ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 41544-088
May 2015

Proposed Programmatic Approach and Policy-Based Grant for Subprogram 1
Kyrgyz Republic: Second Investment Climate Improvement Program

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 12 May 2015)

Currency unit	–	som (Som)
Som1.00	=	$0.016
$1.00	=	Som59.258

ABBREVIATIONS

ADB	–	Asian Development Bank
EEU	–	Eurasian Economic Union
EU	–	European Union
FDI	–	foreign direct investment
GDP	–	gross domestic product
GSP+	–	Generalized System of Preferences Plus
ICIP	–	Investment Climate Improvement Program
IMF	–	International Monetary Fund
IPA	–	Investment Promotion Agency
MOE	–	Ministry of Economy
OECD	–	Organisation for Economic Co-operation and Development
PDSF	–	project development support facility
PPP	–	public–private partnership
SMEs	–	small and medium-sized enterprises

NOTE

In this report, "$" refers to US dollars.

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PROGRAM AT A GLANCE

1. Basic Data				**Project Number:** 41544-088
Project Name	Second Investment Climate Improvement Program (Subprogram 1)	**Department /Division**	CWRD/CWPF	
Country	Kyrgyz Republic	**Executing Agency**	Ministry of Economy	
Borrower	Kyrgyz Republic			

2. Sector	**Subsector(s)**	**ADB Financing ($ million)**
✓ **Public sector management**	Law and judiciary	1.00
	Public expenditure and fiscal management	5.50
Education	Technical and vocational education and training	1.50
Finance	Finance sector development	1.50
	Inclusive finance	1.00
	Small and medium enterprise finance and leasing	4.00
Industry and trade	Industry and trade sector development	5.50
	Total	**20.00**

3. Strategic Agenda	**Subcomponents**	**Climate Change Information**	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
Regional integration (RCI)	Pillar 2: Trade and investment		

4. Drivers of Change	**Components**	**Gender Equity and Mainstreaming**	
Governance and capacity development (GCD)	Institutional development Organizational development Public financial governance	Effective gender mainstreaming (EGM)	✓
Knowledge solutions (KNS)	Application and use of new knowledge solutions in key operational areas Pilot-testing innovation and learning		
Private sector development (PSD)	Conducive policy and institutional environment Promotion of private sector investment		

5. Poverty Targeting		**Location Impact**	
Project directly targets poverty	No	Nation-wide	High

6. Risk Categorization: Complex

7. Safeguard Categorization **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

8. Financing

Modality and Sources	Amount ($ million)
ADB	**20.00**
Sovereign Programmatic Approach Policy-Based Lending (Grant): Asian Development Fund	20.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**20.00**

9. Effective Development Cooperation

Use of country procurement systems	Yes
Use of country public financial management systems	Yes

Source: Asian Development Bank

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed programmatic approach for the Second Investment Climate Improvement Program (Second ICIP), and (ii) a proposed policy-based grant to the Kyrgyz Republic for subprogram 1 of the Second ICIP.[1]

2. The proposed program aims to create a more attractive climate for private sector development in the Kyrgyz Republic. It will provide budget support to implement reforms to (i) increase and diversify financial products and services that better mobilize domestic savings; (ii) increase efficient private sector participation in physical and social infrastructure; (iii) diversify exports and export markets, and foreign direct investment; and (iv) increase the transparency and efficiency of public procurement, and reduce the costs of doing business.[2] The programmatic approach will comprise three subprograms to be implemented during 2015–2018.

II. THE PROGRAM

A. Rationale

3. Since the collapse of the Soviet Union, the Kyrgyz Republic has made significant progress in adopting market-based reforms, with private sector development as the key engine of growth. Nonetheless, growth has occurred largely from natural resource exploitation and remittances-backed private consumption. To stabilize economic growth, the government plans to diversify the economy. The National Sustainable Development Strategy, 2013–2017 of the Kyrgyz Republic aims to (i) create an environment conducive for domestic and foreign investment that will increase domestic productive capabilities and create jobs, and (ii) improve the efficiency of public sector management and administration and the employability of the country's human capital.[3]

4. The Asian Development Bank (ADB) has supported the government to address development constraints on business regulation, access to finance, workers' skills development, and public–private partnerships (PPPs).[4] From 2008 to 2014, the first ICIP and attached technical assistance helped reduce the costs of doing business by eliminating 75% of business licenses required, implementing a one-stop shop business registration system, and creating a single window for pre-customs clearance. Access to finance, particularly through leasing, was improved through enabling legislation. The average volume of leasing transactions increased from \$2.3 million per year during 2008–2011 to \$10.0 million during 2012–2013.[5] The enabling

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1 The design and monitoring framework is in Appendix 1.

2 The Asian Development Bank (ADB) provided program preparatory technical assistance for the Second Investment Climate Improvement Program (TA 8721-KGZ).

3 Government of the Kyrgyz Republic. 2013. *National Sustainable Development Strategy, 2013–2017*. Bishkek. (In addition, on 18 March 2015 the Government of the Kyrgyz Republic approved the Private Sector Development Program for 2015–2017 [Government Resolution No. 129]).

4 ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Program Cluster, Grant for Subprogram 1, and Technical Assistance Grant to the Kyrgyz Republic for the Investment Climate Improvement Program.* Manila (Grants 0120-KGZ and 0121-KGZ, and TA 7162-KGZ); ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Grant for Subprogram 2 and Technical Assistance Grant to the Kyrgyz Republic for the Investment Climate Improvement Program*. Manila (Grant 0319-KGZ and TA 8222-KGZ); ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Grant for Subprogram 3 to the Kyrgyz Republic for the Investment Climate Improvement Program*. Manila (Grant 0393-KGZ).

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

environment for PPPs was strengthened.[6] Improvements include the PPP law (largely in line with international benchmarks); clearly defined coordination, risk management, and development roles among the Ministry of Economy (MOE), the Ministry of Finance, and line ministries; and project preparation support through the Project Development Support Facility (PDSF). Overall, progress has been made in enabling the private sector to contribute more effectively to growth.

5. Despite the progress made under ADB's past assistance there are still policy distortions, including policy and institutional shortcomings, and market failures in five areas, constraining the private sector from contributing more effectively to stable and sustainable economic growth.[7]

6. **Limited access to finance and financial services.** The financial sector has grown steadily, with assets, loans, and deposits all increasing faster than gross domestic product (GDP) since 2011. However, a low level of financial intermediation persists, and savings mobilization is particularly small (financial sector assets were 38% of GDP in 2013).[8] Financial products are not diversified. Financial services and access to finance, including long-term finance for small and medium-sized enterprises (SMEs), are still restricted. High interest rates and collateral requirements also make it difficult for SMEs to borrow. Small agricultural producers and SMEs owned and operated by women are particularly disadvantaged due to a lack of (i) supply chain finance instruments (e.g., warehouse receipts), (ii) an effective commodities exchange, and (iii) mechanisms to reduce the perceived risk of lending under low collateral conditions. Microfinance organizations, with assets over 6% of GDP, provide one-third of the economy's total credit, but are constrained in their ability to grow due to absence of laws that allow deposit-taking and related prudential regulation. Regulations and laws expanding access to Islamic banking services were approved in 2013, but a prudential regulatory framework for Islamic finance does not yet exist.

7. The economy remains heavily cash-based, imposing large costs on the day-to-day transactions of government, businesses, and consumers. New technologies that promote mobile financial services have the potential to lower the costs of providing financial services, reach new customers, increase transparency, and expand lending capacity by increasing the volume of money in the formal financial system. A robust regulatory framework is required to enable these technologies to be deployed in a structured manner and to enable the industry to make the necessary investments.

8. **Nascent private sector participation in infrastructure development.** The legal, regulatory, and institutional framework has been created for private sector participation in infrastructure development, including through PPPs. Strengthening the enabling environment for PPPs under the first ICIP has resulted in a pipeline of 14 projects at various stages of preparation. However, operational knowledge and technical capacity of key government ministries and agencies that select, develop, coordinate, and promote PPPs needs to be further strengthened. In addition, standardized PPP documentation (e.g., concession agreements) needs to be developed to reduce transaction costs. Support needs to continue to ensure that projects progress to the implementation stage and an overall credible PPP program is developed, which selects the most viable projects that are anchored in robust public investment programming and are properly structured, complemented with pilot projects to develop

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[6] ADB. 2014. *Technical Assistance to the Kyrgyz Republic for Strengthening the Enabling Environment for Public–Private Partnerships*. Manila (TA 8688-KGZ).

[7] Sector Assessment (Summary) (accessible from the list of linked documents in Appendix 2).

[8] National Bank of the Kyrgyz Republic. 2013. *Financial Sector Stability Assessment Report.* Bishkek.

operational experience.[9] The banking sector and capital markets are not yet able to provide long-term finance for infrastructure. Government financial support mechanisms (e.g. guarantees, viability gap funds, and mechanisms facilitating long-term debt), especially needed in the early stages of PPP market development, are in early stages of development.

