SECTOR ASSESSMENT (SUMMARY): MULTISECTOR FOR PRIVATE SECTOR DEVELOPMENT[1]

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. The Kyrgyz Republic is considered the most democratic and open society in Central Asia. In the first decade after the breakup of the Soviet Union, the private sector share of gross domestic product (GDP) increased significantly, to about 75% of GDP.[2] However, despite notable examples of entrepreneurship in some industries, such as garments and dairy, the private sector as a whole remains weak and has made limited progress in expanding its productive capabilities to create more wealth. Many of the economy's shortcomings—and low product competitiveness in particular—reflect the weak performance of the private sector.

2. The economy of the Kyrgyz Republic is dominated by small private entities (mainly farmers, individual entrepreneurs, and small enterprises); most operate in the informal sector.[3] The corporate sector remains weak and there are few profitable firms with strong growth prospects. In the Kyrgyz Republic, 60.4% of enterprises are owned by women, which is the highest proportion in the Central Asian region (the regional average is 38.5%). Small rural businesses headed by female entrepreneurs typically produce items such as canned fruit and vegetables, and souvenirs from natural felt and silk.

3. Private ownership dominates most sectors, but particularly agriculture (98.6% of sector share of GDP) and industry (92.9 % of sector share of GDP). State ownership is concentrated in services—primarily infrastructure services (electricity, water, and gas) and social services (education and health). The government, directly or through these enterprises, is typically responsible for the operation of public infrastructure in addition to its policy and regulatory roles. In contrast, the private sector accounts for 99.5% of total retail trade turnover.

4. Investment has increased in recent years and was estimated to equal 27% of GDP in 2013. Private investment has increased from 17% of GDP in 2007 to an average of 19% of GDP during 2011–2013. Foreign investment accounted for 32% of total investment and about half of private investment over this period. Half of foreign investment has been directed to manufacturing, most of it to the Kumtor gold mine, which accounts for 12% of GDP and for the majority of the country's industrial output and exports.[4] The Kyrgyz Republic has attracted more foreign direct investment as a percentage of GDP than have Tajikistan and Uzbekistan, although performance remains slow compared to Armenia and Georgia.

5. Despite positive results to date more needs to be done to improve the private sector investment climate, particularly to enable economic diversification and reduce dependence on external assistance. The following three main constraints prevent the private sector from expanding and adding greater value to products and services.

(i) A challenging business environment that still discourages many entrepreneurs, investors, and lenders from expanding, investing, or lending in the country. Businesses fear

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1 Based on ADB. 2013. *Kyrgyz Republic: Private Sector Assessment Update*. Manila.

2 Private sector share in GDP are European Bank for Reconstruction and Development estimates. The underlying concept of private sector added value includes income generated by the activity of private registered companies and private entities engaged in informal activity where reliable information on informal activity is available.

3 In 2013, according to the National Statistics Committee, the business sector officially comprised about 1,600 large, 800 medium-sized, and 11,700 small enterprises. There were nearly 330,000 registered individual entrepreneurs and 357,000 peasant farmers.

4 Disruptions in Kumtor have a significant impact on GDP. In 2012, annual gold production at Kumtor decreased by 46%, resulting in a 11.7% decline in industrial production and an overall reduction of 0.5% in GDP. Sources: National Statistics Committee; Centerra Gold Inc. 2012 Annual Report.

extortion, nationalization or expropriation by government officials or politically connected individuals, as well as breach of contractual obligations or concession agreements without fair compensation.[5] This is reflected in the expansion of the informal sector and the trend towards smaller enterprises. Corruption remains pervasive and is concentrated in agencies that collect public revenues or have regulatory and administrative powers. Tax administration has been simplified, but taxes are still paid mostly in cash. Cross-border trade through official Kyrgyz Republic channels can be challenging for businesses.

(ii) An increasing shortage of qualified workers prevents firms from moving up the production ladder. Labor costs and migration opportunities are both increasing (para. 8), while the deteriorating quality of education and vocational training since the breakup of the Soviet Union exacerbates the scarcity of qualified workers.

