



Report and Recommendation of the President to the Board of Directors

Project Number: 41544-089
July 2016

Proposed Policy-Based Loan and Grant for Subprogram 2 Kyrgyz Republic: Second Investment Climate Improvement Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 7 July 2016)

Currency unit	–	som (Som)
Som1.00	=	\$0.014
\$1.00	=	Som70.64

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
EBRD	–	European Bank for Reconstruction and Development
EDP	–	Export Development Program
EEU	–	Eurasian Economic Union
EU	–	European Union
FDI	–	foreign direct investment
GDP	–	gross domestic product
GSP+	–	Generalised System of Preferences Plus
ICIP	–	Investment Climate Improvement Program
IMF	–	International Monetary Fund
IPA	–	Investment Promotion Agency
MOE	–	Ministry of Economy
MOF	–	Ministry of Finance
NQI	–	national quality infrastructure
PDSF	–	Project Development Support Facility
PPP	–	public–private partnership
SMEs	–	small and medium-sized enterprises
TVET	–	technical and vocational education and training

NOTE

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

Vice-President	W. Zhang, Operations 1
Director General	S. O'Sullivan, Central and West Asia Department (CWRD)
Director	R. Hartel, Public Management, Financial Sector, and Trade Division, CWRD
Team leader	P. Sood, Senior Financial Sector Specialist, CWRD
Team members	R. Aquino, Operations Analyst, CWRD M. Eshenaliev, Senior Project Officer, CWRD L. Nazarbekova, Principal Counsel, Office of the General Counsel D.C. Song, Senior Financial Sector Specialist, CWRD M. Sual, Operations Assistant, CWRD G. Tentieva, Senior Economics Officer, CWRD
Peer reviewers	T. Lewis, Principal Public–Private Partnership Specialist, Office of Public–Private Partnership J. Procak, Regional Cooperation Specialist, East Asia Department

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 41544-089	
Project Name	Second Investment Climate Improvement Program, Subprogram 2	Department /Division	CWRD/CWPF
Country Borrower	Kyrgyz Republic Ministry of Finance	Executing Agency	Ministry of Economy
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Finance sector development		3.00
	Inclusive finance		3.00
	Small and medium enterprise finance and leasing		6.00
Education	Technical and vocational education and training		2.00
Industry and trade	Small and medium enterprise development		2.00
	Trade and services		3.00
Public sector management	Public expenditure and fiscal management		6.00
		Total	25.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	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:	Low		
7. Safeguard Categorization	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		25.00	
Sovereign Programmatic Approach Policy-Based Lending (Loan): Asian Development Fund		12.50	
Sovereign Project grant: Asian Development Fund		12.50	
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		25.00	
9. Effective Development Cooperation			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan and grant to the Kyrgyz Republic for subprogram 2 of the Second Investment Climate Improvement Program.¹ The program aims to improve the private sector investment climate in the Kyrgyz Republic.² It supports increasing access to finance, enabling private participation in infrastructure, diversifying export products and markets, encouraging diversified foreign direct investment (FDI), improving skills to match market needs, increasing transparency in government, and reducing the cost of doing business.

II. THE PROGRAM

A. Rationale

2. Growth in the Kyrgyz economy slowed from 4.0% in 2014 to 3.5% in 2015 because of negative spillovers from the recession in the Russian Federation and a sharp economic slowdown in Kazakhstan.³ Growth in industry slowed from 5.7% in 2014 to 1.4% in 2015 as gold production and construction halved, while textiles and electricity output also fell. Private consumption remained stable at 94.7% of gross domestic product (GDP), compared with 95.0% in 2014, and capital investment declined from 32.5% of GDP in 2014 to 27.8% in 2015 because of lower remittances and currency depreciation. With GDP growth expected to contract by 1.2% in the Russian Federation⁴ and 2.0% in Kazakhstan⁵ in 2016, growth in the Kyrgyz economy is projected to slow to 1.0% in 2016. The challenging external environment and fiscal and social pressures pose significant downside risks. Accession to the Eurasian Economic Union (EEU) in 2015 also brings risks to the country's competitiveness in trading with non-EEU countries.⁶

3. The Kyrgyz economy depends heavily on natural resource exploitation⁷ and migration-led remittances. Recognizing the importance of diversifying the economy, the government identified the promotion of the private sector as a key priority under its National Sustainable Development Strategy, 2013–2017.⁸ The strategy aims to (i) improve the environment for domestic and foreign investment to increase domestic productivity, (ii) increase transparency and efficiency of the public sector, and (iii) create higher-value jobs for the country's workforce.

¹ The design and monitoring framework is in Appendix 1.

² The proposed subprogram 2 is included in ADB. 2015. *Country Operations Business Plan: Kyrgyz Republic, 2016–2018*. Manila. Subprogram 1 of the Second Investment Climate Improvement Program was approved in June 2015 (ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Grant for Subprogram 1 to the Kyrgyz Republic for the Second Investment Climate Improvement Program*. Manila).

³ The Kyrgyz Republic has significant exposure to the Russian Federation and Kazakhstan through trade, remittances, and investment channels. Remittances contracted 25% in 2015 but still accounted for about 26% of Kyrgyz's gross domestic product (GDP).

⁴ World Bank. 2016. *Russia Monthly Economic Developments (May 2016)* <http://pubdocs.worldbank.org/pubdocs/publicdoc/2016/5/323581462993696688/Russia-Monthly-Economic-Developments-May-2016-eng.pdf>

⁵ The Economist Intelligence Unit. *Kazakhstan*. <http://country.eiu.com/kazakhstan>

⁶ The EEU is an economic bloc comprising a market of 170 million people in Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, and the Russian Federation. While EEU membership may increase trade in goods and services, facilitate more efficient labor and capital flows, and reduce nontariff barriers, the required tariff increase to the level of the EEU common external tariff may deter trade with non-EEU countries.

⁷ For example, gold constitutes about 48% of exports. The Kumtor Gold Company alone accounted for about 7.1% of GDP in 2015.

⁸ Government of the Kyrgyz Republic, 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.

4. Since 2008, the Asian Development Bank (ADB) has been working with the government to improve the investment climate and supporting private sector development.⁹ Additional support is needed to (i) expand access to financial services, (ii) improve physical infrastructure and services, (iii) align workforce skills with market needs, and (iv) reduce corruption and the cost of doing business.¹⁰

5. **Inadequate access to financial services.** Banks dominate the Kyrgyz financial system, representing 87.4% of finance sector assets. While the depth of the financial system¹¹ has improved—the share of loans to GDP rose from 12.4% in 2011 to 27.1% on 30 June 2015—it remains shallow compared with regional peers.¹² The access of small and medium-sized enterprises (SMEs) to suitable products and services is constrained by high bank lending interest rates (18.6% as of December 2015) and excessive collateral requirements (150%–200% of the loan amount). This results in banking services being concentrated on larger companies. Without adequate payment infrastructure (including mobile banking), especially in rural areas, the economy remains heavily cash-based. Despite improvements, cash still is used in 40% of transactions. The financial intermediation of banks can be increased significantly. Most financial flows, including remittances, can be routed through the banking system, thereby increasing funding opportunities for the private economy. Improving lending processes (focusing on cash flows rather than collateral), strengthening payment systems, and improving financial literacy can help broaden private access to finance. Mobile financial services, backed by a sound regulatory framework for an e-economy, can lower the cost of financial intermediation and offer opportunities to expand the outreach to (i) new customers, especially those in rural areas; and (ii) women and marginalized groups to engage in productive economic activities.¹³

6. **High infrastructure and service needs.** Continuing budget deficits have constrained the government's ability to invest in critical infrastructure necessary for private sector activity. Investments and technical competencies are needed to provide better economic and social infrastructure and services (including for trade diversification). A sound policy and regulatory framework, dedicated financing for infrastructure project preparation advisory services and structuring, and improved knowledge and technical capacity of key government ministries and agencies will help prepare bankable projects and facilitate public–private partnership (PPP) transactions that benefit from the expertise and incentives of private entities. To build an effective PPP program, the government needs to improve its ability to plan, regulate, execute, and oversee PPP investments. It also must increase private investor confidence through well-designed contracts, properly allocating risk and reward incentives for investors and executing demonstration projects.¹⁴ Given the early stage of PPP market development in the country and the absence of long-term finance, government support through risk participation, debt, and guarantee instruments is likely required to ensure the viability and affordability of PPP projects.

