

# Kyrgyz Republic Diagnostic

By Hans Holzacker and Dana Skakova

May 2019



**European Bank**  
for Reconstruction and Development

This report was prepared by Hans Holzacker, Lead Regional Economist at the Economics, Policy and Governance (EPG) department at the EBRD and Dana Skakova, an analyst at EPG. Important contributions to the analysis were made by Svenja Peterson, Idil Bilgic-Alpaslan, Anastasia Rodina, Martin Pospisil, Federica Foadelli, Susanne Wischnath, Alper Dincer, Damin Chung, Aziza Zakhidova, Giulia Branzi. We are grateful for guidance and comments provided by Mattia Romani (Managing Director, EPG), Artur Radziwill (Director, Country Economics and Policy) and Peter Sanfey (Deputy Director, Country Economics and Policy). We are also grateful to numerous other colleagues in EPG for helpful contributions.

**Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank's strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in the country.**

**Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy.** Private sector development and entrepreneurship are at the heart of the Bank's mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

**The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are.** Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (**BEEPS**) and the Life in Transition Survey (**LITS**), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and OECD. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

**The diagnostics are led by the EBRD's Country Economics and Policy team,** drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

**The views expressed in the diagnostic papers are those of the authors only and not of the EBRD.**

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# Executive summary

This paper assesses the progress in the Kyrgyz Republic towards a well-functioning, sustainable market economy, and the challenges ahead. It provides a basis for the design of the EBRD Country Strategy for the Kyrgyz Republic and for the structure and prioritisation of ongoing and future investment activities and policy advice/advocacy in the country.

The private sector plays an important role in the Kyrgyz economy. However, private sector productivity has remained rather low, and there is substantial potential for further improving the private sector's performance. Integration into regional and global value chains is slightly higher than on average in Central Asia but below potential, due to the rather slow technology and skills transfer.

The report identifies **four key constraints** holding back private sector growth in the Kyrgyz Republic:

- Improving **governance and the business environment**, strengthening the rule of law and property rights and enhancing institutional capacity of government organisations would make the economy more well-governed;
- Enhancing **access to finance** through provision of affordable local currency lending for SMEs, and broadening the range of financing options to include risk capital and mobile banking would make the Kyrgyz economy more resilient;
- Upgrading **transport and energy infrastructure**, ensuring compliance with technical, sanitary and phytosanitary standards required for exports is needed to make the country more integrated;
- Improving **skills and qualification of the workforce** and the quality of higher education as well as vocational education and training is key to increasing labour productivity, enabling inclusive growth and increasing the competitiveness of the economy.

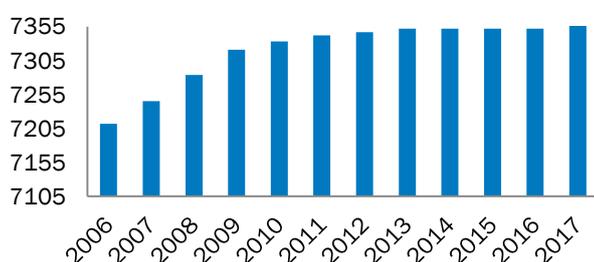
The report also presents scores for the six desirable qualities of a sustainable market economy – *competitive, well-governed, green, inclusive, resilient and integrated* – and a description of the main transition gaps, which are among the largest in EBRD countries of operations.

# 1. The Private Sector: Current Size and Structure

**The private sector plays a key role in the economy.** It generates an estimated 70-75 per cent of GDP. However, its share has remained little changed since the early 2000s, reflecting low competitiveness and stagnant productivity. Addressing the main obstacles to private sector development in the Kyrgyz Republic will be key to unleashing the sector's potential and increasing its contribution to diversification of economic growth and job creation.

**Privatisation allowed the private sector to grow rapidly since independence but privatisation efforts have slowed in the past decade.** The Kyrgyz Republic privatised a total of 7,357 state assets since independence (chart 1). Recent privatisation efforts were guided by the Program for State Property Privatization in the Kyrgyz Republic for 2015-2017, which lists companies offered for both full and partial privatisation. Among these companies are strategic ones such as Kyrgyzstan Airways and Alfa Telecom. In addition, the Concept of Reforming the State-Owned Property approved in June 2015 aims to reduce state participation in non-strategic sectors. However, there are still 135 state-owned enterprises (SOEs) in the Kyrgyz Republic, most of which operate at a loss<sup>1</sup>. Less than 10 per cent of SOEs generate most of the profit. In 2017, the net profit of all SOEs combined was around US\$ 555 million after reaching US\$ 1.7 billion in 2016.