(iii) Finance is expensive, short term, and concentrated in a few sectors. Private entrepreneurs have difficultly accessing external funds for medium- or long-term investments, limiting their ability to expand and compete internationally. With current lending rates averaging 20% for banks and 30% for microfinance organizations, few investment projects are profitable enough to afford such finance. Moreover, the average maturity of bank loans is about 2 years, and only investment projects with relatively constant cash-flow—typically in trade—are able to repay such short-term loans.

6. The government is reforming tax administration with a focus on automating and centralizing operations. The State Tax Service began introducing one-stop shops with no-contact windows for taxpayers in 2010, and has reached almost one third of the country's tax offices to date. Electronic filing was made available to taxpayers in 2010; as of 30 June 2013, 4,665 taxpayers had submitted their tax reports electronically. These reforms have yet to be implemented in most tax offices, and tax administration still fails to conform to international good practice, while corruption remains pervasive. As of 2013, 54% of firms in the Kyrgyz Republic expect to give gifts in meetings with tax inspectors, one of the highest levels in the region. Unscheduled tax audits on businesses are common, although restricted by law to one per year. On average, however, firms receive tax officials or have meetings with them 2.1 times per year, make 51 tax payments per year, and spend 210 hours per year preparing and paying taxes.

7. Cross-border trade through official Kyrgyz Republic channels can be difficult for businesses because of nontariff barriers. Preparing documents for customs clearance is costly—averaging 23 days and $210 for exports, and 25 days and $280 for imports in 2012—and contributing to a total of 63 days and $4,360 for typical export transactions, and 75 days and $5,150 for typical import transactions. The single window for pre-customs clearance of foreign trade started operating in Bishkek in the last quarter of 2013 and has issued over 200 clearance folders for foreign trade transactions; to date over 40 companies have benefitted from the system. However, the system remains uncompetitive.

8. Despite an apparent labor surplus (the unemployment rate was 8.4% in 2012), the Kyrgyz Republic has an increasing shortage of managerial and qualified labor talent. Labor costs are rising for qualified workers needed for production of more valuable goods because opportunities to migrate are becoming more attractive. In recent years more than 1 million workers are estimated to have migrated. The average official monthly wage has increased in real terms and

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[5] For example, the Kumtor mine concession has been renegotiated twice since its operations started in 1997. In February 2013, the Kyrgyz Parliament directed the government to renegotiate the agreement a third time amidst allegations that Kumtor operations have caused massive environmental destruction. In May 2013, Kumtor was forced to suspend its operations after hundreds of demonstrators took control of a substation and shut down all grid power to the operation. The Parliament has yet to ratify the non-binding Heads of Agreement on a potential restructuring of the concession's ownership structure, which was signed by government and the private partner in December 2013.

was Som10,726 (about $228) in 2012. Workers are paid premium wages in the financial services, transport and communications, manufacturing, electricity, gas, and water sectors (e.g., in 2012, the monthly salary of manufacturing workers was 43% above the national average).

9. The qualifications provided by higher education and vocational training are inadequate to meet the requirements of firms in strategic sectors. Only 15% of students enroll in engineering and sciences, compared with 51% in humanities and 25% in education. A significant number of students prefer to pursue degrees more suited for government positions, such as law or economics. Higher education institutions and students also lack access to reliable labor market information systems, which could highlight the jobs in demand. Many entrepreneurs do not trust the country's educational and vocational training institutions to produce quality graduates. A 2009 survey of 109 firms found that two-thirds of firms said graduates from vocational colleges did not meet their requirements; 58% said these graduates needed in-house training.

