SECTOR ASSESSMENT (SUMMARY): MULTISECTOR

A. Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. Value-added growth of registered private companies averaged 6.6% annually from 2009 to 2012.[1] However, individual entrepreneurs and low value-added informal activities have absorbed 70% of total employment. Registered private companies have accounted for only 11% of employment, much of it in state-owned enterprises and nonprofit entities.

2. The government recognizes formal private sector development as a priority under its National Sustainable Development Strategy, 2013–2017.[2] The country's business and investment climate has improved, but policy distortions and market failures in key areas still constrain private sector growth.[3] Corruption (real and perceived) continues to be high, increasing the costs of doing business. The outreach and depth of financial services are limited because of the small formal financial sector, and an economy characterized by low domestic savings, low and inefficient financial intermediation, and a heavily cash-based economy. Workforce skills are not aligned with market needs. Public utilities, which are responsible for developing infrastructure and delivering services, continue to be inefficient. Private sector participation in infrastructure is low.

B. Finance

3. The finance sector is dominated by 24 commercial banks with total assets of approximately Som178.2 billion ($2.62 billion equivalent), representing 87.4% of financial system assets as of 31 December 2016. Two-thirds of the banks are majority owned by foreigners. The five largest banks hold about half of the total deposits and loans. The banks are concentrated in the larger cities of Bishkek and Osh, with a total of 325 bank branches nationally. Other than microfinance organizations, the development of non-bank financial institutions, such as insurance and mortgage finance companies, is at a very early stage.

4. The Kyrgyz banking sector has grown dynamically since 2013—total assets grew at an average rate of 17% per year, and the loan book increased by a total of 20%. Notwithstanding the strong credit growth, the sector remains small. The level of financial intermediation is low but improving—as of the end of December 2016, assets stood at 39% of gross domestic product (GDP), customer loans at 20%, and customer deposits at 23%. Confidence in banks remains low—most (55%) of customer deposits are demand deposits, and only 10% have a tenor of 1 year and above. Most loans are also short-term: 38% of gross loans have a tenor of 1 year or more. About one-third of the population saved money in 2014, but only 3.7% have a bank account and only 1.0% saved at a financial institution.[4] About 35.5% of the population received a loan in 2014, but only 11.3% have a loan at a financial institution. The Central Bank has proactively started to focus on de-dollarization of the banking sector, by mandating different minimum reserve requirements for deposits in local and hard currencies, a ban on consumer and mortgage lending

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[1] World Bank Group. 2015. *Kyrgyz Republic: Biannual Economic Update*. Washington, DC (fall).

[2] Government of the Kyrgyz Republic. 2013. *National Sustainable Development Strategy, 2013–2017*. Bishek; Government of the Kyrgyz Republic. 2015. *Private Sector Development Program 2015-2017.* Bishkek.

[3] ADB. 2014. *The Kyrgyz Republic: Strategic Assessment of the Economy—Promoting Inclusive Growth*. Manila.

[4] In the Kyrgyz Republic, only banks and credit unions are legally allowed to take deposits. As of the end of September 2014, deposits in credit unions represented 0.14% of total deposits. Microfinance organizations require special licenses to offer demand deposits.

in foreign currency, and stricter provisioning requirements for unhedged business loans in foreign currency. Thus, in 2016 the share of foreign currency loans dropped from 55.1% to 44.5% of banks' gross loan book, and the share of foreign currency deposits decreased from 69.9% to 53.4% of the aggregate deposit base. Because of high collateral requirements, most investment financing comes from the retained earnings of enterprises and household savings. The government securities market is small; the longest bond maturity is 7 years. Capital markets are insignificant.

5. The economy is largely cash-based, with a low share of noncash payments to total payments. However, the National Bank of the Kyrgyz Republic'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. As 31 March 2017, 25 banks had issued the "Elcard" national card, and 17 banks had issued cards offered by international card schemes, with a total of 1,692,000 cards issued. There are 1,319 ATMs with 7,383 terminals in service. As of the first quarter of 2017, the volume of payment card transactions totaled Som38,293 million, an increase of 46.1% over the first quarter of 2016. More than 6.2 million payment card transactions had been executed as of 31 March 2017, an increase of 12.2% compared with the same period in 2016. Greater access to electronic payments tends to increase the number of transactions rather than the value of each transaction, indicating improving financial services for small transactions.