**Chart 1: Number of privatised enterprises**

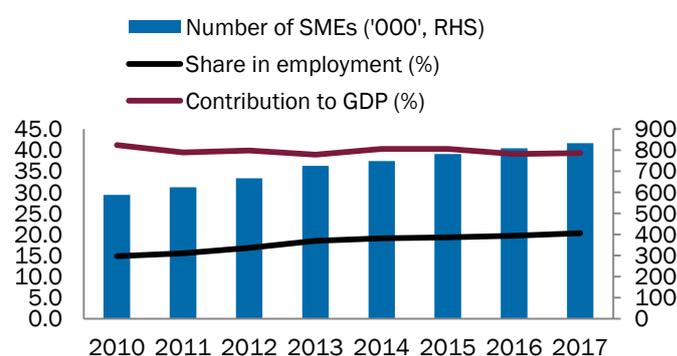


Source: National Statistics Committee of the Kyrgyz Republic.

**While there are no new plans currently to undertake large-scale privatisation, the authorities**

**are taking measures to improve the performance of SOEs.** As a first step, the State Property Management Fund under the Government of the Kyrgyz Republic, which is responsible for managing SOEs, is developing a methodology for assessing the profitability of JSCs with a government share and plans to introduce performance KPIs for SOEs.

**Chart 2: Evolution of SMEs**



Source: National Statistics Committee of the Kyrgyz Republic.

**The private sector landscape is dominated by SMEs.<sup>2</sup>** According to official statistics, SMEs contributed 39.3 per cent of GDP in 2017, and in 2013-17 their contribution was 40 per cent of GDP on average<sup>3</sup> (chart 2). This is a relatively high share compared to other countries of Central Asia. However, it is below the EBRD countries of operations' average of more than 50 per cent, a share that tends to be even higher in small economies. The highest value added comes from individual entrepreneurs at 21.2 per cent of GDP. Excluding farmers, the share of SMEs in total employment was 20.4 per cent in 2017. SMEs dominate in agriculture and service sectors, such as wholesale and retail trade, and hospitality. SMEs generated 96.7 per cent of hospitality services, 82.6 per cent of wholesale and retail trade, and 62.1 per

<sup>2</sup> SMEs include small enterprises, medium enterprises, farmers and individual entrepreneurs. Definition of small and medium enterprises is sector-dependent. Small enterprises in industry, construction and agriculture are defined as enterprises employing fewer than 50 persons, and in trade and services - fewer than 15 persons. Medium enterprises in industry, construction and agriculture are defined as enterprises employing between 51-200 persons, and in trade and services - between 16-50 persons.

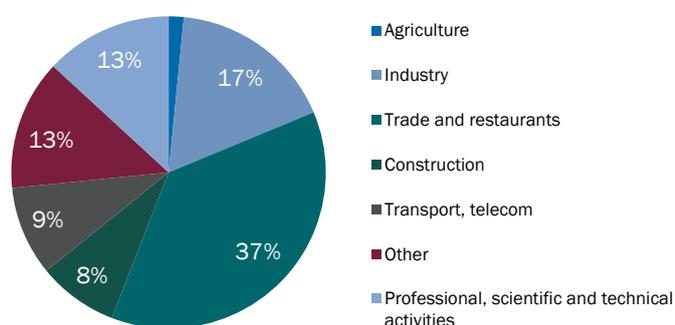
<sup>3</sup> Excluding the contribution of the Kumtor gold mine, the share of SMEs in GDP would be about 44 per cent.

<sup>1</sup> According to statistics provided by the State Property Management Fund, which include JSCs where government is a shareholder

cent of agricultural output. In contrast, SMEs are underrepresented in industry, contributing about 21 per cent of total industrial output.