9. **Undiversified trade and investment.** Trade and investment remain undiversified despite generally open policies.[10] International trade has become an increasingly important part of the economy, with the Kyrgyz Republic's trade-to-GDP ratio rising from 95% in 2005 to over 143% in 2013. However, exports remain concentrated on a low number of value-added products sent to a few destinations.[11] This puts exporters at risk when any export markets experience an economic downturn, as is currently happening in the region.[12] The country is open to foreign direct investment (FDI), but FDI is forthcoming mostly for capital-intensive, extractive industries like mining and energy, and from a limited number of investors.[13] Therefore, FDI has minimal linkages with the local economy and generates limited employment. Investment-related disputes are inevitable in any country, but repeated renegotiation of contractual obligations has occurred on one major mining operation. This carries serious reputational risks, undermining other efforts to promote investment.[14]

10. **Industry–labor market skills mismatch.** The curricula and training being provided under the general education and technical and vocational education systems are not compatible with the current and future needs of the labor market. As a result, there is an oversupply of unskilled workers and professionals with law, economics, and management degrees, and there is a shortage of graduates in scientific, technical, and engineering fields, and of workers qualified for mid-level positions requiring technical and other industry-specific skills.

11. **Weak governance.** Lack of transparency and real and perceived corruption continue to adversely affect the investment climate. The country's corruption perception index is ranked 136 out of 175 countries, improved from 154 in 2013.[15] Progress is being made, but challenges remain. A reduction from 370 to 98 in the number of activities requiring licenses, tax payment automation, and risk-based business inspections (all introduced under the first ICIP) has helped reduce corruption. E-procurement, which accounted for about 5% of GDP and about 20% of the budget in 2014, can increase transparency and reduce corruption.

12. **Government efforts and development coordination.** The government has been providing subsidies through six commercial banks to facilitate lending to the agricultural sector at lower interest rates.[16] In addition, the State Economic Development Fund provides direct

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[9] Although the PPP program needs to be accelerated, even in countries with the most developed PPP markets, it took 3 to 7 years after a government decision to pursue PPP for the first PPP contracts to be awarded.

[10] World Trade Organization. 2013. *Trade Policy Review: Kyrgyz Republic.*

[11] World Bank. Trade (% of GDP). http://data.worldbank.org/indicator/NE.TRD.GNFS.ZS (accessed 08 May 2015).

[12] Switzerland, Kazakhstan, the Russian Federation, the United Arab Emirates, and Uzbekistan account for over 80% of all exports. Exports are concentrated in gold (the Kumtor Gold Company alone accounted for 7.4% of GDP in 2014 and for over 40% of total exports), minerals, textiles, and agriculture products, with little value added.

[13] The Foreign Direct Investment Regulatory Restrictiveness Index places the country roughly in line with the Organisation for Economic Co-operation and Development (OECD) average. OECD. 2013. *Promoting Investments and Job Creation in Central Asia through Business Linkage Programs.* Paris. The majority of FDI in 2014 (88%), as in 2013, was in extractive industries. FDI in the first 9 months of 2014 fell by 35.4% compared to the same period in 2013 due to the falling prices of oil and gold and the strengthening of the US dollar. This adversely affected Kazakhstan and the Russian Federation, the main investors in the Kyrgyz Republic.

[14] The terms of operation of the Kumtor Gold mine (accounting for 7.4% of GDP in 2014) are still under renegotiation. Also see List of Ineligible Items (accessible from the list of linked documents in Appendix 2).

[15] Transparency International. 2014. http://www.transparency.org/country#KGZ.

[16] According to the State Economic Development Fund, these subsidies amounted to about $9 million in 2013.

loans to selected commercial banks for on-lending to agriculture. The Fund is also considering additional financial support to existing loan guarantee schemes. An interagency task force has been set up to explore warehouse receipt financing.[17] The strategic move to increase the share of noncash payments and settlements from paper-based to electronic financial payments is being supported at the highest levels of government. The Pensioner Card allows pension payments to be transferred to a bank account, with reduced banking fees for accessing these funds.[18] The State Benefits Program enables benefits to be transferred directly to the bank accounts of recipients, with withdrawal enabled through debit cards. An initiative for payroll cards for public sector employees has also been implemented.[19] Given the opportunities and challenges of joining the Eurasian Economic Union (EEU), the government is also pursuing other markets and other sources of foreign capital, including through hosting visits and leading trade and investment missions to the People's Republic of China, the European Union (EU), and North and Southeast Asia.[20] The recently approved Private Sector Development Program (footnote 3) will help simplify and automate trade and customs procedures, and rationalize the incentive system for investors. Amendments made to the Law on Investment in February 2015 protect investors from arbitrary changes in their contracts and enables the government and foreign investors to negotiate contracts directly and expeditiously.

13. The government's efforts to remove constraints to growth are supported by various development partners.[21] The International Monetary Fund's Extended Credit Facility (2011–2014) supported efforts to consolidate the country's fiscal position and develop the financial sector. The credit facility approved in April 2015 will support fiscal sustainability and reforms to boost the economy's potential. The World Bank's Development Policy Operations 1 and 2 concentrated on public finance management, corruption, and increasing competitiveness. The International Finance Corporation is working on risk-based inspections, agricultural export potential, and the investment policy framework. The United States Agency for International Development, Japan International Cooperation Agency, European Bank for Reconstruction and Development, German development cooperation through KfW and GIZ, and the Swiss State Secretariat for Economic Affairs also support various aspects of private sector development.

14. **Reform program and budget support.** Through the Second ICIP, ADB will continue to support the National Sustainable Development Strategy, 2013–2017 in removing development constraints (paras. 6–11) detailed in the development policy letter.[22] Reforms listed in the policy matrix (Appendix 4) will facilitate the Kyrgyz Republic's transition to a sustainable economic development path. Budget support is necessary to finance part of the development financing needs, particularly covering the period between the introduction of reforms and the fiscal benefits resulting from the reforms.[23] Although not used as a determinant of the program size, ADB's support is also expected to help the government finance the direct and indirect fiscal costs of implementing and monitoring the reforms. The government has the ability to implement the reforms effectively, demonstrated by its experience under the first ICIP and with the policy-based programs of other development partners.

[17] State-owned Ayil Bank has piloted a few warehouse receipt financing transactions.
[18] This initiative is currently being rolled out and will reach about 191,000 pensioners when complete.
[19] At the end of 2014, 117,000 accounts had been opened and over 21,000 cards had been issued.
[20] The EEU is the economic bloc currently comprising Armenia, Belarus, Kazakhstan, and the Russian Federation. On 8 May 2015, the EEU countries signed a series of protocols on the Kyrgyz Republic's accession to the EEU. On 20 May 2015, these protocols were ratified by the parliament of the Kyrgyz Republic.
[21] Development Coordination (accessible from the list of linked documents in Appendix 2).
[22] Development Policy Letter (accessible from the list of linked documents in Appendix 2).
[23] Justification of Policy-Based Assistance (accessible from the list of linked documents in Appendix 2).

15. **Programmatic approach.** The Second ICIP is a programmatic approach with a results orientation, with upstream reforms followed by downstream implementation and monitoring. Four outputs will be delivered through a package of policy reforms phased over three subprograms. The subprograms are chronologically sequenced to ensure that each subprogram builds on the satisfactory performance of the previous one, and that there is flexibility to incorporate experience and changes in the external environment in subsequent subprograms. The approach helps ensure that the reforms are effectively implemented, and not confined to amendments in laws and regulations.[24] The policy actions completed under subprogram 1, and the indicative policy actions under subprograms 2 and 3, are in the policy matrix (Appendix 4).

16. **ADB's value additions and lessons.** ADB's long-term partnership with the government during the first ICIP enabled ADB to motivate the government to undertake reforms that might not have been addressed otherwise. For example, ADB advised the government to avail of the Generalized System of Preferences Plus (GSP+) of the European Union (EU)[25] in parallel with accession to the EEU, and to fund an annual review of the sovereign rating to help open access to international capital markets.[26] Lessons from ADB's PPP advisory experience in Bangladesh, India, Indonesia, Pakistan and the Philippines has helped shape the country's PPP program in line with international good practice, and ADB's experience in other countries will also be utilized as appropriate. A key lesson from the first ICIP—that results-based and activity-oriented policy actions are more likely to yield results than process-oriented actions—has been incorporated into this program (footnote 5).

17. **Alignment with ADB's strategy.** The Second ICIP is aligned with the development priorities set out in the country partnership strategy, 2013–2017 and the Midterm Review of Strategy 2020, and is included in the country operations business plan, 2015–2017.[27] Public sector management to improve the investment climate is an operational priority under the country partnership strategy. The constraints to private sector development are multidimensional and complex, and therefore require a multisector approach (footnote 7).