C. Trade

6. Trade and investment policies are generally open but need to be implemented more effectively. In 2016, total exports were approximately $1.5 billion, up from $1.29 billion in 2015. However, exports continue to be concentrated on a few products—specifically gold and other minerals (58% of the total), textiles and agriculture[5]—and in a few markets: Kazakhstan, the People's Republic of China (PRC), the Russian Federation, Switzerland, and Turkey. Gold accounts for nearly 48.1% of total exports, and the Kumtor Gold Company alone accounted for 7.1% of GDP in 2015. The concentration presents a major risk to exporters if the economies of importing countries contract, or nontariff barriers are erected among Eurasian Economic Union (EEU) members. Opportunities for product and market diversification are increasing; for example, in January 2016 the Kyrgyz Republic achieved Generalized System of Preferences Plus (GSP+) trade status with the European Union (EU). As a result, exports to the EU (comprising beans, mushrooms, honey, dried fruits, and textiles) surged from $50 million in 2015 to $72 million in 2016.[6] Tariffs for over 6000 products have been lowered significantly, and sales are expected to increase as current and potential exporters familiarize themselves with consumer preferences and EU quality standards. Although the long-term impact on exports cannot yet be gauged, accession to the EEU resulted in a 4.3% increase in exports in 2016. Infrastructure such as laboratories and equipment to ensure that product quality meets international export standards is obsolete, as is the local knowledge to implement these standards. Trade is also impeded by inefficient customs procedures that require time-consuming paperwork to be filled in to clear goods at the border. Financial products catering to export-oriented small and medium-sized enterprises are limited.

[5] The top 10 exports, which also included agriculture and textile products, accounted for 81.9% of total exports.

[6] Armenia (also a member of the Eurasian Economic Union) and the Philippines are recent recipients of GSP+ status. Armenia's exports to the EU (around €60 million in 2014) surged in the first 6 months of 2015 to €58 million. Exports from the Philippines to the EU (approximately €584 million in 2014) increased in the first 6 months of 2015 alone to €743 million after receiving GSP+ status in late 2014.

7. The legal framework for foreign direct investment (FDI) is adequate, with the FDI Regulatory Restrictiveness Index comparable with that of the PRC, Russian Federation, and Ukraine.[7] FDI is concentrated in capital-intensive, extractive industries, particularly gold mining, with a limited number of investors. Technology, skills transfer, and links with local suppliers are limited. FDI nearly doubled from about $727 million in 2014 to about $1.5 billion in 2015. Power generation and financial services represented the bulk of FDI. FDI from non-Commonwealth of Independent States members accounted for 63.3% of FDI in 2015, with the PRC accounting for 30.2% of the total. FDI decreased by 16.6% (around $535 million) from January to September 2016. From 2014–2016 foreign investors brought lawsuits against the Kyrgyz Republic, with potential claims of $1.8 billion. At the end of 2016, the government had settled around $1.5 billion (85%) of these potential liabilities.

D. Education

8. Education is provided in state and private educational institutions. Serious challenges remain despite efforts made to improve student learning outcomes at all education levels, including: (i) insufficient funding; (ii) old or dysfunctional infrastructure; (iii) outdated teaching content; (iv) insufficient pre- and in-service teacher training quality in subject knowledge and pedagogical skills; (v) outdated or absent teaching and learning materials; (vi) lack of effective external and internal quality assurance mechanisms; and (vii) poor management of education quality at all levels. The challenges particularly concern technical and vocational education and training (TVET), which does not prepare students sufficiently for entry to the labor market. Poor cooperation between the TVET sector and industry is a major obstacle to providing adequate training in response to labor market needs. Many TVET graduates do not work in the field for which they are trained, and hold jobs for which they have no formal qualification.[8] Reform will require structural changes, including improving primary and secondary TVET governance.[9]

E. Public Sector Management

9. The budget preparation process is in line with many good international practices and capacity for proper budgeting is gradually evolving. Some medium-term budget framework principles have been introduced in budget planning. Fiscal aggregates of the main categories of revenues and spending are included but forecasting remains weak. Sector strategy documents are developed separately from the budget process, resulting in expenditures not corresponding with the strategic programs of the ministries.[10] The budget remains a 1-year annual document approved by the Parliament and the practice of frequent revisions to the budget allocations undermines its credibility. Almost all known off-budget funds, except fiscal reports of some government agencies and the energy sector, have been consolidated into the budget. Internal audit systems have improved—internal audit units have been established across the public administration and the internal audit department has been re-instated in the Ministry of Finance—but capacity is limited, both in terms of skills and staff numbers. Such reform efforts take time, suggesting long-term planning and action are needed.

