—	10,000
3. Contract Negotiations	5,000	—	5,000
4. Communications	15,000	—	15,000
5. Transport	40,000[a]	—	40,000
6. Office Equipment (computers, software, UPS, printers, fax)	50,000	30,000	80,000
7. Translation	—	20,000	20,000
8. Contingencies	90,000	10,000	100,000
Subtotal (A)	**740,000**	**60,000**	**800,000**
B. Government Financing			
1. Office Support	—	20,000	20,000
2. Counterpart Staff	—	5,000	5,000
3. Contingency	—	5,000	5,000
Subtotal (B)	—	**30,000**	**30,000**
Total	**740,000**	**90,000**	**830,000**

— = magnitude zero
[a] Includes procurement of one 4WD vehicle.