18. **Areas outside the country partnership strategy, 2013–2017**. Although not explicitly covered as a sector in the country partnership strategy, the Second ICIP addresses trade and investment issues. Diversifying trade and investment has become imperative because the Kyrgyz Republic's accession to the EEU is likely to add a considerable layer of uncertainty to its medium-term growth prospects. Accession to the EEU could result in increased trade in goods and services (the enlarged EEU market is estimated at 170 million people), more efficient labor and capital flows, and a decline in nontariff barriers. However, increasing the current tariff levels, to align them with the common external tariff of the EEU, could deter trade with non-EEU member countries and may have financial implications due to tariff renegotiations with World Trade Organization members.

B. Impact and Outcome

19. The impact of the Second ICIP will be increased private sector investment. The outcome will be an improved business and investment climate in the Kyrgyz Republic.

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[24] Programmatic Approach Concept (accessible from the list of linked documents in Appendix 2).

[25] GSP+ is a trade privilege that grants zero or preferential tariffs for over 7,000 products from certain countries, including the Kyrgyz Republic, which ratify and implement international conventions related to human and labor rights, environment, and good governance.

[26] ADB is also supporting the government to obtain the first sovereign credit rating for the Kyrgyz Republic.

[27] ADB. 2013. *Country Partnership Strategy: Kyrgyz Republic, 2013–2017*. Manila; ADB. 2014. *Country Operations Business Plan: Kyrgyz Republic, 2015–2017*. Manila.

C. Outputs

20. The Second ICIP will deliver four outputs through 21, 30 and 20 policy actions under subprograms 1, 2 and 3 respectively.

21. **Output 1: Financial deepening and access to finance increased.** The objective of this output is to increase access to finance and financial services by (i) reducing the costs and risks of lending to SMEs and expanding the range of lending products, including through (a) risk-sharing mechanisms particularly for SMEs owned or managed by women,[28] (b) Islamic finance, (c) climate finance, and (d) the development of a commodities exchange; (ii) developing mobile financial services; and (iii) strengthening microfinance sector supervision to ensure sound growth of the sector, including allowing deposit-taking microfinance organizations.

22. Subprogram 1 supported the (i) establishment of the enabling legal environment for mobile financial services through approval of the law on payment system; (ii) development and approval of a strategic plan for the retail payment system, with regulatory and oversight framework; (iii) development and approval of the draft concept for a risk-sharing facility for SMEs owned or managed by women and a commodities exchange to support warehouse receipt financing; and (iv) development and approval of the coordination mechanism between the off- and on-site supervision departments of the central bank to strengthen risk-based supervision of the microfinance sector.

23. **Output 2: Comprehensive public–private partnership program fostered**. The objective of this output is to improve the enabling environment for PPPs, including through government financial support mechanisms, and to build greater government operational knowledge and capacity. The legal and regulatory framework will be strengthened, and rigorous and well-documented project preparation, appraisal and approval processes, and supporting tool kits will be developed. Investment programming and public finance management of PPPs, i.e. fiscal risk assessment and management, will be supported. Government capacity will be built for each stage of the project development and implementation process through learning by doing on pilot projects. Pilot projects will also help test the robustness of the enabling framework.

24. Subprogram 1 supported (i) the approval of the government's PPP development program, including a capacity-building program, for 2015–2020; (ii) the approval of amendments to the PPP law to provide a more structured approach to procurement; (iii) PDSF start-up, by approving funds for the pre-feasibility study of a computer tomography (health) project, which has undergone gateway reviews required by the PPP project preparation process; (iv) the approval of fiscal risk guidelines for PPPs, including guidance on contingent liabilities, to ensure transparent budgeting of PPP fiscal costs; (v) proposals for financial schemes to support the commercial viability of, and enable availability of long-term finance for, PPP projects; and (vi) the development of a draft health sector strategy and multiyear investment plan including PPPs prioritizing women's projects. A comprehensive website (ppp.gov.kg) and communication plan have been launched to increase awareness about and credibility of the PPP program.

25. **Output 3: Trade and investment diversification facilitated**. The objective of this output is to help the government implement the country's liberal trade and investment policies effectively. This will be done through policy and institutional support, including for the key areas identified in the national Export Development Program: trade promotion, access to finance,

[28] The facility will create synergies with the Development of Women's Entrepreneurship Project (Grant 9170-KGZ).

national quality infrastructure, and trade facilitation infrastructure.[29] Since trade and investment facilitation also requires a service-oriented approach, reforms will also cover conveying market intelligence to exporters on new markets, developing workers' skills in line with current and future market requirements, and making trade finance available to SMEs. An investment grievance redress mechanism, based on international good practice, will be established. A sovereign credit rating will be obtained to enable prospective lenders and investors to assess and price country risk.[30]

26. Subprogram 1 supported the (i) approval of the national Export Development Program; (ii) implementation of the Investment Promotion Agency (IPA) strategic plan, including through adequate staffing, establishing the IPA website (in English and Russian) as the primary and comprehensive source of information for potential foreign investors, and starting the customer relationship management system to manage information flow with prospective investors; (iii) approval of a draft concept paper on the modernization of national product quality assurance infrastructure for public and private sector stakeholder consultation;[31] (iv) preparation of the GSP+ application and its submission to the EU; (v) preparation of a draft proposal, with organizational chart, operational plan, and budget, for establishing an EEU help desk; (vi) establishment of an inter-ministerial working committee under the Center for Judicial Representation, with an action plan and budget to set up an investment redress mechanism, which will identify and review prospective investment disputes before their escalation to litigation; (vii) designation of the IPA as the MOE representative on the National Skills Development Council of the Agency for Vocational Education to help identify and develop market-responsive vocational skills training and curriculum, including attracting women to traditionally male occupations such as engineering and finance;[32] and (viii) the engagement of a rating agency to start the sovereign rating process.

27. **Output 4: Transparency and efficiency of doing business increased**. The objective of this output is to increase transparency and reduce corruption in government operations and to further reduce the costs of doing business, especially for SMEs. This output will mainstream e-procurement in government agencies and enhance the integrated tax administration system.

28. Subprogram 1 supported (i) start-up of key modules to enable central government agencies to use the full e-procurement system,[33] and (ii) approval of the law on amendments to the tax code to reduce the frequency of tax filing for businesses from monthly to quarterly.

D. Development Financing Needs

29. The Second ICIP is estimated to cost $63 million equivalent for 2015–2018, to help support a part of the development financing needs from the perspective of the overall projected budgetary financing requirements of the country (para. 14). The development financing needs are projected at approximately $600 million (2015), $517 million (2016), and $424 million (2017) (footnote 23). The government has requested a grant not exceeding $20 million from ADB's

[29] The Export Development Program outlines the country's export strategy and specific courses of action to implement it. It also takes into account the implications for the Kyrgyz Republic of joining the EEU.
[30] This will catalyze reforms to improve country risk and enable access to international capital markets in the future.
[31] This will help assess the infrastructure upgrades and investments needed to comply with product quality (assurance) requirements of the EEU and other possible markets. ADB findings on the existing infrastructure and institutional capacity to comply with sanitary and phytosanitary standards will be included.
[32] The identification and development of market-responsive vocational skills training and curriculum will also leverage the Second Vocational Education and Skills Development Project (Loan 2902-KGZ and Grant 0307-KGZ).
[33] ADB. 2012. *Technical Assistance to the Kyrgyz Republic for Implementing the E-Procurement System*. Manila.

Special Funds resources to help finance subprogram 1. Subprogram 2 (with an estimated loan amount of $23 million) and subprogram 3 (with an estimated loan amount of $20 million) are subject to further discussion between ADB and the government.

E. Implementation Arrangements

30. MOE is the executing agency. MOE, Ministry of Finance and National Bank of the Kyrgyz Republic are the key implementing agencies. The program will be implemented from July 2014 to October 2018, with subprogram 1 implemented from July 2014 to June 2015. Subprogram 2 is expected to be implemented from July 2015 to October 2017 and subprogram 3 from July 2017 to October 2018. The subprogram 1 grant will be provided in a single tranche and funds may be withdrawn upon fulfillment of the policy actions (Appendix 4). The subsequent subprograms will be submitted for ADB Board consideration upon completion of the policy actions. The proceeds of the grant will be disbursed in accordance with ADB's simplification of disbursement procedures and related requirements for policy-based loans.[34] The proceeds will be used to finance the foreign exchange cost of items produced and procured in ADB member countries, excluding items included in a list of ineligible items and imports financed by other bilateral and multilateral sources.[35] Local currency generated from the grant will be directed to the government's bank account to cover a part of the development financing needs for 2015.