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[7] The FDI Regulatory Restrictiveness Index (FDI Index) measures statutory restrictions on foreign direct investment in 62 countries, including all Organisation for Economic Co-operation and Development and G20 countries, and covers 22 sectors.

[8] European Training Foundation. 2016. *Report on Tracer Study of 2015 VET Graduates in the Kyrgyz Republic*; European Training Foundation. 2017. *Torino Process 2016–17.*

[9] Primary TVET aims to train qualified personnel; secondary TVET aims to train mid-level specialists.

[10] World Bank. 2015. *Kyrgyz Republic - Capacity Building in Public Financial Management Project.* Washington, D.C. http://documents.worldbank.org/curated/en/585291467991051088/Kyrgyz-Republic-Capacity-Building-in-Public Financial-Management-Project

10. The large informal economy results in a narrow tax base, with highly centralized fiscal system; local governments collect only property and land taxes. Tax revenues represented 20% of GDP in 2015. The revised tax code introduced in 2009 has improved tax policy and administration, reducing the tax compliance burden on businesses and encouraging their formalization. The State Tax Service is the sole agency responsible for tax reporting and collecting value-added tax on imports following EEU accession. Automation of tax and customs is improving revenue performance.

11. Access to information on government and public affairs is improving, with online publication of the budget and e-procurement. The government has launched a centralized e-procurement portal, which increased public procurement transparency. E-procurement increased competitive bidding, measured as a share of public procurement and the number of bidders per bid. Government's anticorruption actions are monitored under the Organisation for Economic Co-operation and Development's Istanbul Anti-Corruption Action Plan.

F. Government Strategy

12. The government is addressing the constraints to private sector development through the National Sustainable Development Strategy, 2013–2017 (footnote 2). The strategy aims to (i) create an environment conducive to investment, (ii) improve public sector management and administration, and (iii) enhance the employability of the workforce. The National Export Development Plan, 2015–2017 focuses on export development and diversification, including to the EEU. Proactive actions to capitalize on the EU's GSP+ trade privileges are under way. The Investment Promotion Agency is streamlining export development and investment promotion. One of the objectives of the Education Development Strategy 2012–2020 is improving the quality and relevance of the TVET system, albeit mostly with international support.[11] The policy, legal and regulatory, and institutional framework for public–private partnerships has been established and pilot projects are being prepared. The Private Sector Development Program, 2015–2017 (footnote 2) covers reforms of the investment law, simplification of trade and customs procedures, automated tax reporting, and improved public administration. Changes to regulations for e-money, payment system operators and payment organization are being actively considered to expand internet and mobile money and payment services.

G. ADB Sector Experience and Assistance Program

13. The Asian Development Bank (ADB) experience has shown that the private sector can contribute to stable economic growth by creating jobs, and products and services with greater value added. ADB's sovereign[12] and nonsovereign initiatives have helped the country address key constraints affecting private sector development by expanding access to finance, particularly to small and medium-sized enterprises and women. Assistance for public–private partnership pilot projects is gradually building government experience and private sector confidence.[13] To capitalize on the EEU accession and GSP+, trade and investment diversification is being supported.[14] ADB will also support the government's Education Development Strategy, 2012–2020 to produce more skilled and qualified workers.[15]

[11] Government of the Kyrgyz Republic. 2012. Education Development Strategy of the Kyrgyz Republic for 2012–2020. Bishkek. http://www.globalpartnership.org/fr/download/file/fid/44406