10. The financial sector has grown over the past decade but remains small by international standards. The system is largely private; about 75% of banking assets and 100% of microfinance assets belong to private shareholders. Financial sector assets increased from an estimated 10% of GDP in 2000 to 40% of GDP in 2013. Banks dominate the financial sector with an 80% asset share, despite strong growth in microfinance. Microfinance organization assets account for 6.8% of GDP. The government securities market is small (3.0% of GDP in 2013); the longest bond maturity is 2 years. Capital markets and the insurance industry have been nominal in size and stagnant for many years. The leasing market is starting to benefit from tax code revisions that became effective in 2013; there were $7.1 million of transactions in 2012, up from an annual average of $2.3 million in 2008–2011. The country's economy remains cash based, and most households keep their money at home rather than in banks. Money outside banks exceeds 100% of deposits. Depositor confidence has been affected by historic episodes of mismanagement in banks, and the recently introduced deposit insurance has yet to make an impact.

Major Indicators of the Microfinance Sector

	2008	2009	2010	2011	2012	2013
Number of microfinance organizations	291	359	397	454	320	277
Microfinance organization loans (% of GDP)	3.4	3.9	4.5	5.1	4.6	5.0
Loans by microfinance organizations, (% of total credit)	19.6	20.3	22.8	30.0	25.1	24.0
Number of clients served ('000)	311	412	485	580	529	…
Percentage of women (% of number of clients served)	73.7	72.9	73.4	74.2	72.1	…
Average nominal interest rate (%)	32.5	34.5	38.8	38.3	34.9	31.0
Non-performing loans (% of gross loans)	8.5	3.7	4.4	3.2	4.2	2.7

GDP = gross domestic product.

Source: National Bank of the Kyrgyz Republic and National Statistics Committee.

11. Loans by microfinance organizations account for 24% of total credit, while up to 50% of all credit is microcredit, if that provided by banks is included. Microfinance organizations are often the only finance providers in rural areas, where the poor are concentrated, as banks focus on urban borrowers who can offer collateral. Agricultural lending accounts for 41.7% of the loan portfolio of microfinance organizations, compared with 17.3% for banks. Microfinance organizations make more active use of uncollateralized and group lending. Microfinance has disproportionately benefited women, as they are less able to offer collateral. Women account for almost 75% of borrowers from microfinance organizations; 86.6% of them borrowed less than Som 50,000 ($1,029). Average loan sizes range from $1,000 for large microfinance organizations to less than $100 for small ones. Large lenders provide credit for up to 4 years, small ones only for a few months. Annual lending rates average 31%, but range from 20% to over 100%, and vary mainly by funding costs, loan purpose, risk, and maturity period. The geographical coverage of microfinance appears regionally balanced, considering population density.

12. The loan portfolio of microfinance organizations grew from less than 2% of GDP in 2006 to 5.1% of GDP in 2011; credit growth averaged 47.8% per year in 2007–2011 (35.4% in real terms). Microfinance organizations increased rapidly in number until mid-2012, when the National Bank of the Kyrgyz Republic began closing those in non-compliance. At the end of 2013, there were 277 microfinance organizations; the 15 largest accounted for 87% of the loan portfolio and 93% of borrowers, and are relatively well capitalized, with access to wholesale funding from domestic and international markets. Recent sector growth has been financed through new capital and retained earnings. The sector's debt-to-equity ratio is 1.7, far below the peak of 4.9 in 2008. Microfinance organizations currently have over 500,000 borrowers; an estimated 16% borrow from more than one microfinance organization. Banks also provide microfinance, particularly Ayil Bank, which was the largest microfinance organization before it was transformed into a bank in 2006, and Bai Tushum, a former microfinance organization that obtained a banking license in November 2012 and became the sixth-largest bank by share capital.[6]

2. Government's Sector Strategy

13. The National Sustainable Development Strategy 2013–2017 is based on a vision of Kyrgyz Republic as a country with robust economic growth and high attractiveness for investors.[7] The strategy foresees measures required for reinforcing the rule of law and combating corruption. In the economic sphere the major focus of the public authorities is to create an attractive environment for domestic and foreign investors. Of particular importance is the need to attract private investment that increases productive capabilities and creates jobs.