III. DUE DILIGENCE

A. Economic and Financial

31. Growth is expected to be positive for 2015 but is projected to decline to 1.7%, reflecting recession in the Russian Federation, sluggish performance in Kazakhstan, and a further decline in gold production. The fiscal deficit increased to 4.3% of GDP in 2014 as slowing growth contributed to a shortfall in revenue. The fiscal deficit is projected at around 5.0%–8.0% of GDP in 2015–2016. Reduced revenues will have negative implications on sustaining reforms to ensure a stable growth path. Remittances, constituting about 25% of GDP in 2014, are projected to decline by about 15% in 2015 (having declined by 5%-7% in the first quarter of 2015). The growing fiscal and current account deficits, along with the already limited fiscal space, will also constrain the ability of the government to mitigate the negative impact of any additional external shock. The Second ICIP injection will not result in a surfeit of capital inflows and foreign exchange, nor will it undermine the money supply and exchange rate.[36]

32. The reforms supported by the Second ICIP entail net negative direct and indirect fiscal costs to the government i.e., costs of adjustment of implementing and monitoring the reforms. However, these reforms will, in time, generate a positive fiscal feedback by creating a wider and more diversified economic and tax base. This improved tax base, combined with effective tax administration, will help generate increased revenues for the government. Key economic benefits include a more formal economy and an increase in the volume of money in the financial system from increased use of noncash payments. Access to credit for the private sector, particularly SMEs, will be increased, including through risk-sharing facilities for women

[34] ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.
[35] List of Ineligible Items (accessible from the list of linked documents in Appendix 2). Grant proceeds disbursed against imports will require a certificate from the government stipulating that the value of the total imports of Kyrgyz Republic minus its imports from nonmember countries, ineligible imports, and imports financed under other official development assistance, is greater than the amount of the grant expected to be disbursed in 2015. ADB will have the right to audit the use of the grant proceeds and to verify the accuracy of the government's certification.
[36] International Monetary Fund Assessment Letter (accessible from the list of linked documents in Appendix 2).

entrepreneurs, innovative products (such as warehouse receipts), and the development of Islamic finance and Islamic financial products. Improved public investment planning and PPP projects will create priority infrastructure assets with efficient public service delivery and increased transparency in government transactions. Government e-procurement will enable substantial cost savings and efficiency improvements. Effective implementation of trade and investment policies will help diversify the economic base, create more job opportunities, and increase avenues for revenue generation. Tax administration reforms can increase transparency, in addition to raising revenues. The investment grievance redress mechanism will improve investor confidence. Based on the experiences of other countries, implementing the requirements of GSP+ alone could raise substantial additional revenues for the government.[37]

B. Governance

33. Risks in public finance management are high, but reforms are advancing including budget automation and improved management information systems. Necessary key reforms include strengthening of budget processes and the link between a medium-term budget framework and the annual budget, and improving budget transparency. Development of the treasury system in line with international accounting standards is being introduced with International Monetary Fund (IMF) support. High procurement and corruption risks are being mitigated through mainstreaming e-procurement in government, supported under the proposed program. Automation of tax and other services is also helping to reduce rent-seeking opportunities. The Organisation for Economic Co-operation and Development (OECD) is helping implement the government's National Anti-Corruption Program and Action Plan (approved 2012).[38] ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and MOE.

C. Poverty and Social

34. An improved business climate will help create new enterprises and support existing businesses to grow and innovate. This will create more jobs, including for the poor and rural workers. Improved public infrastructure and services, such as for health, district heating, and transport, will also benefit the poor and vulnerable. The Second ICIP is categorized as effective gender mainstreaming, since it helps address some key issues facing women in accessing finance; receiving technical support for business development; and participating in policy, trade, and investment bodies. Specific gender actions include (i) establishing a financial risk-sharing facility for women-owned or operated SMEs; (ii) ensuring gender balance in the staffing of the PPP Unit and the IPA, including gender sensitization training; (iii) prioritizing PPP projects with poverty and gender impacts and ensuring social and gender impact assessments in the evaluation of PPP projects; (iv) developing market-responsive courses and training, including those that promote women's access to nontraditional occupations; and (v) providing technical support services to women SMEs to cope with increased export options expected under GSP+.

D. Safeguards

35. Activities under the Second ICIP are confined to policy and institutional reforms. The program is unlikely to have adverse impacts on the environment, require involuntary resettlement, or affect indigenous peoples. Safeguards categorization for environment, involuntary resettlement, and indigenous peoples are all C.

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[37] Economic Analysis (accessible from the list of linked documents in Appendix 2).
[38] OECD. 2014. *Istanbul Anti-Corruption Action Plan: Kyrgyz Republic Progress Update*. Paris.

E. Risks and Mitigating Measures

36. Major risks and mitigating measures are summarized in Table 1 and detailed in the risk assessment and risk management plan.[39] The integrated benefits and impacts of the program are expected to outweigh the costs with the existing mitigating measures.

Table 1: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Slowdown in the Russian Federation, geopolitical tensions, accession to the EEU and domestic politics adversely impact trade and investment and the local currency, and delay reforms.	Trade and investment diversification is being supported under the program, including availing the EU's GSP+ trade privilege.
Weak public financial management systems adversely impact budget planning and execution, and transparency and accountability.	Public financial management systems, including budget processes, internal audit, institutional and human resources, and project management capacity, are being improved with multi-donor support.
Delay in comprehensive implementation of e-procurement.	A centralized public e-procurement system is being established in Ministry of Finance with support under the Technical Assistance for Implementing the E-Procurement System (TA 8297-KGZ).
Change in government after the parliamentary elections in November 2015 undermines reforms.	Reforms support the approved National Sustainable Development Strategy, 2013–2017.
Corruption and perceived corruption could continue to deter domestic and foreign investment.	The program supports e-procurement in central government agencies, tax administration improvements, and investment grievance mechanisms.

EU = European Union, EEU = Eurasian Economic Union, GSP+ = Generalized System of Preferences Plus, TA = technical assistance.

IV. ASSURANCES

37. The government has assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the grant documents. The government has agreed with ADB on certain covenants for the program, which are set forth in the grant agreement.

V. RECOMMENDATION

38. I am satisfied that the proposed programmatic approach and policy-based grant would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

(i) the programmatic approach for the Second Investment Climate Improvement Program, and

(ii) the grant of $20,000,000 to the Kyrgyz Republic for subprogram 1 of the Second Investment Climate Improvement Program, from ADB's Special Funds resources, and such other terms and conditions as are substantially in accordance with those set forth in the draft grant agreement presented to the Board.

Takehiko Nakao
President

26 May 2015

[39] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
Impact Increased private sector investment	Share of private investment in GDP increased to 20.0% by 2023 (baseline 2008–2013: average of 18.3%)	Annual statistical yearbook of National Statistics Committee (www.stat.kg)	**Assumption** Economic opportunities for domestic and foreign capital increase. **Risk** Economic slowdown in the Russian Federation, geopolitical tensions, and domestic politics adversely reforms agenda.
Outcome Improved investment and business climate	Domestic credit to the private sector increased to 18.0% of GDP from 2015–2019 (baseline 2010–2014: 15.7%) At least one PPP project (with gender, social, and environment assessments) competitively tendered by 2018 (baseline 2014: 0) E-procurement operationalized in at least 50% of central government agencies by 2018 (baseline 2014: 1%)	NBKR annual report MOE (PPP unit) notification MOF notification	**Assumption** Private sector development remains a key government priority. **Risks** Continued low transparency, corruption, and perceived corruption could deter domestic and foreign investment. Accession to the EEU may delay non-EEU related reforms.
Outputs 1. Financial deepening and access to finance increased	**Subprogram 1**: Law on payment system approved by March 2015 **Subprogram 2**: Regulations for e-money, payment system operators, and remote financial services approved by February 2016 **Subprogram 3:** Lending by banks to women owned or managed SMEs increased by 15% by December 2017 (baseline: survey in 2015) **Subprogram 2**: Innovative financing products for SMEs (warehouse receipts, risk sharing facilities, climate finance, and/or Islamic finance) introduced in relevant financial intermediaries by December 2016	Government legal database Resolutions of the board of NBKR Consultant report: Survey of clients of Risk Sharing Facility for women owned or managed SMEs; National Statistics Committee; NBKR annual report	**Assumptions** Finance sector development continues to be a government priority. Government strengthens advocacy and awareness of the benefits of noncash transactions. Government aligns SME development, including improved access to finance and financial services, with priority sectors of the national Export Development Program.