⁹ ADB. Kyrgyz Republic: Investment Climate Improvement Program (Subprogram 1). <http://www.adb.org/projects/41544-022/main#project-documents>; and footnote 2.

¹⁰ Sector Assessment (Summary) (accessible from the list of linked documents in Appendix 2).

¹¹ Financial system depth means the increased provision of financial services for the economy.

¹² National Bank of the Kyrgyz Republic. 2015. *The Financial Sector Stability Assessment Report, May 2015*. Bishkek.

¹³ ADB. 2015. *Aid for Trade in Asia and the Pacific: Thinking Forward About Trade Costs and the Digital Economy*. Manila.

¹⁴ ADB. 2014. *Technical Assistance to the Kyrgyz Republic for Strengthening the Enabling Environment for Public–Private Partnerships*. Manila (TA 8688-KGZ). Achievements include the PPP law and regulations assigning roles for the Ministry of Economy (coordination), Ministry of Finance (risk management), and line ministries (project initiation and development); and the establishment of the Project Development Support Facility for project preparation advisory and structuring. The TA supports output 2 of the second program.

Experience in countries with well-developed PPP markets indicates that at least 5 years are required to reach contract awards for the first PPP projects.

7. **Trade and investment diversification.** Although the government's trade and FDI¹⁵ policies support market openness, as shown by the improvement in the trade-to-GDP ratio from 95% (2005) to 133% (2015), the Kyrgyz Republic exports mainly gold and other minerals, textiles, and agriculture products. Kazakhstan, the Russian Federation, Switzerland, the United Arab Emirates, and Uzbekistan absorbed more than 80% of the value of these exports in 2014.¹⁶ In addition, EEU accession has increased the country's exposure to this economically volatile region, making trade diversification necessary. FDI is focused on a few capital-intensive investments in mining and energy, with minimal technology and skills transfer or links with the local economy.¹⁷ A transparent investor grievance and dispute resolution mechanism will provide out-of-court settlement of investment disputes and avoid protracted and costly litigation and renegotiation of contracts.¹⁸

8. **Industry–labor market skills mismatch.** The curricula of the technical and vocational education and training (TVET) systems need to be recalibrated to meet the needs of private enterprises. While industry sector skills councils have been established, private company representation is missing. As a result, TVET offerings are essentially driven by student demand, rather than by potential employer requirements. The Kyrgyz International Business Council has singled out the lack of qualified workers as a key hurdle to attracting foreign investment. Equipping the labor force with skills demanded by the private sector will help increase the growth and productivity of the economy, enhance opportunities for investments in human capital, and reduce income inequality.

9. **Weak governance and high cost of doing business.** Corruption remains a key obstacle for doing business. Regulatory and legal reforms are needed to ease the barriers to formalizing businesses, reduce arbitrary discretion of officials, and improve accountability of licensing and inspection bodies. E-procurement in the public sector will help limit discretion (reducing the likelihood of petty corruption) and enhance transparency, accountability, and efficiency in service delivery. It will also create business opportunities for the private provision of public services. Simplifying regulations and reducing compliance costs, including taxes, will give unregistered firms incentives to register and pay taxes.

10. While investment and funding from the People's Republic of China and the Russian Federation will continue, systematic reforms are essential to increase the value addition of formal SMEs in the economy, create jobs, and reduce the Kyrgyz economy's dependence on extractive industries and remittance-backed private consumption.¹⁹

¹⁵ United Nations Conference on Trade and Development. 2016. *Investment Policy Review: Kyrgyzstan*. Geneva.

¹⁶ Gold accounts for more than 40% of the total value of exports of gold and other minerals, textiles, and agriculture products. Central Asia and the Russian Federation absorb about 80% of non-gold exports.

¹⁷ In 2014, FDI was concentrated on exploration, mining, and manufacturing (79%), mainly from Canada, the Russian Federation, and the United Kingdom.

¹⁸ The operating contract of the Kumtor gold mine is being renegotiated.

¹⁹ SMEs in the Kyrgyz Republic are defined in terms of employees, turnover, and sector. In agriculture, hunting and forestry, fishing, fish farming, mining, processing, construction, and production and distribution of electricity, gas, and water, small enterprises have 16–50 employees and annual turnover of Som150,000–Som500,000, while medium-sized enterprises have 51–200 employees and annual turnover of Som500,000–Som2,000,000. In trade, motor vehicle repairs, household goods and personal items, hotels and restaurants, transport and communication, finance, real estate, renting and consumer services, education, health care, and social and personal services, small enterprises have 8–15 employees and annual turnover of Som230,000–Som500,000, while medium-sized

11. **Government efforts and development coordination.** To mitigate the risks of lending to SMEs, five regional public credit guarantee funds have been set up, which had leveraged Som172 million by an aggregate capital of Som32.5 million as of 2014.²⁰ Warehouse receipts financing is being piloted, and the Law on Warehouse Receipts is being drafted. To reduce the share of cash circulating in the economy, payments through banks covered 90.5% of public sector salaries and 33.4% of pensions in 2014. Amendments to the PPP law, and improved project development and transaction advisory and government financial support, have resulted in 14 projects at different stages of preparation—with the first PPP contract award scheduled for mid-2017.²¹ In addition, the amended Law on Investment improves investor protection.

12. Some of Kyrgyz's development partners are supporting government efforts to improve the investment climate.²² The International Monetary Fund's extended credit facility, approved in April 2015, supports fiscal and debt sustainability and financial sector stability.²³ The World Bank helps improve public financial accounting, disclosure, and audit. The International Finance Corporation assists in improving the foreign investment policy and related laws, and agribusiness regulations; and provides PPP transaction advisory services. The Swiss State Secretariat for Economic Affairs is cofinancing activities of the World Bank Group. The United States Agency for International Development helps improve the competitiveness of textile, tourism, and construction sectors. The Japan International Cooperation Agency, European Bank for Reconstruction and Development (EBRD), and German development cooperation through KfW and GIZ are supporting SME and private sector development and PPPs.

13. **ADB's value addition.** The programmatic approach has enabled the government to build systematically on achievements, incorporate appropriate lessons, and steer a comprehensive reform program. ADB's continuing support and government progress made under the program have triggered more ambitious reforms. For example, the government

- (i) is gradually increasing cashless payments through the banks to (a) help reduce the size of the informal economy, (b) improve financial system depth by increasing deposits in the formal financial system, (c) provide financial services to the currently underbanked (mainly the poor and women), and (d) increase the transparency of transactions;
- (ii) developed its PPP policy, legal, institutional, and financial framework in line with international good practice, resulting in a pipeline of 14 projects, with one project expecting the contract award by mid-2017;²⁴
- (iii) acquired the Generalised System of Preferences Plus (GSP+) trade privilege from the European Union (EU) to diversify exports, which resulted in Turkish company Deniz Tekstil setting up a textiles factory near Kara-Balta to export to the EU and the EEU;²⁵
- (iv) obtained on December 2015 its first sovereign credit rating by leading rating

enterprises have 16–50 employees and annual turnover of Som500,000–Som2,000,000. The informal economy is estimated to deprive the Kyrgyz economy of revenues equivalent to 6%–13% of GDP.