3. ADB Sector Experience and Assistance Program

14. ADB assistance is based on the vision that achieving higher production capabilities requires a supportive framework that provides the predictability and confidence the private sector needs to invest in the country. ADB private sector development initiatives have focused on improving the business environment for private investors and entrepreneurs by tackling the key problems described in para. 5. ADB has also approved a non-sovereign operation to expand access to finance by private firms and help them improve performance, grow, innovate, and export.[8] ADB will continue to support access by firms and investors to long-term financing for productive capacity and infrastructure investments in the country. Greater access to finance in rural areas will promote inclusiveness. Both long-term financing and overall financial inclusion can be achieved through financial sector expansion, which should be based on increased and longer-term domestic funding options, in particular formal savings. ADB will continue efforts to increase the responsiveness of the vocational education system to labor market needs.

15. The government has begun to develop a framework for public–private partnerships (PPPs) and further assistance is required to develop (i) PPP sector policies and regulatory reforms; (ii) guidelines for project preparation, evaluation and selection; (iii) government instruments for preparation and implementation of PPPs such as viability gap fund and partial risk instruments, based on prudent fiscal management and governance principles; (iv) government capacity to protect its interests and value-for-money in designing, negotiating, and monitoring PPPs, including through a single government agency with overall responsibility for the PPP program; and (v) transparent and efficient procurement processes.

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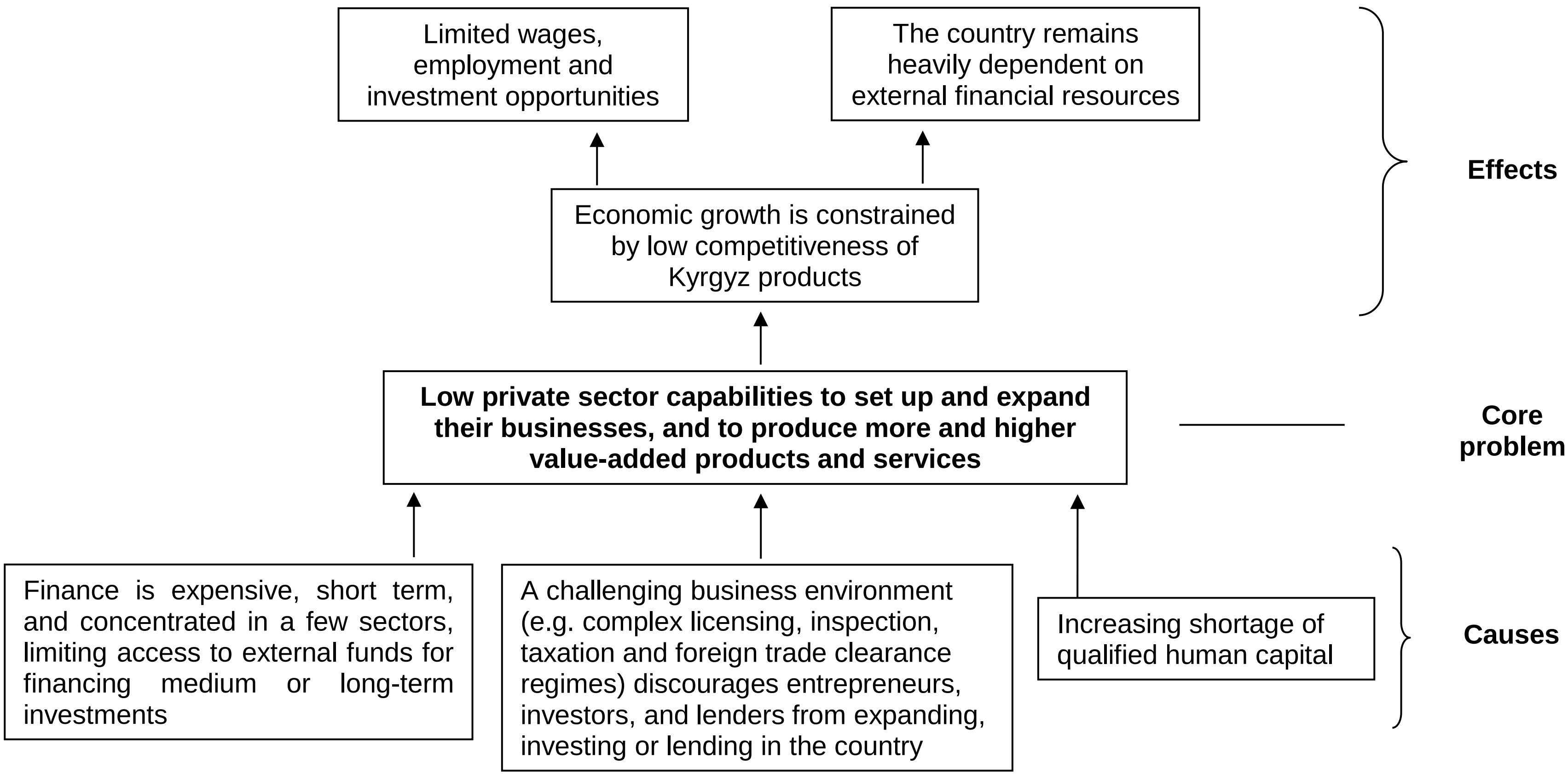
[6] Bai Tushum received a license for collecting term deposits in July 2011 and a full banking license in November 2012. Client deposits increased from Som5.1 million at the end of 2011 to Som86.3 million at the end of 2012 and to Som348.4 million (or about $7.1 million) in December 2013.