**The true contribution of SMEs is underestimated in official statistics due to the presence of a sizeable informal sector**, which accounted for 23.6 per cent of GDP in 2017, according to official estimates. It is likely that the size of informal economy is even more significant. In a 2012 study supported by the World Bank<sup>4</sup>, the informal sector contribution was estimated to be around 40 per cent. Informality prevails in agriculture, construction and services. An OECD report<sup>5</sup> states that approximately two-thirds of workers operate in the informal sector, of which 80 per cent are employed in agriculture. There are various factors pushing firms/workers into the informal sector, including social security contributions (27.25 per cent of the payroll), excessive administrative hurdles, and cumbersome regulation. The presence of a large informal sector disadvantages registered firms and exposes the formal sector to unequal competition. The government, with the help of international experts, is now assessing the current share of the informal economy and developing an updated action plan.

**Chart 3: Number of enterprises with foreign participation by sector**



Source: National Statistics Committee of the Kyrgyz Republic.

**Foreign-owned companies play a substantial role in the Kyrgyz economy.** Gross value added produced by enterprises with foreign investment equalled 22 per cent of GDP in 2017. Their share in exports was 28 per cent, their share in imports 30 per cent. There were 3107 enterprises with foreign capital participation in 2017, up from 2611 in 2010. Foreign-owned companies were concentrated in trade (37 per cent of all enterprises with participation of foreign capital), followed by industry (17 per cent) and professional and scientific activities (13 per cent) (chart 3).

**There are relatively high FDI inflows in the Kyrgyz Republic.** Gross FDI inflows varied between 7 and 24 per cent of GDP during the last six years (table 1). Most of the FDI is concentrated in mining and the related professional, engineering and scientific activities. Largest foreign investor is China, followed by Russia and Canada. FDI from Kazakhstan is also significant.

**Table 1: Foreign direct investment**

	2013	2015	2018
No of enterprises	2,767	3,138	na
No of employees	59,966	59,262	na
Gross inflow of FDI, US\$ mn	964.5	1573.3	570
% of GDP	13.2	23.5	7.1
Net inflow of FDI, US\$ mn, BoP	-	1009.1	18.5*
Gross inflows by country			
China	468.3	474.4	245
Russia	69.8	515.5	123
Canada	104.8	130.3	5.1
Kazakhstan	52.3	20.8	29.5
Gross inflows by sector			
Mining	23.2	14.7	77
Manufacturing	317.7	564.7	266
Electricity, gas, water, heat	16.2	136.7	15.8
Trade	66.6	64.8	35.7
Telecom	3.2	5.7	36.7
Financial sector	99.8	411.9	52.6
Professional, scientific & technical activities	403.4	261.9	70.6

Source: National Statistics Committee of the Kyrgyz Republic

<sup>4</sup>Hasanov et al (2012) Analysis of informal economy in the Kyrgyz Republic  
<sup>5</sup>OECD/ILO (2017) How Immigrants Contribute to Kyrgyzstan's Economy, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264287303-en>

**However, FDI inflows decreased sharply in the past two years, in part reflecting investment cycles, but also in response to various obstacles.**

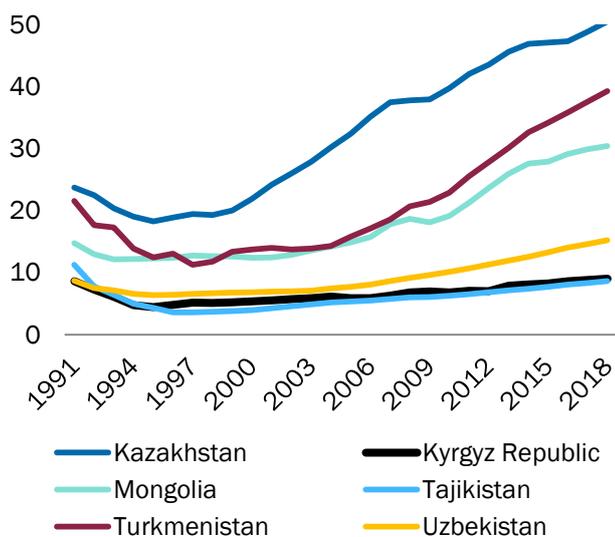
Gross FDI inflows fell to US\$ 570 million in 2018 from a peak of a peak of USD 1,573 million in 2015 (table 1). There were also significant outflows, and net FDI according to balance of payments statistics turned negative in 2017. Obstacles include business environment issues such as regulation volatility related to political perturbations, discretionary powers of tax officials, corruption and limited independence of judicial system. Issues around Kumtor gold mine operations, including ongoing disputes since 2015 over the control of the mine, led to a sharp drop in Canadian FDI in 2017. A resolution of disputes around Kumtor can likely reinstate investor confidence, and support growth of FDI. Another major constraint is the small size of the Kyrgyz market. Better integration into global and regional value chains would allow better exploitation of economies of scale and scope and thus contribute to the Kyrgyz Republic's attractiveness as an investment destination.