²⁰ The regions are Jalal-Abad, Kant, Kara-Balta, Karakol, and Osh. The Association of Guarantee Funds of the Kyrgyz Republic, a member of the Association of the European Union Guarantee Funds, manages the funds.

²¹ Hemodialysis center and clinical laboratories.

²² Development Coordination (accessible from the list of linked documents in Appendix 2).

²³ International Monetary Fund Assessment Letter (accessible from the list of linked documents in Appendix 2).

²⁴ PPP work is closely coordinated with the International Finance Corporation, Japan International Cooperation Agency, and EBRD.

²⁵ GSP+ is a trade privilege granted by the EU to a few countries to help diversify their economies. It provides zero or highly preferential tariffs for exports of more than 7,000 products from these countries. The countries are required to ratify and implement international conventions on human and labor rights, environment, and good governance.

- agencies (B, stable from Standard & Poor's; B2, stable from Moody's Investors Service) to provide a basis for investors and lenders to price country risks and to open opportunities to diversify its funding sources; and
- (v) began matching TVET curricula to market demand.²⁶

14. The key lesson from the first program²⁷ and subprogram 1 of the second program (footnote 2) is that results-based, activity-oriented policy actions and sustained engagement with the government yield good results. This lesson has been incorporated into subprogram 2.

15. **Alignment with ADB's strategy.** The program and its subprograms are aligned with the development priorities in the country partnership strategy, 2013–2017²⁸ and the Midterm Review of Strategy 2020,²⁹ and are included in the country operations business plan, 2016–2018 (footnote 2). Private sector development through investment climate improvement is a priority under the country partnership strategy.

B. Impact and Outcome

16. The impact of subprogram 2 will be increased private sector investment in the economy. The outcome will be an improved business and investment climate in the Kyrgyz Republic.

C. Outputs

17. The second program comprises three subprograms to support reforms under four outputs (paras. 18–24). All policy actions completed under subprogram 1 remain intact, and the 21 subprogram 2 policy actions have advanced the progress made under subprogram 1. Subprogram 2 actions were completed in June 2016, well within schedule,³⁰ despite elections in 2015 and the formation of a new government.

18. **Output 1: Access to finance increased.** This output aims to increase access to finance by reducing the costs and risks of lending to SMEs, increasing cashless payments, and increasing the access of the underbanked (rural population, poor people, women, and those in the informal sector) to the formal financial system. Subprogram 1 (i) prepared the concept for a risk-sharing facility through a guarantee fund for SMEs, (ii) established enabling laws and regulations for electronic payments and mobile financial services, and (iii) prepared a strategic plan for retail payments including regulatory oversight.

19. Under subprogram 2, the government (i) implemented a risk management system, internet payment systems, and a dispute resolution system for the Interbank Processing Center (IPC); (ii) approved the IPC business strategy, 2016–2018 and built the requisite IPC staff capabilities; (iii) put in force regulations for e-money, payment systems operators, and remote delivery of other financial services; (iv) integrated relevant payment cards and money transfer cards;³¹ (v) launched the State Program on Financial Literacy; and (vi) approved the

²⁶ ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Grant to the Kyrgyz Republic for the Second Vocational Education and Skills Development Project*. Manila.

²⁷ ADB. 2015. *Completion Report: Investment Climate Improvement Program in the Kyrgyz Republic*. Manila.

²⁸ ADB. 2013. *Country Partnership Strategy: Kyrgyz Republic, 2013–2017*. Manila.

²⁹ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

³⁰ The amount has been increased to support the policy action on the establishment of the State Guarantee Fund, which the government has agreed to capitalize from the republican budget.

³¹ The first allows easier access to the e-wallet value stored in Elsom cards issued by the Kyrgyz Investment and Credit Bank. The second allows receipt of remittances without visiting a bank.

establishment of an SME guarantee fund with \$1 million capitalization from the budget and identified priority export-oriented SMEs that qualify for support under the national Export Development Program (EDP).³²

20. **Output 2: Public–private partnership program enhanced.** This output aims to enable private sector participation in infrastructure investments and services by providing well-structured and bankable PPPs to the market. It will gradually build operational experience through learning-by-doing on pilot projects.³³ Subprogram 1 strengthened the PPP framework by (i) drafting amendments to the PPP law; (ii) approving funding for advisory and structuring support from the Project Development Support Facility (PDSF), established in 2014 for pilot projects (footnote 14); and (iii) approving guidelines on identifying and managing PPP fiscal risks, including PPP contingent liabilities. It also developed a PPP manual, which included a model concession agreement and set out policies and procedures for PPP selection, preparation, due diligence and approval, fiscal risk identification and management, and tender proceedings. It also launched a communication plan to increase PPP public awareness.

21. Under subprogram 2, the government (i) began structured implementation of its PPP program, including recruiting and training PPP staff in key agencies; (ii) amended PDSF regulations to streamline its steering committee’s approval process for funding prefeasibility studies, feasibility studies, and/or transaction advisory of projects; (iii) established a PPP council headed by the vice prime minister to strengthen oversight of PPP implementation; (iv) undertook an interministerial review of the health and transport (road) sectors, and approved strategies and multiyear public investment plans (up to 2025), including PPPs, in those sectors; (v) approved PDSF funding for five projects and announced competitive tenders for related prefeasibility and feasibility studies; (vi) signed the feasibility study and transaction advisory contract for a CT scan project; (vii) drafted the mechanism and guidelines for long-term debt financing of PPP projects; and (viii) amended the draft budget code to include government financial support for PPP projects. The Parliament amended the PPP law.

22. **Output 3: Trade and investment diversified.** This output aims to implement the Kyrgyz Republic’s trade and investment policies, including the priorities set out in the EDP, 2015–2017 and capitalizing on the export opportunities provided by EEU membership and the GSP+ privileges (footnote 25). Since trade and investment facilitation also covers services, this output provides for the identification of and information on new markets for Kyrgyz exporters and opportunities for prospective foreign investors, including addressing investors’ grievances and developing workers’ skills in line with market demand. Subprogram 1 helped the country (i) apply for GSP+ status and prepare for its first sovereign credit rating, (ii) implement the strategy of the Investment Promotion Agency (IPA), (iii) draft a strategy for modernizing the national quality infrastructure (NQI) for trade in line with international requirements, and (iv) establish industry–TVET coordination for skills development.

23. Under subprogram 2, the government (i) established the EDP secretariat and implemented the strategy implementation management tool, a web-based interface to support all the functions required to effectively manage EDP implementation;³⁴ (ii) obtained GSP+ trade

³² The EDP, 2015–2017 lays out specific courses of action to develop the country’s export sector. It also takes into account the implications for the Kyrgyz Republic joining the EEU.

³³ Pilot projects are being developed in health, medico services, roads, tourism, and urban transport.

³⁴ The International Trade Centre—the joint agency of the World Trade Organization and the United Nations—is providing support. <http://www.intracen.org/itc/about/#sthash.HKp7OEqq.dpuf>

status; (iii) prepared an action plan to identify trade diversification opportunities under GSP+;³⁵ (iv) streamlined export and investment facilitation under the IPA; (v) approved the Strategy for the Modernization of NQI (incorporating EEU quality standards);³⁶ (vi) approved a resolution to establish an investor grievance redress mechanism under the IPA; (vii) compiled a database of existing and new investors grievances, and drafted the process for addressing such grievances; (viii) obtained the country's first sovereign credit rating (para. 13); and (ix) introduced industry-reviewed TVET curricula in select institutes.