[7] National Council for Sustainable Development of the Kyrgyz Republic. 2013. *National Sustainable Development Strategy for the Kyrgyz Republic for the period of 2013–2017*. Bishkek.

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

Problem Tree for Private Sector Development



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

Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	**Indicators with Targets and Baselines**	**Outputs with ADB Contribution**	**Indicators with Incremental Targets**	**Planned and Ongoing ADB Interventions**	**Main Outputs Expected from ADB Interventions**
Improved investment climate and business environment	Share of private investment in GDP increased to 23% on average in 2013–2017 (baseline: average of 21.1% in 2007–2011) Number of products exported with competitive advantage increased from 63 in 2011 to 80 (average 2013–2017)	Cost of regulatory compliance reduced	Time to prepare and process export and import documents reduced by 50% by 2017 (2012 baseline: 23 days for preparation and 25 days for processing) Transactions in the official electronic payment system increased to 250% of GDP in 2013–2017 (baseline: average of 220% in 2007–2011)	**Planned key activity areas** Business environment and investment climate reforms (75% of funds) Financial sector development (25% of funds) **Pipeline projects with estimated amounts** ICIP Subprogram 3, $22 million (2014) ICIP Second Generation Subprogram 1, $20 million (2015) Financial Technology for the Poor Project, $10 million (2016) ICIP Second Generation Subprogram 2, $20 million (2017) **Ongoing projects with approved amounts** Women's Entrepreneurship Development Project ($1.5 million) CAREC Regional Improvement of Border Services Project ($8.4 million)	**Pipeline projects** Licensing and control-supervisory systems streamlined by 2017 Mobile banking framework and electronic payment infrastructure in rural areas further developed by 2017 PPP Project Development Support Facility established and funded by 2015 **Ongoing projects** At least 500 female micro-entrepreneurs (50% of whom are in rural areas) receive training to improve their knowledge and skills for developing sustainable women's microenterprises by 2017
		Access to finance improved	Credit to the private sector increases to 17% of GDP in 2013–2017 (baseline: average of 13.6% 2007–2011) Number of access points for financial transactions in regions outside of Bishkek, Chui and Issyk-Kul increased from 829 in 2012 to 2,000 in 2017[a]		
		Public–private partnerships facilitated	Contracts for at least 3 financially sound PPP projects are signed by 2017[b]		

ADB = Asian Development Bank, CAREC = Central Asia Regional Economic Cooperation; GDP = gross domestic product; ICIP = Investment Climate Improvement Program; PPP = public–private partnership; SME = small and medium-sized enterprise.
[a] Financial transactions include deposits or withdrawals of cash from an account, and financial settlement of credit or commercial transactions using an account.
[b] Financially sound projects are those that have been subject to and passed the Ministry of Finance's risk assessment screening.
Source: Asian Development Bank.