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
2. Comprehensive PPP program fostered	**Subprogram 2:** Business case(s) for financial support mechanism(s) (viability gap fund, long-term debt fund, or guarantees) developed by January 2016 **Subprogram 3:** At least two priority sector prefeasibility or feasibility studies, funded by the PDSF, completed (with social, gender, and climate impact assessments) by May 2016, and contract for at least one competitively tendered project signed by December 2017 **Subprogram 2:** Infrastructure development and financing strategy, including PPP and climate finance, and list of priority projects for private participation, for at least three sectors prepared by March 2017	MOE and MOF notification MOE notification and PPP website MOE notification and PPP website	**Assumptions** Political championship for PPP market development is strengthened. Government ensures adequate availability of funds in the PDSF and timely disbursements through streamlined internal processes.
3. Trade and investment diversification facilitated	**Subprogram 1:** National Export Development Program approved and IPA business plan (strategy) operationalized by March 2015 **Subprogram 2:** Kyrgyz Republic receives GSP+ status by March 2016 **Subprogram 2:** Short-term practical training or industry apprenticeship programs with at least five domestic market- or export-focused companies or SMEs operationalized (with at least 40% female participation) by IPA and AVE by March 2017	Government order and MOE notification Government order and MOE notification MOE (IPA) notification	**Assumption** Cooperation and coordination between concerned line ministries, Ministry of Justice and MOE, and between MOE and AVE are effective.
4. Transparency and efficiency of doing business increased	**Subprogram 2:** Law On Amendments to the Tax Code approved by October 2015 **Subprograms 1 and 2**: Full e-procurement system operationalized in at least 20 government entities by March 2015 and in at least 50 by June 2016 (baseline 2014: 40 agencies using paper-based and e-procurement)	Government legal database MOF notification	

Activities and Milestones	Inputs
1. **Financial deepening and access to finance increased** 1.1 Draft revised payment system development legislation, including regulation for (i) oversight in line with international good practices, and (ii) enabling e-payments (by February 2015) 1.2 Draft concept papers for the establishment of a risk-sharing facility for women owned or managed SMEs and a commodities exchange to support warehousing receipt systems (by March 2015) 1.3 Approve design, legal framework, and funding for a risk-sharing facility for women owned or managed SMEs and approve the establishment of a commodities exchange (by June 2016) 1.4 Complete assessment of the market for Islamic finance in the country, including needed key regulatory amendments (by January 2016), and approve necessary measures and regulations (by January 2017) 2. **Comprehensive PPP program fostered** 2.1 Finalize fiscal risk guidelines, including on contingent liabilities, and prepare proposals for possible government financial support schemes, including legal normative acts (by March 2015) 2.2 Prepare PPP manual, tool kits, guidelines, and model documents (outline and full business cases, PPP suitability filters, risk allocation, contracts, gender and environmental safeguards, requests for proposals, requests for qualifications) for key priority sectors (by February 2016) 2.3 Draft PDSF amendments to enable single sourcing of advisory services (by March 2016) and make budget or other financing arrangements for the needed financial support schemes (by March 2017) 2.4 Tender at least one PDSF-funded project prefeasibility or feasibility study and approve at least two more projects for PDSF support (by May 2015) 2.5 Support MOE in managing PDSF-funded consultants for prefeasibility studies or feasibility studies (from May 2015 to December 2017) **3. Trade and investment diversification facilitated** 3.1 Draft GSP+ application to the European Union (by March 2015) 3.2 Draft paper on national (product assurance) quality infrastructure and upload on MOE website for stakeholder consultation (by March 2015) 3.3 IPA and AVE (and sector councils of National Skills Development Council) place professional school students for practical training/apprenticeships in SMEs (by March 2017) 3.4 Operationalize investor grievance redress mechanism (by October 2016) **4. Transparency and efficiency of doing business increased** 4.1 Roll out e-procurement modules in key agencies (by December 2015) 4.2 Implement key aspects of State Tax Service strategy related to reducing taxation procedures for businesses (by March 2016)	ADB: $20 million equivalent for Subprogram 1 ADB: $23 million equivalent for Subprogram 2 ADB: $20 million equivalent for Subprogram 3 Technical Assistance Grant ADB: $500,000 (2016)

ADB = Asian Development Bank, AVE = Agency for Vocational Education, EEU = Eurasian Economic Union, GDP = gross domestic product, GSP+ = Generalized System of Preferences Plus, IPA = Investment Promotion Agency, MOE = Ministry of Economy, MOF = Ministry of Finance, NBKR = National Bank of the Kyrgyz Republic, PDSF = Project Development Support Facility, PPP = public–private partnership, SMEs = small and medium-sized enterprises.
Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=41544-088-3

1. Grant Agreement
2. Sector Assessment (Summary): Multisector for Private Sector Development
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Economic Analysis
6. Country Economic Indicators
7. International Monetary Fund Assessment Letter[1]
8. Summary Poverty Reduction and Social Strategy
9. Risk Assessment and Risk Management Plan
10. List of Ineligible Items

Supplementary Documents

11. Programmatic Approach Concept
12. Justification of Policy-based Assistance
13. Summary of Achievements under the Investment Climate Improvement Program (2008 - 2014)
14. Technical Assistance List

[1] http://www.imf.org/external/np/sec/pr/2015/pr15165.htm. The linked document is the press release dated 8 April 2015. According to the International Monetary Fund (IMF), responses to the multilateral development banks' requests for the IMF assessment of a country's macroeconomic conditions and policies will be conveyed whenever possible through the most recent press release, chairman's statement produced in the context of Article IV surveillance, IMF-supported program or staff monitoring program, or a previous assessment letter (if it remains valid). Barring any major changes in the country circumstances, the public information notice, chairman's statement, or previous assessment letters are expected to remain valid for a period of up to 6 months. An assessment letter would only be called for if either (i) the most recent assessment is more than 6 months old, or (ii) IMF staff considers that there have been material changes in the country's circumstances that call for an updated assessment.

DEVELOPMENT POLICY LETTER

КЫРГЫЗ РЕСПУБЛИКАСЫНЫН ПРЕМЬЕР-МИНИСТРИ

ПРЕМЬЕР-МИНИСТР КЫРГЫЗСКОЙ РЕСПУБЛИКИ

720003, Бишкек ш., Абдумомунов көч., 207

720003., г. Бишкек, Абдумомунова, 207

2015-ж.г. « 6 » 05 №16-18444

Mr. TakehikoNakao
President
Asian Development Bank
Manila, Philippines

Subject: Second Investment Climate Improvement Program (ICIP), Subprogram 1.

Dear President Takehiko Nakao,

On behalf of the Government of the Kyrgyz Republic I thank the Asian Development Bank (ADB) for its continued support of the Kyrgyz Republic's development process, including support for reforms to improve the country's business and investment climate.

This letter explains the recent and expected economic developments in the Kyrgyz Republic; provides information on reforms that are being implemented by the Government with the objective of improving the country's business and investment climate; development partner support for and coordination on reforms in this area; and how the proposed program addresses the continuing constraints to private sector development.

The Kyrgyz Republic achieved rapid economic growth over the past few years but progress is beginning to slow down. After the rapid, albeit volatile, growth period of 2008-2013, when the annual real GDP growth averaged 4.6% (fluctuating from 0.5% to 10.9%), growth in the Kyrgyz Republic slowed to 3.6% in 2014.The main factors of the economic growth delay in 2014 include high economic base of 2013 (10,9% increase) and the deteriorating economic situation in Russia and Kazakhstan, the country's main trading and investment partners. A nearly 20% depreciation in the local currency accelerated inflation to 10.5% (December 2013). The fiscal deficit was equal to 0.5% of GDP in 2014 and 0.7% in 2013. The loss of non-tax revenue from closing the Transit Center at Manas Airport[1]was partly offset by higher grants and expenditure cuts.

[1] Moreover, payments($120 million annually) for the use of the Transit Center at Manas airport for the NATO troop operations in Afghanistan are discontinued, due to its closure in July 2014.

On the supply side, the plunge in gold production by 6.3%, following a year when gold output had doubled, caused industrial growth to slow down for 1.7% in 2014 after the 35.9% growth in 2013. Non-gold GDP rose by 4.6%, buoyed by expansion in services and construction. The drop in gold production also led to declines by 3.0% in manufacturing although there was growth in production of food, construction, and other minerals. Services, which represent about half of the country's Gross Domestic Product (GDP), expanded by 4.1%, as higher consumer demand and improved cross-border trade boosted retail and wholesale trade by 8.3%, services of hotels and restaurants by 9.6%, and transportation by 3.0%. However, adverse weather conditions, which reduced farm output, led to a 0.6% contraction in agriculture.

Strong performance of 2013 and increased donor support in 2014 improved slightly the Government's fiscal buffer, but underlying weaknesses of the budget remain. Growth projection for 2015 remains positive, but is likely to slow to 2.0%. The fiscal deficit forecast is around -3.3% to -2.2% of GDP in 2015-2016. The outlook has worsened due to the economic slowdown in Russia, with which the Kyrgyz Republic, like the other oil importing former Soviet republics, is closely linked via trade, foreign direct investment and remittance flows. Russia is projected to go into recession in 2015 as inflation rises to double digits, foreign investment remains low and capital flight remains high. With the decline of oil prices, the Russian Ruble is expected to continue to weaken. The slowdown in Russia –the combined effect of the fall in the price of oil (its main export), financing difficulties due to sanctions over the Ukraine crisis and the depreciation of the Ruble against the dollar - are already beginning to spillover to the former Soviet republics, including the Kyrgyz Republic. Remittances, which constitute about 25% of GDP, have declined by 5.1%, and are equal to $1.8 billion. Remittances are projected to reduce by about 15% in 2015. Lower remittance inflows, in turn, will suppress household incomes and consumption, and put further pressure on the local currency and the prices of imported goods.