24. **Output 4: Transparency and ease of doing business increased.** This output aims to increase transparency in government and reduce the regulatory and tax-related costs of doing business to give private businesses incentives to expand and formalize, including formalization of businesses in the informal sector, many of which are owned by women. Subprogram 1 supported the rollout of e-procurement in all government agencies, as well as the approval of legal amendments to reduce the tax filing frequency for SMEs. Under subprogram 2, the government (i) issued the regulation on e-procurement system maintenance, assigning responsibilities to relevant government agencies; (ii) allocated a budget for the e-procurement system effective 1 April 2016 (to ensure continuity after the completion of an ADB's technical assistance project);³⁷ (iii) increased the limit for business turnover exemption from the value-added tax; (iv) waived sales tax on exports and on all noncash payments; and (v) reduced tax compliance costs by reducing tax collection from three agencies to one, the State Tax Service.

D. Development Financing Needs

25. The overall program has three subprograms and an estimated funding requirement equivalent to \$70 million for 2015–2018. Subprogram 1 was funded by a grant of \$20 million, disbursed in 2015. Funding for subprogram 2 totals \$25 million equivalent. The government has requested (i) a loan in various currencies equivalent to SDR8,890,000, and (ii) a grant not exceeding \$12.5 million, both from ADB's Special Funds resources to help finance the program.³⁸ The loan will have a 24-year term, including a grace period of 8 years, an annual interest rate of 1.0% during the grace period and 1.5% thereafter, and such other terms and conditions set forth in the draft financing agreement. Subprogram 2 funding will be disbursed in a single tranche upon loan and grant effectiveness.

26. The size of subprogram 2 is based on the government's development financing needs, the nature of the required reforms, and the fiscal benefits and development impact. The development-related financing gap is about \$299.4 million for 2016, an increase of 31.4% from 2015.³⁹ The fiscal deficit is projected at 4.9% of GDP in 2016 and 4.1% in 2017. The gap is to be met mainly from long-term loans from foreign sources (projected at \$124.9 million) and anticipated budget support from the World Bank (\$24.0 million), ADB (\$25.0 million), International Monetary Fund (\$26.0 million), Russian Federation (\$30.0 million), and EU and other development partners (\$19.9 million). The remaining gap is expected to be met from revenues from proposed privatizations (\$42.1 million) and issuance of government bonds (\$7.5 million). ADB's subprogram 2 will help narrow the financing gap by about 8.3% in 2016. Public external debt surged from 53% of GDP in 2014 to 63% of GDP during 2015 because of the

³⁵ Priority export industries are agriculture (fruits, vegetables, meat, and dairy products), textile and apparel, tourism, construction materials, and bottled water. These industries also benefit from the zero or low tariffs of the GSP+.

³⁶ EU quality standards will be incorporated during the time frame of subprogram 3.

³⁷ ADB. 2012. *Technical Assistance to the Kyrgyz Republic for Implementing the E-Procurement System*. Manila.

³⁸ Development Policy Letter (accessible from the list of linked documents in Appendix 2).

³⁹ Government of the Kyrgyz Republic, Ministry of Finance. 2015. *Budget Law*. Bishkek.

continuing depreciation of the Som, which lost nearly 20% of its value against the dollar during 2015. It is expected to peak at 66% in 2017 before moderating to 65% in 2018. Because of the parliamentary elections in 2015, the government delayed fiscal consolidation measures to 2016 to improve debt sustainability to an acceptable level by 2018, while continuing to fund programs to reduce poverty and boost growth. Budget support is necessary to finance part of the development financing needs, covering the period from the introduction of reforms to the realization of fiscal benefits.⁴⁰

E. Implementation Arrangements

27. The Ministry of Economy (MOE) is the executing agency. The MOE, the Ministry of Finance (MOF), and the National Bank of the Kyrgyz Republic are the implementing agencies. The government can implement the reforms effectively, as demonstrated by its experience under the first program and the effective execution of policy-based programs with other development partners, including the World Bank. Two technical assistance projects support the implementation of subprogram 2.⁴¹ All policy actions under subprogram 2 were completed by the implementing agencies in June 2016; the implementing agency responsible for completing a specific policy action will be indicated in the financing agreement. Follow-up actions for subprogram 3 are being firmed up (Appendix 4). The proceeds of the policy-based loan and grant will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2015, as amended from time to time). The proceeds will be used to finance the foreign exchange cost of items, excluding items in the list of ineligible items and imports financed by other bilateral and multilateral sources.⁴² Implementation of the overall program is expected to finish by October 2018. Subprogram 1 was implemented from July 2014 to June 2015, while subprogram 2, which began implementation in July 2015, is expected to be completed in July 2016.

III. DUE DILIGENCE

A. Economic and Financial

28. The reforms supported by the program entail (i) short-term direct and indirect costs to the government to implement and monitor reforms, and (ii) fiscal benefits in the form of increased revenues from greater and diversified economic activities. Indirect costs are staff time and administrative expenses. Direct costs include the costs associated with establishing guarantee facilities and implementing pilot e-payments projects; required government funding to enable private participation in infrastructure, including NQI for trade, infrastructure project development, and advisory services; and sovereign ratings reviews. The reforms will create a bigger formal and diversified economy. Key cost savings and long-term gains from the reform program will be (i) expanded access to credit for the private sector through guarantee facilities, as well as an increase in the volume of money and payments made in the banking system; (ii) increased financial savings and efficiency gains from improved public investment planning, execution, and leveraging of finance through private sources, including PPPs; (iii) more value-added jobs through effective implementation of trade and investment policies; (iv) greater formalization of the economy by easing of registration, tax compliance, and tax administration; (v) greater investor confidence and higher investments; and (vi) improved cost efficiency from

⁴⁰ Program Impact and Justification of Policy-Based Lending (accessible from the list of linked documents in Appendix 2).

⁴¹ ADB. 2016. *Minor Change in Scope: Second Investment Climate Improvement Program—Increase in TA Amount, Change in Implementation Arrangements, and Request for Extension of Completion Date*. Manila; and footnote 14.

⁴² List of Ineligible Items (accessible from the list of linked documents in Appendix 2).

the government's expanded use of e-procurement. Higher expenditures are imperative, necessitating budget support (footnote 40).

B. Governance

29. Public financial management risks are high but manageable.⁴³ Budget processes and transparency are being improved, and links between the medium-term budget framework and the annual budget are being strengthened with multi-donor support. Central Treasury systems are being strengthened and fully automated: all regional treasury departments are connected to the central system and the expenditure segments are fully automated. The World Bank's Kyrgyz Audit and Financial Reporting Enhancement Project is supporting audit and financial reporting reforms. Under the grant project that supported the first program (2008-2014), the MOE approved contracts which overcharged for the delivery of training components. ADB is working with the Government and the MOE to mitigate risks of similar recurrences, and to recover these funds.⁴⁴ Public procurement policy has been improved with support from EBRD and the United Nations Commission on International Trade Law. Through ADB support, a modern e-procurement system is being mainstreamed across all central government agencies (footnote 37). Streamlined tax regulations, lower tax rates, and the automation of tax filing (with support under output 4) are reducing the cost of compliance and rent-seeking opportunities of tax collection officials. The Organisation for Economic Co-operation and Development is helping the government monitor the progress and efficiency in anticorruption reforms.⁴⁵ ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and MOE.