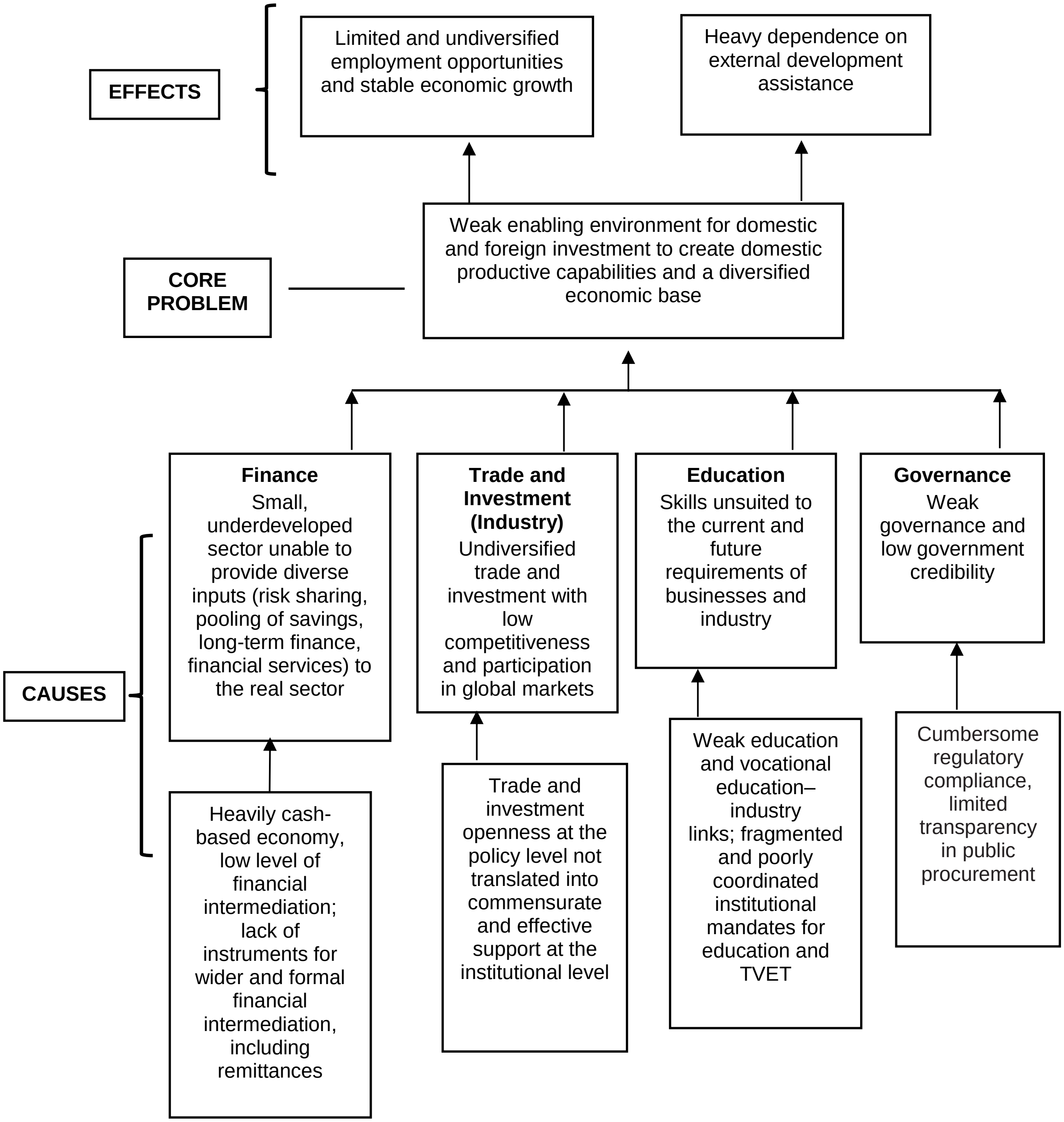
[12] ADB. 2015. *Completion Report. Kyrgyz Republic: Investment Climate Improvement Program.* Manila (Subprogram 1, Grant 0120-KGZ [SF]; Subprogram 2, Grant 0319-KGZ [SF]; and Subprogram 3, Grant 0393-KGZ [SF]).

[13] ADB. Kyrgyz Republic. Strengthening the Enabling Environment for Public–Private Partnerships.

[14] ADB. 2015. *Kyrgyz Republic: Accession to the Eurasian Economic Union—Capturing the Opportunities and Addressing the Risks.* Manila.

[15] ADB. Kyrgyz Republic. Second Vocational Education and Skills Development Project.

Problem Tree



TVET = technical and vocational education and training.