The limited fiscal cushion projected for 2015-16 will put persistent pressure on the fiscal and external accounts of the country. Public external debt was equal to 50.9% of GDP at the end of 2014 from 47.1% a year earlier. The 19.6% depreciation of the Som in the course of the year adversely affected country's foreign currency-denominated debt. The government is committed to fiscal consolidation - restraining expenditure on low-priority items in light of the conservative revenue forecasts. The economic growth may recover to around 3.3% in 2016, from the 2.0% forecast for 2015, subject to the recovery in Russia and other regional trading partners. However, the high possibility of depreciation of the Som in 2015, due to the projected weak growth in Russia and Kazakhstan, will weigh on inflation, personal incomes, and external debt. The public external debt is expected to rise further to 56% to GDP in 2015.

Accession to the Eurasian Economic Union is likely to add a considerable layer of uncertainty to the Kyrgyz Republic's medium-term growth prospects. The Kyrgyz Republic is scheduled to join the Eurasian Economic Union (EEU) – comprising Russia, Belarus, Kazakhstan, Armenia and the Kyrgyz Republic -in May 2015. The country could benefit from increased trade in goods and services (given that the enlarged consumer market of the EEU is estimated at 170 million people),more efficient flows of labor and capital, and a decline in non-tariff trade barriers. However, it will likely lead to an increase in its currently liberal tariff levels to align them with the Common External Tariff of the EEU. This, in turn, could deter trade with non-EEU member countries and also have financial implications due to tariff re-negotiations with World Trade Organization (WTO) members. Further pressure on inflation is expected, due to the large import content in the intermediate and final consumer goods baskets. Failure to meet EEU standards and technical regulations in the short term may dent export opportunities.

The Kyrgyz Republic has made significant progress in implementing policy, legal and institutional reforms to improve the business and investment climate for the private sector to become the main engine of growth. The partnership with the ADB Investment Climate Improvement Program (2008-2014), complemented by interventions from other development partners, helped reduce some of the key constraints to private sector development. These constraints included the high cost of regulatory compliance, limited access to finance and financial services, lack of skilled workers to match the needs of businesses and industry and lack of private sector participation in developing infrastructure. Specifically, excessive licensing and inspection requirements, and cross-border trade barriers such as pre-customs clearances, were reduced, and a single window for foreign trade established. Electronic filing of tax and payment of patents was introduced in all regions, and risk-based inspections were made mandatory by law. The legal framework for secured lending has been developed. The National Bank of the Kyrgyz Republic improved prudential regulations for the supervision of financial services providers. Credit information was improved with the establishment of a private credit bureau. The legal framework for consumer financial protection was also improved. The range of financial products and services, particularly for women, was increased, along with establishing an institutional mechanism for more market-responsive vocational education. The framework for public-private partnerships was developed, given that the government envisages significant investment needs and an increased role for the private sector, including through public–private partnerships (PPPs), in developing and financing economic and social infrastructure.

We remain committed to ensuring stable economic growth that will create jobs and reduce poverty, and is powered by domestic and foreign investment. The National Sustainable Development Strategy (NSDS) 2013-2017 of the Kyrgyz Republic envisions stable economic growth through economic diversification and reduced dependence on external assistance. It specifies the government's commitment to create an environment conducive for domestic and foreign investment that will increase domestic productive capabilities and create jobs. ADB's Country Partnership Strategy (CPS) 2013–17 for the Kyrgyz Republic is also aligned with the NSDS (2013–17).Within this period, the NSDS envisions that the Kyrgyz Republic "should become a country oriented at successful implementation of the NSDS, with improved governance institutes, effective laws, advanced human resource capacity willing to strengthen the basis of the country's sustainable development, people's advanced environmental and economic thinking and improved social and economic ratings in global development".

While progress has been made, constraints to business development and investments remain. The Government of the Kyrgyz Republic is therefore, keen to undertake the proposed second round of reforms, including increasing transparency and reducing corruption, so that these remaining constraints can also be addressed through timely and effectively implemented policy and institutional reforms.

We recognize that small and medium enterprises (SMEs) are critical for private sector development and hence, for long term, stable economic growth. Improving access to finance for this sector is a key priority. In 2014 the total number of employees in business (excluding farms) totaled 438.1 thousand(an increase of 20.7 thousand). The share of small and medium-sized businesses in the GDP amounted to 39.0% or 155.5 billion soms (In 2013, it was equal to 38.9% or 138.0 billion soms).Despite a financial sector that has grown steadily over the past decade -with assets, loans and deposits all increasing faster than GDP since 2011, the banking sector loan portfolio doubling in size in the last 5 years, and the share of loans with maturity over 12 month sin creasing - access to finance is still limited. Financial intermediation is low and SMEs are seen as high-risk borrowers, facing higher collateral, guarantee, and interest rate requirements. Availability of collateral is limited, as is the use of credit guarantees. Getting better access to finance will help the SME sector grow and innovate, creating more diversified and higher value-adding jobs. Access to finance will be improved by expanding the range of financial products available to SMEs including risk-sharing mechanisms, especially for women-owned SMEs, Islamic finance and warehouse receipts backed by an efficiently functioning commodity exchange.

The economy is still heavily cash-based. Innovative use of technology, backed by a sound regulatory framework, is important for improving access to finance and financial services. In conjunction with increasing confidence in the banking system, electronic payment instruments can encourage businesses to move into the formal economy, reducing corruption and the inefficiency costs of a cash-based economy, enable the unbanked to start a transaction history, and improve financial inclusion. Savings, borrowing, insurance, and transfers can be simplified and made more accessible through mobile and electronic financial systems. Since the microfinance sector forms an important part of the financial sector in the country, providing a third of the economy's credit, prudential regulation to promote sector consolidation, and supervisory capacity for risk-based supervision, needs to be strengthened.

The government envisages significant new investments and improved technical capacity to develop economic and social infrastructure, with an increased role for the private sector as articulated in the NSDS 2013-17, including through PPPs. The Kyrgyz Republic inherited substantial infrastructure assets and almost full coverage of basic health, education, and municipal services infrastructure from the former Soviet Union. Economic hardships and resulting budgetary deficits since independence have constrained the government's ability to maintain and rehabilitate existing assets and construct new ones. Technical capacity has also significantly deteriorated. Eroding infrastructure, particularly unreliable electricity, has become a constraint for private sector development.

With sustained ADB support, we have approved the PPP Law and established the legal and regulatory framework for PPPs, largely in line with international good practice. The institutional framework has also been established – the Ministry of Economy (MOE) as the primary agency for PPP development and implementation; the Ministry of Finance (MOF) as Fiscal Risk Management Unit; and PPP focal points in key line ministries and in the City Development Agency, Bishkek. PPP tender procedures have been approved, and a tender commission has been established. A Project Development Support Facility with a budget allocation of $4 million up to 2016 has been operational zed for project preparation support.

We need to continue strengthening the enabling environment for PPPs, and develop pilot projects to build operational capacity of the government and work as feedback mechanisms to improve the credibility and effectiveness of our PPP program.

The government acknowledges that the country needs to diversify its exports and investments. It needs to increase the competitiveness of its firms to enable their greater participation in global markets. During 2013 the foreign trade turnover (goods and services) of the Kyrgyz Republic amounted to 476.2 billion soms, equal to 134.0% of GDP; in 2005 it was equal to 95,9 billion soms of

95.1% of GDP. However, the country's exports are heavily concentrated on a few markets such as Russia, Kazakhstan and China and the export base is limited to minerals, agriculture and textiles. Most of the foreign direct investment (FDI) is in the extractive sector and largely concentrated on the Kumtor gold mine, which accounts for nearly 12% of GDP and for the majority of the country's industrial output and exports.FDI is also concentrated on a few investors.

On the one hand, the country's accession to the EEU is bringing huge demands on the already strained institutional capacity needed to support an open and liberal trade and investment regime. Our agencies will have to understand and comply with a myriad of requirements covering product quality, customs and border controls, and other measures that impact the flow of goods. On the other hand, the economic slowdown in the region, particularly Russia, is making it imperative for us to diversify exports and investments. It is critical for the Kyrgyz Republic to enhance its attractiveness to foreign investors by attracting sourcing more labor and production inputs from local companies. Towards this end, our policy support is complemented with appropriate institutional level support, including under the four key areas - trade information and promotion, access to finance, national quality infrastructure and trade facilitation infrastructure - identified in the national Export Development Program, which also takes into account implications of joining the EEU. The Investment Promotion Agency was established in March 2014, under the MOE, to develop and implement measures to stimulate foreign and domestic private investment activity. To diversify our exports and export markets, we are submitting our application to the European Union to avail of the General System of Preference (GSP) Plus privilege.