C. Poverty and Social

30. Better access to finance, diversified trade and investment, improved public infrastructure, and reduced costs of doing business will stimulate private sector activity. New enterprises and growth of and innovation in existing ones, will create more and higher value-added jobs. Improved public infrastructure and services will directly benefit the poor and vulnerable, as will the expansion of mobile and e-payments. Subprogram 2, categorized as *effective gender mainstreaming*, will address the insufficient representation of women in economic policy development and implementation, and unequal access to assets and resources. SMEs owned by women will be supported by the guarantee fund and will be provided with dedicated business development support to capitalize on the EEU and GSP+ export opportunities. Key implementing agencies under the program, including the MOE and MOF, are hiring women to ensure appropriate gender balance in key technical positions. Infrastructure PPP projects with positive poverty and gender impacts are being prioritized, and the design of infrastructure PPP projects will consider solutions that positively impact poverty and gender. The market-linked TVET programs will aim to provide 25% of the jobs and internships to women. Reducing taxes and tax compliance requirements will encourage unregistered businesses, many of which are owned by women, to enter the formal economy.

⁴³ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

⁴⁴ ADB. 2013. *Completion Report: Investment Climate Improvement Program System Support Project in the Kyrgyz Republic*. Manila. Entities involved are now sanctioned by ADB.

⁴⁵ Organisation for Economic Co-operation and Development. Anti-Corruption Network for Eastern Europe and Central Asia. Istanbul Action Plan. <http://www.oecd.org/corruption/acn/istanbulactionplan/> (accessed April 2016).

D. Safeguards

31. Program activities are confined to policy and institutional reforms. None of the activities will require involuntary resettlement or affect indigenous peoples. The program is unlikely to have adverse impacts on the environment. Safeguards categorization for environment, involuntary resettlement, and indigenous peoples are all C in accordance with ADB's Safeguard Policy Statement (2009).

E. Risks and Mitigating Measures

32. The economy faces substantial downward risks to investments, remittances, and exports because of the slowdown of its major trading partners in Central Asia. These risks are mitigated by the country's acquisition of the EU's GSP+. The MOF is developing the treasury single account system and plans to launch the pilot by December 2016. It is also in discussions with the Turkish Cooperation and Coordination Agency for a project in 2016 to develop the software for financial management information system. The MOF is also working on bringing the treasury system software in line with EEU requirements. Progress will continue to be monitored during the preparation of subprogram 3. Corruption risks are being mitigated by mainstreaming government e-procurement, reducing tax compliance burdens, and establishing an investor grievance redress mechanism. The benefits and impacts of the program are expected to outweigh the costs and mitigate risks.

IV. ASSURANCES

33. The government has assured ADB that implementation of subprogram 2 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 loan and grant documents.

V. RECOMMENDATION

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

- (i) the loan in various currencies equivalent to SDR8,890,000 to the Kyrgyz Republic for subprogram 2 of the Second Investment Climate Improvement Program, from ADB's Special Funds resources, with an interest charge at the rate of 1.0% per annum during the grace period and 1.5% per annum thereafter; for a term of 24 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft financing agreement presented to the Board; and
- (ii) the grant not exceeding \$12,500,000 to the Kyrgyz Republic from ADB's Special Funds resources for subprogram 2 of the Second Investment Climate Improvement Program, on terms and conditions that are substantially in accordance with those set forth in the draft financing agreement presented to the Board.

Takehiko Nakao
President

8 July 2016

DESIGN AND MONITORING FRAMEWORK

Impact the Program is Aligned with			
Increased private sector investment in the economy ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome Improved investment and business climate	<p>a. Domestic credit to the private sector increased to 18.0% of GDP (2015–2019) (2010–2014 baseline: 15.7%)</p> <p>b. At least one PPP project (with gender, social, and environment assessments) competitively tendered by 2018 (2014 baseline: 0)</p> <p>c. E-procurement functional in at least 90% of central government agencies by 2018 (2014 baseline: 1%)</p>	<p>a. NBKR annual report</p> <p>b. MOE (PPP unit) notification</p> <p>c. MOF notification</p>	<p>Low transparency, corruption, and perceived corruption deter investment</p> <p>Accession to the EEU may delay non-EEU related reforms</p>
Outputs 1. Access to finance increased 2. PPP program enhanced	<p>1a. IPC (i) established a risk management system, an internet payment gateway, and a dispute resolution system to improve the operations; (ii) approved the IPC business strategy 2016–2018; and (iii) executed payment and money transfer services by June 2016.</p> <p>1b. NBKR established regulations for e-money, operators of payment systems, and the remote delivery of financial services to ensure the launch of mobile financial services that will benefit the under-banked (rural population, poor people, women, and informal sector) by June 2016.</p> <p>1c. Government implemented the State Program on Financial Literacy to increase bank customer awareness of the benefits, costs, and risks of using electronic payments and financial services by June 2016.</p> <p>1d. Government approved the establishment of a state (national) guarantee fund for SMEs with at least \$1 million capital allocated by the 2016 budget, with at least 20% of the benefiting SMEs being majority owned by women by June 2016.</p> <p>2a. Government executed the PPP development program, including capacity building by June 2016.</p> <p>2b. Government recruited (or reassigned) and deployed adequately skilled staff (at least 35% of whom are women) in relevant line ministries and/or agencies to develop PPP transactions by June 2016.</p>	<p>1a–d. MOE program evidence of compliance report^b</p> <p>2a–h. MOE program evidence of compliance report</p>	<p>Political economy compulsions adversely impact the reforms agenda</p> <p>Weak public investment planning and management delay decision making at key stages of project development</p>

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
3. Trade and investment diversified	<p>2c. Government (i) amended PDSF regulations to expedite project preparatory and/or advisory funding for PPPs by the PDSF steering committee, and (ii) established a PPP council, headed by the vice prime minister by June 2016.</p> <p>2d. Government (i) approved development strategies with multiyear investment plans (up to 2025) for the health and transport (roads) sectors, and (ii) submitted at least one health sector and one transport sector PPP project for PDSF funding by June 2016.</p> <p>2e. Parliament approved amendments to the PPP law by June 2016.</p> <p>2f. Government included in the Draft Budget Code appropriate provisions for government financial support for PPPs and drafted a plan and guidelines for long-term debt financing of PPP projects by June 2016.</p> <p>2g. PDSF steering committee approved PDSF funding for at least five projects, and relevant line ministries and/or agencies published tenders by June 2016.</p> <p>2h. Ministry of Health commissioned PDSF-funded transaction advisory contract for the CT scan (health) project by June 2016.</p> <p>3a. Government established the EDP, 2015–2017 monitoring and implementation secretariat and implemented the EDP tracking system by June 2016.</p> <p>3b. Kyrgyz Republic acquired the EU GSP+ trade privilege, and the government established a working group chaired by the MOE to draft a time-bound action plan for trade expansion under GSP+ by June 2016.</p> <p>3c. Government approved the Strategy for the Modernization of National Quality Infrastructure for Trade (incorporating EEU quality standards) by June 2016.</p> <p>3d. Government mandated IPA as the single agency responsible for investment and export promotion, and adequately staffed IPA (including with female professional staff by June 2016.</p> <p>3e. Designated by government to address investor grievances and establish a grievance redress mechanism, IPA (i) established a</p>	3a–g. MOE program evidence of compliance report	Lack of effective coordination between MOE, concerned line ministries, AVE, and IPA; and resulting delays in critical decisions

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
4. Transparency and ease of doing business increased	<p>database registering all grievances, (ii) drafted a process for out-of-court settlement of investor grievances, and (iii) identified the required modifications of law and regulations to establish a grievance redress mechanism by June 2016.</p> <p>3f. MOE and MOF (i) published Standard & Poor's and Moody's sovereign credit ratings; and (ii) commissioned and budgeted for annual sovereign ratings update by internationally recognized agencies, from 2016 onward by June 2016.</p> <p>3g. AVE (i) established occupational standards for at least one skill each from the three priority occupations identified by IPA; (ii) approved, through relevant sector councils (having appropriate industry representation), those standards; and (iii) signed, through TVET schools, internship agreements, for at least 50 TVET students (25% of whom are women) by June 2016.</p> <p>4a. MOF approved the regulation on e-procurement system operation and maintenance and concluded related employment contracts and budgets by June 2016.</p> <p>4b. Government reduced the administrative burdens for small business by (i) exempting from value-added tax businesses with annual turnover of up to Som8 million, (ii) waiving sales tax on exports and on all noncash transactions, (iii) approving a simplified tax declaration form for individuals, and (iv) simplifying tax reporting for individual entrepreneurs to a single agency by June 2016.</p>	4a–b. MOE program evidence of compliance report	Resources are not made available to mainstream e-procurement in government
Key Activities with Milestones Not applicable.			
Inputs ADB: \$12.5 million equivalent (loan) and \$12.5 million (grant) for subprogram 2 from ADF.			
Assumptions for Partner Financing Not applicable.			

ADB = Asian Development Bank, ADF = Asian Development Fund, AVE = Agency for Vocational Education, EEU = Eurasian Economic Union, EU = European Union, GDP = gross domestic product, GSP+ = Generalized System of Preferences Plus, IPA = Investment Promotion Agency, IPC = Interbank Processing Center, 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, TVET = technical and vocational education and training.

^a Government of the Kyrgyz Republic, 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; and Government of the Kyrgyz Republic, Ministry of Economy. 2015. *Private Sector Development Program 2015–2017*. Bishkek.

^b Evidence submitted by MOE for tranche release of subprogram 2.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=41544-089-3>

1. Financing Agreement
2. Sector Assessment (Summary): Finance
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Country Economic Indicators
6. International Monetary Fund Assessment Letter¹
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

Supplementary Documents

10. Program Impact and Justification of Policy-Based Lending
11. Summary of Achievements under the Investment Climate Improvement Program (2008–2014)

¹ International Monetary Fund (IMF). 2016. IMF Executive Board Completes the Second Review Under the Extended Credit Facility Arrangement for the Kyrgyz Republic and Approves \$13.4 Million Disbursement. Press Release No. 16/291. 17 June. <http://www.imf.org/external/pubs/ft/scr/2016/cr16186.pdf>. According to the 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 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
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720003, Бишкек ш., Абдумомунов көч., 207

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№ 16-23985

Mr. Takehiko Nakao
President
Asian Development Bank
Manila, Philippines

Subject: Second Investment Climate Improvement Program (ICIP), Subprogram 2

Dear President 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 grew at 3.5% in 2015 reflecting a moderate decline from 4.0% in 2014 due to negative spillovers from the continued recession in the Russian Federation and Kazakhstan, where growth in 2015 contracted by 3.7% and 1.0% respectively. The Kyrgyz economy is linked very significantly to these two economies through trade, remittance, and investment flows. Growth is projected to further decline to 1.0% in 2016. The fiscal deficit is projected at 4.9% of GDP in 2016 and 4.1% in 2017. The combined impact of a large public investment program and currency depreciation (the Som lost nearly 28% of its value by December 2015 against the dollar) has raised significantly the public debt as a percentage of GDP – it has surged from 53% of GDP in 2014 to 63% of GDP during 2015. Significant further depreciation could pose risks for the otherwise well capitalized, but highly dollarized, financial sector. The economy has shown some resilience in the face of adverse regional shocks but potential growth is constrained by persistent structural challenges, particularly lagging productivity, heavy dependence on natural resource exploitation, remittances, and foreign aid.

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.

As articulated in its National Strategy on Sustainable Development (NSSD) for 2013-2017, the Government of Kyrgyz Republic, aims to build a stable society and improve people's living standards through stable economic growth, an enabling business environment, and improved rule of law. In particular, private sector led economic growth has been highlighted as the principal driver for state sovereignty and national security. To achieve these goals, the

NSSD has made improving business environment favourable for private sector development one of its top policy priorities and the national Private Sector Development Program (PSDP) was adopted by the Government on March 16, 2015. It provides a vision of the government's reform agenda for private sector development and creates a unified platform for support by development partners.

The Government of the Kyrgyz Republic attaches great importance to this issue and has taken various measures to stimulate the inflow of investments into the country and private sector development. 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.

The liberalization of investment regime and trade policy through the elimination of administrative restrictions and reducing barriers for investors, improvement of legislation and the liberalization of internal and external trade regimes were and are strategically important directions in the activity of the Government. In recent years, the Government of the Kyrgyz Republic has been able to strengthen the legal framework for the conduct of investment activities in the Kyrgyz Republic with the adoption of amendments to the investment, tax and other legislation. The Law "On investments in KR", was amended to provide protection to domestic and foreign against the risks associated with the changes in the legislation of the Kyrgyz Republic. To stimulate economic activity, progressive reforms on reduction of administrative barriers have been undertaken: the number of permits and licenses has been reduced from 500 to 98 and the number of controlling state bodies reduced from 21 to 13.

Fiscal reforms helped to create the most liberal tax regime in the region, with corporate income tax rate of 10%, income tax rate of 10%, and VAT rate of 12.

As a result of these reforms, the Kyrgyz Republic has improved its various international rankings. In addition, in 2015 to expand the range of investors, evaluate the creditworthiness of the country, improve the country's image, as well as guide further reforms, the country was assigned its first ever sovereign credit rating - B Stable from Standard & Poor's; B2 Stable from Moody's).

Despite the slowdown of the economic growth in the main partner countries, with a negative impact on the economy of the Kyrgyz Republic in 2015, a reduction in investment and exports, inflow of foreign direct investments into the Kyrgyz Republic increased by 12.6% in comparison with 2014.

The Government of the Kyrgyz Republic will continue to make every effort to ensure the sustainability of public investment policy, the implementation of distribution mechanisms and support investments in order to solve one of the most important tasks of the government - "Building a paradise for investors". We remain committed to ensuring stable economic growth that will create jobs and reduce poverty, and is powered by domestic and foreign investment.

The country has also acceded to the Eurasian Economic Union (EEU) which has diverse and significant implications for the country's economy. Long-term growth and poverty reduction prospects will depend on the Kyrgyz Republic's ability to stimulate private sector investment and development, as well as to promote exports to the newly created EEU. Joining the EEU gives Kyrgyz producers an opportunity to reach a much larger market, while creating demand to reform the investment climate in directions that will be necessary to compete on a regional or global scale. This is a long-term transition from a gold- and remittance-dependent economy

toward a competitive economy integrated into regional and global trade networks. On the one hand, this transition will require the country 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. The Kyrgyz Republic's economic policies, regulations, and the legal framework need to be adjusted to those of the EEU, and the potential economic and social costs of the accession need to be minimized. On the other hand, the economic slowdown in the EEU region, particularly Russia, is making it imperative for us to diversify exports and investments. 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 have also acquired the European Union's General System of Preference Plus (GSP+) trade 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.

In the framework of the implementation of the Second Investment Climate Improvement Program (Second ICIP), and its subprogram 2, the Government will continue to address policy and institutional barriers to private sector development, particularly for formal small and medium sized enterprises, (SMEs), by: (i) improving access to financial services, (ii) improving deteriorated physical infrastructure and services, (iii) aligning workforce skills with market needs, and (iv) reducing corruption and the cost of doing business. These cross-sectoral and systematic reforms are critical to achieve the objectives set out in the NSDS 2013-2017 and wean the economy from its dependency on extractive industries and remittances-backed private consumption.