In parallel with our EEU accession measures, we assiduously abide by our WTO and World Customs Organization (WCO) commitments and obligations. We are moving forward with implementing provisions of the WTO Trade Facilitation Agreement (TFA), to include establishment of a Trade Facilitation Committee. The TFA in many respects mirrors the WCO's Revised International Convention on the Simplification and Harmonization of Customs procedures (Revised Kyoto Convention, RKC). RKC accession is being pursued in parallel with implementation of TFA provisions. At the same time, implementation of the WTO Sanitary and Phyto-Sanitary (SPS) Agreement is essential for the Kyrgyz Republic's agro-industrial complex to access new markets, increasing the prospects for attracting greater volumes of direct foreign investment in this sector and for diversifying the national economy. With technical assistance from ADB and other development partners, we are making progress in this respect.

Investment-related disputes are inevitable in any country but litigation is a costly option for all parties concerned. We also need to develop an investment grievance redress mechanism, based on international good practice, to increase investor confidence and avoid costly litigation. Obtaining a sovereign credit rating will enable prospective lenders and investors gain an aggregate view of the country risk.

For all of the above to be realized, the government realizes that it needs to ensure that the skills of its workforce cater to the current and emerging needs of the market. Currently, the output of the education and the Technical and Vocational Education training (TVET) is incompatible with the requirements of the labor market. There is an oversupply of professionals holding law, economics, and management degrees as well as of unskilled workers, and a shortage of graduates in scientific, technical, and engineering fields, and of workers qualified for mid-level positions requiring technical and other specific skills. This industry and labor market skills mismatch needs to be remedied, including through industry apprenticeships.

Given that improving a country's business and investment climate requires a range of reforms across several areas, the government is ensuring that the programs and interventions of the various development partners is coordinated and helps creates appropriate synergies and leverage of resources.

In conclusion, we assure ADB that the Government remains firmly committed to the reform agenda outlined above and to build on and effectively implement the reforms already instituted. We deeply appreciate ADB's leading role in support to improve investment climate reforms over the long term. To assist continuation of recent, successful efforts, we look forward to a rich policy dialogue with the ADB in the framework of the Second Investment Climate Improvement Program and the early consideration of the proposed policy-based loan for the first subprogram of the Second Investment Climate Improvement Program.

Yours sincerely,

Temir Sariev
Prime Minister
of the Kyrgyz Republic

POLICY MATRIX

Outputs	Subprogram 1 Policy Actions (Completion by June 2015)	Subprogram 2 Stand-by Indicative Actions (Completion by October 2017)	Subprogram 3 Indicative Actions (Completion by October 2018)
Output 1: Financial deepening and access to finance increased			
1.1. Support the structured development of electronic payments and mobile financial services	1.1.1 The Government to establish an enabling legal environment for MFS by approving the Payments System Law.	To enable use of innovative technologies, including MFS, the NBKR to implement priority recommendations from the assessment of the technical and organizational capacities of the national payment system operator (Interbank Processing Center).	NBKR to increase the efficiency of the payment system by: (i) [Requiring the banking sector to move from deferred to real time net settlement]; (ii) Broadening the participation in the retail clearing system; and (iii) Increasing transaction switching, access points' infrastructure and incentive systems for agents and public.
		NBKR to approve and implement the regulations for e-money, operators of payment systems and the remote delivery of financial services to ensure structured launch of MFS and thereby help deepen access to finance and extending financial inclusion to the otherwise unbanked, such as the rural population, the poor, women and those in the informal sector.	
	1.1.2 NBKR to approve a strategic plan for the development of the payment system with respect to retail market development, regulatory framework and oversight.	NBKR, in partnership with the financial services industry, to execute a rolling communications plan to increase uptake of electronic payments through: a) consumer financial literacy; b) industry education on electronic payments.	NBKR to review progress in implementation of payment system development strategic plan.
1.2. Reduce the costs and risks of lending to SMEs	1.2.1 MOE to approve concept paper (i) including business case, for a risk sharing facility to support SMEs, including women owned and managed SMEs, with potential for growth[a] in line with the national EDP; and (ii) for a commodities exchange.	Government to issue Decree approving design and funding arrangements for women SME risk sharing facility (including possible partial capitalization from the JFPR Women Entrepreneurship Development Project) to enable the Women SME Risk Sharing Facility to start operations.	Government to carry out performance review of the women SME risk sharing ability. If satisfactory, Government to approve measures to scale-up operations.
		Based on market analysis, Government to approve the establishment of a commodities exchange.	Government to (i) assess and adopt legal and regulatory amendments, and (ii) approve detailed

Outputs	Subprogram 1 Policy Actions (Completion by June 2015)	Subprogram 2 Stand-by Indicative Actions (Completion by October 2017)	Subprogram 3 Indicative Actions (Completion by October 2018)
			implementation plan with clear milestones and responsibility chart to operationalize the commodities exchange.
1.3. Strengthen prudential supervision and conditions for financial sector deepening	1.3.1 NBKR to strengthen risk-based supervision for the microfinance sector by approving an internal document through NBKR management on the roles, responsibilities and coordination mechanisms for on-site and off-site supervision of the sector.	NBKR to implement: (i) a training program for risk-based supervision of the microfinance sector, including AML/CFT issues. (ii) the risk-based supervision approach as reflected in the on-site inspection plan, developed with inputs from off-site supervision department. NBKR to undertake an assessment of the market for deposits and existing constraints to microfinance organizations' (MFOs) transformation into deposit taking MFOs.	NBKR to have at least 10 qualified staff on risk-based supervision between on-site and off-site departments. NBKR to implement the amendments to the Law on Microfinance, if warranted by the assessment, to enable qualified MFOs to transform into deposit taking MFOs with appropriate prudential requirements.
		NBKR to complete an assessment of the market for Islamic banking and finance in the Kyrgyz Republic, including identifying key regulatory changes required. NBKR, in partnership with Gozfinandzor (State Service for Financial Market Supervision and Regulation) and the financial services industry represented at least by the Association of Banks and the Association for Microfinance Institutions, to: (i) adopt a national program for promoting consumer financial literacy, including raising awareness of Islamic finance and Islamic financial products; and (ii) execute a rolling communication plan to implement (i).	NBKR to approve necessary measures and key regulatory amendments, for the sustainable development of Islamic banking and finance based on the assessment in SP2.
Output 2: Comprehensive public-private partnerships program fostered			
2.1 Strengthen policy, institutional and legal framework	2.1.1 MOE to complete inter-ministerial review and submit for Government approval, the PPP development program, including a capacity building	Government to implement PPP Development program and capacity building program.	Government to build capacity of PPP staff in key ministries and or agencies (increased in line with the growing PPP project pipeline and ensuring at least 35% of staff are female); and provide appropriate training including gender

Outputs	Subprogram 1 Policy Actions (Completion by June 2015)	Subprogram 2 Stand-by Indicative Actions (Completion by October 2017)	Subprogram 3 Indicative Actions (Completion by October 2018)
	program, for the period 2015–2020 (with at least 20% women participation).		sensitivity training and orientation as feasible.
	2.1.2 MOH to develop a draft health sector strategy that includes PPP and multi-year investment plan, and includes at least one gender and social development project that directly benefits the poor, youth, and women.	Sector strategies that include PPP and multi-year investment plan approved for the health and roads sectors, and at least [1] prospective PPP project from each sector completes prefeasibility/ feasibility study with PDSF support.	Bishkek CDA to approve city development strategy that includes PPP and multi-year investment plan and at least [2] prospective PPP projects complete prefeasibility/ feasibility study with PDSF support.
	2.1.3 To further strengthen the PPP legal and regulatory framework, Government to submit for approval amendments to the PPP Law and its regulations.	Amendments to the PPP Law and its regulations adopted.	
	2.1.4 MOE to operationalize a (i) comprehensive PPP website; and (ii) PPP communication plan, to disseminate information and raise public and private sector awareness about PPPs for infrastructure and social projects that directly benefit the poor or women.[b]	To facilitate exchange of international good practice in PPP development MOE to sign and establish twinning agreement with a PPP Unit in another developing country with extensive PPP experience.	
2.2 Strengthen Public Financial Management of PPPs	2.2.1 To ensure appropriate and transparent budgeting of fiscal costs of PPP projects and minimizing of fiscal risks, MOF to approve fiscal risk guidelines for PPPs (including guidance on contingent liabilities).	To ensure budget transparency of PPPs, Government to reflect in budget documents information on guarantees and or other form/s of financial support. To limit total annual government payment/ financial support for PPP project(s), Government to approve regulation to limit government payments to less than [percentage to be assessed during SP2] of total government expenditure (based on a relevant and carefully assessed benchmark).	MOE/MOF to incorporate in the budget in accordance with international accounting standards, contingent liabilities arising from any PPP project contract signed.
2.3 Operationalize the Project	2.3.1 Relevant government bodies to:	Government to tender PDSF supported pre-feasibility/ feasibility study/transaction	Government to sign contract for a competitively bid project.