Access to finance: Despite strong credit growth, the finance sector in the Kyrgyz Republic remains small, highly dollarized with foreign currency denominated loans and deposits exceeding 50% and concentrated on short tenors with an average weighted loan maturity of less than two years. Formal financial intermediation is limited, albeit improving. Collateral requirements for SMEs remain high. The economy is largely cash-based with a low share of noncash payments to total payments. However, NBKR's strengthened regulations for mobile financial services and payment service providers are increasing service offerings through electronic payment transactions, payment cards, ATMs and point of sale terminals. The objective of this reform is to increase access to finance by reducing the costs and risks of lending to SMEs, reducing the cash-based economy, and increasing the lending capacity of, and access of the currently un-banked to, the formal financial system. Under subprogram 1, the government (i) prepared the concept for a risk-sharing facility through a guarantee fund for SMEs; (ii) established enabling laws and regulations for electronic payments and mobile

financial services, and (iii) prepared a strategic plan for retail payments including regulatory oversight. Under Subprogram 2, the government is focusing on the structured development of electronic payments and mobile financial services, and establishing a state guarantee fund for export oriented SMEs that qualify for support under the national Export Development Program (EDP).

Public-private partnerships. 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 objective of reforms in this area is to enable private sector participation in infrastructure investments and services, particularly by bringing well-structured and bankable PPPs to the market. Under subprogram 1, the government strengthened the PPP framework by drafting amendments to the PPP law, approving guidelines on identifying and managing PPP fiscal risks, including PPP contingent liabilities, and also developed a PPP manual including a model concession agreement and setting out policies and procedures for PPP selection, preparation, due diligence and approval, fiscal risk identification and management, and tender proceedings. It also launched a communication plan to increase PPP public awareness. Overall, with sustained ADB support, we have established the legal and regulatory framework for PPPs, largely in line with international good practice, with clearly defined roles and responsibilities of the Ministry of Economy (MOE) Ministry of Finance (MOF), and line ministries and agencies. A Project Development Support Facility with a budget allocation of \$4 million up to 2016 has been operationalized for project preparation support.

Under Subprogram 2, the government is focusing on developing a pipeline of projects and start implementation of some of these projects—to build operational capacity of the government and to work as feedback mechanisms to further improve the PPP-enabling framework as well as enhance the credibility and effectiveness of our PPP program. Currently, the state authorities are preparing for the implementation of PPP projects in the field of urban infrastructure and health.

Trade and investment diversification. The generally open trade and investment policies of the country are not effectively implemented. Exports are heavily concentrated on a few markets including the Russian Federation, Kazakhstan, and the People's Republic of China (PRC) and on a few products (minerals, agriculture, and textiles). Gold accounts for nearly 48% of total exports, and the Kumtor Gold Company alone accounted for 7.1% of GDP in 2015.

The objective of the reforms in this area is to effectively implement the Kyrgyz Republic's trade and investment policies, including the priorities set out in the EDP 2015–2017, and capitalizing on the export opportunities provided by the EEU accession and the European Union's GSP+ trade privilege. Under subprogram 1, the country prepared and submitted documentation for the GSP+, undertook discussions and preparatory work for its first sovereign credit rating and implemented the Investment Promotion Agency's (IPA) strategy.

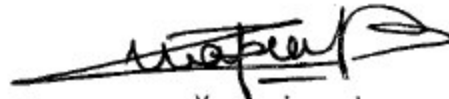
Under Subprogram 2, the government is focusing on preparing a time bound action plan to identify trade diversification opportunities under the GSP+ and the EEU, streamlining export and investment facilitation under the IPA, initiating the establishment of an investor grievance redress mechanism for out of court settlement of investment disputes, ensuring regular reviews of the that the country's sovereign credit rating, and introducing industry-reviewed TVET curricula in select institutes.

Transparency and ease of doing business increased. This objective of reforms under this area is to increase transparency in government and reduce the regulatory and tax-related

costs of doing business. Under subprogram 1, the government implemented e-procurement in all central government agencies and the approved legal amendments to reduce the tax filing frequency for SMEs. Under subprogram 2, the government is focusing on providing adequate financial and technical resources to ensure sustainability of the e-procurement system, further reducing the costs of doing business for SMEs by increasing the limit for business turnover exemption from value-added tax, waiving sales tax on exports and on all non-cash payments and streamlining tax collection under a single agency.

The Government of the Kyrgyz Given that improving a country's business and investment climate requires systematic policy and institutional reforms across sectors/areas, the government is adequate coordination among the interventions of the various development partners, to ensure appropriate synergies and more effective use of resources.

Republic would like to assure ADB that it remains firmly committed to reforms required to create a conducive environment for private sector development. The Government deeply appreciates ADB's leading role and sustained partnership to improve the Kyrgyz Republic's business and investment climate. To assist with advancing the achievements made so far, the Government looks forward to continuing 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 and grant for subprogram 2 of the Second Investment Climate Improvement Program.



Yours sincerely,

Sooronbay Jeenbekov
Prime Minister
of the Kyrgyz Republic

POLICY MATRIX

Outputs	Subprogram 1 Policy Actions (Completed June 2015)	Subprogram 2 Policy Actions (Completion by June 2016)	Subprogram 3 Indicative Actions (Completion by October 2018)
Output 1: Access to finance improved			
1.1. Support the structured development of electronic payments and mobile financial services	The government to establish an enabling legal environment for mobile financial services by approving the Payments System Law.	1.1.1 To enable use of innovative technologies including mobile financial services, National Bank of the Kyrgyz Republic (NBKR) to: (i) establish Risk Management System, Internet Payment Gateway and dispute resolution system to improve the operations of the Interbank Processing Center (IPC); (ii) approve the IPC business strategy 2016-2018; and (iii) execute payment and money transfer services.	NBKR to increase the efficiency of the payment system by: (i) broadening the participation of nonbanking institutions in the retail payment system; (ii) Implementing at least [3] pilot projects in electronic/mobile payments. (e.g., public transport mobile payments infrastructure, mobile banking/electronic money platform for IPC payment system member banks) (iii) Increasing transaction switching, access points' infrastructure, and incentive systems for agents and the public.
	NBKR to establish strategy and regulations for expanding the coverage of the payment system to retail transactions.	1.1.2 NBKR to establish regulations for e-money, operators of payment systems and the remote delivery of financial services to benefit the under banked (rural population, poor, women, and informal sector)	NBKR to review progress in implementation of payment system development strategic plan.
		1.1.3 Government to carry out the State Program on Financial Literacy to increase bank customer awareness on the benefits costs and risks on the use of electronic payments and financial services.	
1.2. Reduce the risks of lending to SMEs	MOE to approve concept for business cases for (i) 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) a commodities exchange.	1.2.1 Government to approve the establishment of a guarantee fund for SMEs with at least \$1 million capital allocated by the Republican Budget 2016, with at least 25% of the benefitting SMEs being women-owned or managed.	Government to carry out performance review of the SME guarantee fund and approve measures to implement recommendations
1.3. Strengthen prudential supervision and conditions for financial sector deepening	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 introduce Islamic finance products (based on market assessment) and develop and strengthen the legal and regulatory framework for supervision and regulation of Islamic banking and finance.