Outputs	Subprogram 1 Policy Actions (Completion by June 2015)	Subprogram 2 Stand-by Indicative Actions (Completion by October 2017)	Subprogram 3 Indicative Actions (Completion by October 2018)
Development Support Facility (PDSF) to develop pipeline of PPP projects	(i) tender a PDSF financed pre-feasibility or feasibility study for at least [1] PPP project, preferably a social sector project; and (ii) submit for approval by PDSF Committee, at least [2] projects for pre-feasibility or feasibility study financing from the PDSF (in addition to the CT scan project).	advisory for at least [3] new projects, including at least one social sector project. Government to broaden the mandate of the PDSF steering committee to strengthen governance and coordination of PPP reforms.	
2.4 Establish needed government financial support mechanisms	2.4.1 To support commercial viability of PPP projects and enable availability of long-term financing for PPP projects, MOF to prepare and review the proposals of possible financial support schemes (such as a long-term debt facility, viability gap fund and guarantee mechanisms).	Government to review and agree on the appropriate financial support mechanism (s) based on the analysis and recommendations from the proposals prepared.	Government [to review the possibility of] budget allocation or any other financing arrangement to operationalize the agreed support mechanism(s).
Output 3: Trade and investment diversification facilitated			
3.1 Strengthen the policy and institutional framework for trade	3.1.1 Prime Minister's Office to approve the revised national EDP. 3.1.2 MOE to prepare a draft project proposal, including organizational chart, operational plan and budget, to establish a Eurasian Economic Union (EEU) Help Desk.	Government to implement the EDP through specific actions under four key areas of the Program i.e., trade information and promotion (including operationalizing the EEU Help Desk, and website), access to finance, national quality infrastructure and trade facilitation.	
	3.1.3 To comply with product quality requirements for the EEU and export markets such as the EU, MOE to prepare and publish on its website, a draft concept paper on the modernization of national	Government to approve Concept Paper and develop a strategy for modernization of national quality infrastructure.	Government to implement the strategy on modernization of national quality infrastructure.

Outputs	Subprogram 1 Policy Actions (Completion by June 2015)	Subprogram 2 Stand-by Indicative Actions (Completion by October 2017)	Subprogram 3 Indicative Actions (Completion by October 2018)
	quality Infrastructure, incorporating ADB findings on the existing physical infrastructure and institutional capacity to implement sanitary and phytosanitary standards.		
	3.1.4 To avail of the EU Generalized System of Preferences Plus (GSP+) status (granting preferential or zero tariffs for nearly 7000 export products) MOE to submit application to EU.	MOE to identify at least [15] priority export sector oriented women SMEs (majority owned, managed or women employees) which can be linked to the Women SME risk sharing facility which will become operational under 2.2.1, subprogram 2.	Government to form an inter-ministerial committee together with exporter associations to analyze and implement the technical requirements of GSP+.
		To access new markets, expand trade, and attract direct foreign investment, government to implement WTO commitments such as the Trade Facilitation and Sanitary and Phyto-Sanitary Agreements, World Customs Organization initiatives such as the Revised Kyoto Convention, and estimate the compensation becoming due towards WTO members in the light of EEU accession.	MOE to commence negotiations with individual WTO member countries on tariff changes and /or compensation and implement the agreements reached.
3.2 Operationalize and strengthen the institutional framework for investment promotion	3.2.1 IPA of MOE to implement its 2015–17 strategic plan, covering: (i) staffing with at least 30% women technical staff; (ii) operationalization of the website in Russian and English (providing information at least on investment laws and incentives, on the economy, and taxation and company registration); (iii) operationalization of the customer relationship management system to manage the information flow with potential investors.	MOE to prepare a report, analyzing and recommending policy and institutional reforms to increase trade and foreign direct investment, based on: (i) feedback from current and potential foreign investors on impediments to foreign direct investment; and (ii) experiences of other similar (size, consumer base) economies in merging export and investment promotion into one unit.	MOE to implement recommendations of the report, as warranted.

Outputs	Subprogram 1 Policy Actions (Completion by June 2015)	Subprogram 2 Stand-by Indicative Actions (Completion by October 2017)	Subprogram 3 Indicative Actions (Completion by October 2018)
	3.2.2 Government to establish, with an action and budget plan, an interagency working committee, (having at least 1 senior level woman representative) headed by the Center for Judicial Representation and including MOF, MFA, MOJ, MOE and other relevant government agencies, as the first step towards creating an institutional platform for resolution of investment grievances.	Working Committee to establish and implement an investor grievance redress mechanism.	At least [2] investment related disputes reviewed by the grievance redress mechanism and recommendations made.
3.3 Sovereign Rating to encourage financial market development and international capital flows	3.3.1 MOE to sign a contract with one of the three international credit rating agencies (S&P, Moody's or Fitch) to start the sovereign rating process.	The government to make annual budget allocation or other financial arrangements from 2016 onwards to ensure regular review of the sovereign credit rating and implement reforms warranted by the review to improve the rating.	
3.4 Support the development of market-based skills for SMEs	3.4.1 To ensure matching of skills and vocational training to the needs of local exporters as well as foreign investors, MOE to: (i) designate the IPA as its representative on the National Skills Development Council of the AVE; and (ii) sign an MOU with AVE to collaborate on the identification of market-relevant skills and the development of market-responsive vocational skills training and curriculum, including vocational skills aimed at attracting more women into traditional male occupations.[c]	To ensure that skills development curriculum and training are aligned with domestic industry or export oriented-companies as well as potential foreign investors, AVE to prepare a report on the gaps between the IPA-identified skills requirements and AVE's current curriculum and training. Internships provided for professional school students (at least 25% of whom are women) from by at least two (2) domestic or export oriented companies.	Internships provided for professional school students (at least 40% of whom are women) by at least five (5) domestic or export oriented companies. To ensure appropriate policy interventions for market-based skills development for existing as well as potential sectors, AVE to prepare a draft concept paper on the roadmap for developing the skills for a knowledge-based economy.

Outputs	Subprogram 1 Policy Actions (Completion by June 2015)	Subprogram 2 Stand-by Indicative Actions (Completion by October 2017)	Subprogram 3 Indicative Actions (Completion by October 2018)
Output 4: Increased transparency and efficiency of doing business			
4.1 Improve the transparency and efficiency of public procurement	4.1.1 To increase competition, transparency and efficiency in public procurement, at least 20 state and municipal bodies start using the e-procurement system.	MOF to submit a draft resolution to the Government on funding support to ensure continuation or sustainability of the e-procurement system (after ADB technical assistance completion). Government to approve resolution mandating all public procurement agencies use e-procurement software system as shared infrastructure.	Government to mainstream e-procurement in at least 70% of all central government agencies, with adequate budget or other appropriate funding arrangements.
4.2 Reduce costs of tax compliance	4.2.1 To reduce tax filing/ payment frequency for SMEs from monthly to quarterly, thereby reducing transaction costs, Government to approve the draft law on amendments to the Tax Code.	Government to streamline taxation systems and procedures for businesses in line with the State Tax Service Development Strategy (2015-2017) and assessment of the current tax administration system.	

ADB = Asian Development Bank, AVE = Agency for Vocational Education, CDA = Bishkek City Development Agency, EDP = Export Development Program, EEU = Eurasian Economic Union, EU = European Union, IPA = Investment Promotion Agency, JFPR = Japan Fund for Poverty Reduction, MFA = Ministry of Foreign Affairs, MFS = mobile financial services, MOE = Ministry of Economy, MOF = Ministry of Finance, MOH = Ministry of Health, MOJ = Ministry of Justice, NBKR = National Bank of the Kyrgyz Republic, SME = small and medium-sized enterprise, PDSF = project development support facility, PPP = public-private partnership, WTO = World Trade Organization.

[a] Providing support to *growth-oriented women SMEs* focuses support to women micro-entrepreneurs (who currently make up 70% of all micro-entrepreneurs) to who have the potential to graduate to small or medium entrepreneurs. This will help address the issue of the “missing middle” – for micro-enterprises ready to graduate to SMEs, as well as to existing SMEs who would like to expand, but have limited access to finance and relevant financial services.

[b] Examples of *social projects that directly benefit the poor* are health projects that reduce maternal and child mortality, social protection projects, urban infrastructure projects (roads, transport, parking) that impact women’s safety, or education projects that improve girls’ access to non-traditional occupations.

[c] This includes an assessment of the gap between existing training and curricula and current and future skills requirements of the domestic market; (ii) an analysis of how men and women are tracked into ‘gender-appropriate’ occupations; and (iii) identify, recommend, approve, and implement policy and program actions that will encourage girls to enroll in non-traditional occupations, including through public awareness and communication plans.