Output 2: Public–private partnership program enhanced			
2.1 Strengthen policy, institutional, and legal framework	MOE to complete interministerial review and submit for government approval, the PPP development program.	2.1.1 Government to execute the PPP Development program, including capacity building.	Government to undertake review of implementation of program and allocated necessary funding, as warranted.
		2.1.2 Government to recruit and deploy adequately skilled staff (at least 35% of whom are women) in relevant line ministries and/or agencies to develop PPP transactions.	Commensurate with the growing PPP project pipeline, government to build capacity of PPP staff in key ministries and/or agencies (with at least 45% female staff).
		2.1.3 Government to (i) amend Project Development Support Facility (PDSF) Regulations to expedite project preparatory and/or advisory funding for PPPs by the PDSF Steering Committee; and (ii) establish a PPP Council, headed by the Vice Prime Minister.	In order to ensure effective continuation of the PPP program, the PPP council to meet on a regular basis i.e. at least every 2 months.
	MOH to develop a draft health sector strategy that includes PPP and multiyear investment plan, and includes at least one gender and social development project that directly benefits the poor, youth, and women.	2.1.4 Government to: (i) approve development strategies with multiyear investment plans (up to 2025) for the health and roads sectors; and (ii) submit at least one health sector and one road sector PPP project for PDSF funding.	Bishkek CDA to approve city development strategy that includes PPP and multiyear investment plan. At least [2] prospective PPP projects each from the strategy/program for health, roads, and Bishkek City Development, complete pre-feasibility/feasibility study with PDSF support.
	Government to submit for approval amendments to the PPP Law and its regulations.	2.1.5 Parliament to approve amendments to the PPP Law.	Government to approve (amendments to) regulations to allow direct contracting of advisory services where at least 70% of the advisory services cost comes from external financing.
	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		
2.2 Establish Government Financial Support Mechanisms within Public Financial Management Framework	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).		Government to (i) manage the fiscal risk exposure on PPPs by limiting the annual budget support through appropriate legislation; and (ii) MOF to incorporate, in the budget and in accordance with international accounting standards, contingent liabilities arising from any PPP project contract signed.

	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).	2.2.1 Government to (i) include in the Draft Budget Code appropriate provisions for government financial support; and (ii) draft a plan and guidelines for long-term debt financing of PPP projects.	MOF to (i) approve a scheme and related guidelines for long-term debt financing of PPP projects, and (ii) develop appropriate legislation on limiting the annual budget support for PPPs to manage the PPP related fiscal risk exposure. Government to (i) formally establish the legal entity to facilitate long-term debt financing; and (ii) [review the possibility of] budget allocation or any other financing arrangement to operationalize the agreed support mechanism(s).
2.3 Operationalize the Project Development Support Facility to develop pipeline of PPP projects	Relevant government bodies to: (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).	2.3.1. PDSF Steering Committee to approve PDSF funding for at least 6 projects and relevant line ministries and /or agencies to publish tenders. 2.3.2 MOH to commission PDSF-funded transaction advisory contract for the Computer Tomography Scan (health) project.	Government to award contract for a competitively bid project.
Output 3: Trade and investment diversified			
3.1 Strengthen the policy and institutional framework for trade	Prime Minister's Office to approve the revised national Export Development Program (EDP). MOE to prepare a draft project proposal, including organizational chart, operational plan, and budget, to establish a Eurasian Economic Union (EEU) Help Desk.	3.1.1 Government to establish the Export Development Program (EDP) 2015-2017 monitoring and implementation secretariat and implement the EDP tracking system	Government to track progress on EDP implementation and based on SIMT reports, recommend necessary changes at the institutional level to ensure deadlines are adhered to
	To avail of the EU Generalized System of Preferences Plus (GSP+) status (granting preferential or zero tariffs for nearly 7,000 export products) MOE to submit application to EU.	3.1.2 Kyrgyz Republic to acquire the EU GSP+ trade privilege;	
	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 quality Infrastructure (NQI), incorporating ADB findings on the existing physical infrastructure and institutional capacity to implement sanitary and phytosanitary standards.	3.1.3 Government to approve the Strategy ("Concept") for Modernization of National Quality Infrastructure (NQI) for Trade (incorporating Eurasian Economic Union, EEU quality standards). 3.1.4 (i) Government to establish a working group chaired by MOE; and (ii) MOE to draft time bound action plan MOE to draft time bound action plan for trade expansion under GSP+.	For both EEU and EU government to implement the strategy on Modernization of NQI (using textile-garments as a pilot sector), by: (i) preparing a draft manual (guidance tool) for textile/garment exporters; and (ii) identifying 6 current textile/garment exporters, with at least 3 women-owned enterprises, and monitor their progress in complying with EEU and EU standards and progress in exporting to EEU, EU (establishing a set of criteria and measure improvements over a period of time)

			To access new markets, expand trade and attract FDI, (i) Government to implement WTO commitments (such as Trade Facilitation and Sanitary and Phytosanitary Agreements, World Customs Organization initiatives); and (ii) MOE to commence negotiations with individual WTO member countries on tariff changes and/or compensation and implement the agreements reached.
3.2 Strengthen the institutional framework for investment and trade promotion	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.	3.2.1 Government to mandate Investment Promotion Agency (IPA) as the single agency responsible for investment and export promotion, and adequately staff IPA (including with female professional staff).	Government to prepare a marketing and branding strategy (incorporating exports to EU) as part of an investment promotion strategy targeting Chinese, Russian, and Kazakh companies.
	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 (CJR) and including MOF, MFA, MOJ, MOE and other relevant government agencies, as the first step toward creating an institutional platform for resolution of investment grievances.	3.2.2 (i) Government to designate IPA to address investor grievances and establish a grievance redress mechanism; (ii) IPA to: -establish database registering all investor grievances; - draft process for out-of-court settlement of investor grievances; and - identify the required modifications of law and regulations.	Government to approve and implement new/revised investor grievances redress mechanism. At least [2] investment related disputes reviewed by the grievance redress mechanism and recommendations on resolution made.
3.3 Sovereign Rating to encourage financial market development and international capital flows	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.	3.3.1 Government (MOE-MOF) to: (i) publish sovereign credit ratings assigned by Standard & Poor's and Moody's; (ii) commission and budget for annual sovereign ratings update by internationally recognized agencies, from 2016 onwards.	Government and NBKR to implement reforms warranted by the periodic rating reviews Government to explore the option of floating a sovereign or corporate bond to gauge if the sovereign credit rating will allow a cheaper source of financing for short or long-term government needs
3.4 Support the development of market-based skills for SMEs	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	3.4.1 Agency for Vocational Education (AVE) to: (i) set occupational standards for at least one skill each from the three priority occupations identified by IPA; (ii) ensure relevant Sectoral Councils (with	Internships provided at domestic industry or export-oriented companies to at least 200 TVET students (25% of whom should be women). Comprehensive assessment of the (i) retention

	<p>AVE; and</p> <p>(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.</p>	<p>appropriate industry representation) approval of the standards; and</p> <p>(iii) ensure signed internship agreements (between TVET schools and private sector companies) for internships for at least 50 TVET students (25% of whom are women).</p>	<p>trends of TVET students beyond their internships; and (ii) impact of CBT in TVET institutes and the effectiveness of the mechanism for aligning skill development to the market need.</p>
Output 4: Increased ease of doing business			
4.1 Improve the transparency and efficiency of public procurement	To increase competition, transparency, and efficiency in public procurement, at least 20 states and municipal bodies start using the e-procurement system.	4.1.1 MOF to approve the Regulation on e-procurement system operation and maintenance and conclude related employment contracts and budgets.	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	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.	4.2.1 Government to reduce administrative burdens for small business by: <ul style="list-style-type: none"> (i) exempting business from value-added tax with annual turnovers up to Som8 million; (ii) waiving sales tax on exports and on all noncash transactions; (iii) approve a simplified tax declaration form for individuals; and (iv) simplify tax reporting for individual entrepreneurs, to a single agency.^a 	To bring more citizens under tax coverage, government to facilitate tax filing through the STS website using e-signature authentication (financial support from the budget or development partners).

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, GSP+ = Generalized System of Preferences (Plus), IPA = Investment Promotion Agency, MFA = Ministry of Foreign Affairs, MFS = mobile financial services, MOE = Ministry of Economy, MOF = Ministry of Finance, MOH = Ministry of Health, NBKR = National Bank of the Kyrgyz Republic, SME = small and medium-sized enterprise, PDSF = project development support facility, PPP = public-private partnership, TVET = technical and vocational education and training, WTO = World Trade Organization.

^a This action will also benefit the micro and small entrepreneurs, many of whom are women.