## 2. Performance and productivity of the Kyrgyz economy

**While the contribution of the private sector to the economy is high, the sector's productivity and competitiveness has remained weak.** Labour productivity in the Kyrgyz Republic is one of the lowest in Central Asia, and is not keeping up with productivity growth in the region (chart 4).

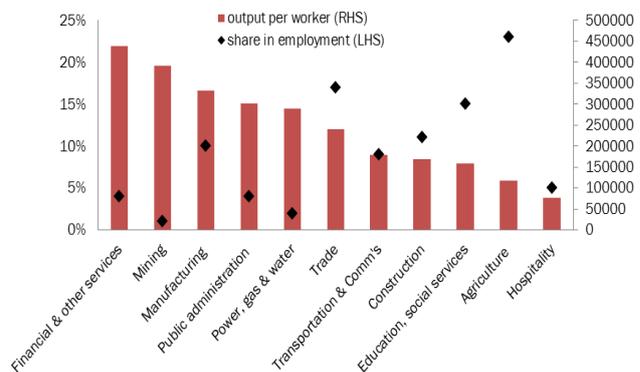
Employment is concentrated in trade, construction, and agriculture, which lag in productivity (chart 5). High productivity is concentrated in foreign-invested companies, which produced their 22 per cent share in GDP in 2017 with an only 3 per cent share in employment. They are concentrated in mining, with little spill-over effects for the rest of the economy. The SME share in employment has risen significantly during the last decade, but the share in GDP has not (chart 2), reflecting weak productivity growth among SMEs and informality. Factors inhibiting faster productivity growth among SMEs include a business climate little conducive to company growth, limited access to capital and finance, insufficiently qualified workforce, soft and hard infrastructure constraints and slow technology transfer.

**Chart 4: Labour productivity (GDP per person employed, constant 2011 PPP \$)**



Source: International Labour Organization, ILOSTAT database via World Bank.

**Chart 5: Labour productivity and employment share by sector (2017)**

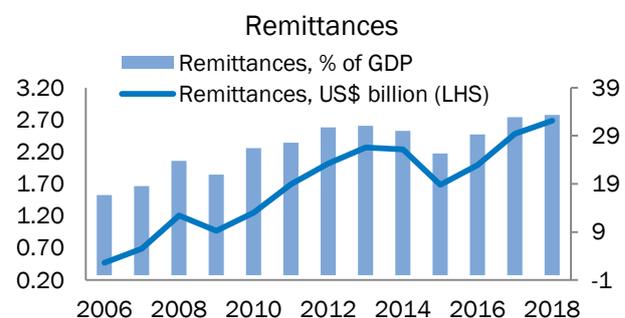


Source: National Statistics Committee of the Kyrgyz Republic.

**Economic growth in the Kyrgyz Republic is strongly dependent on gold production and remittances.**

Real GDP growth averaged 4.4 per cent in the past decade underpinned by remittances-driven consumption and gold production. While remittances accounted for around 33 per cent of GDP in 2018, gold production at Kumtor (the largest gold mine), contributed approximately 9 per cent of GDP in 2018 (chart 6).

**Charts 6: Remittances**



Source: National Statistics Committee of the Kyrgyz Republic, World Bank World Development Indicators.

### 3. EEU accession and external trade developments

**In August 2015, the Kyrgyz Republic became a member of the Eurasian Economic Union (EEU).**

This can provide substantial opportunities to the country in terms of trade creation, increased investment inflows and improved labour market access to the countries of the EEU. EEU accession has resulted in some redirection from re-export orientation of the economy to the export of more of locally produced goods, which will likely improve the overall economic structure and support higher value added generation in the medium to long run. Exports rose by 17 per cent in US\$ terms between 2015 and 2018, and excluding gold<sup>6</sup> by 32 per cent. This was mainly driven by higher exports of apparel, copper scrap, glass, cement, woven cotton and a recovery in electricity exports. Imports increased by 19 per cent over the same period, and 28 per cent excluding mineral fuels<sup>7</sup>. Import growth was mainly due to higher imports of textiles and shoes, machinery, and animals and agricultural products.

**Table 2: Foreign trade by country, per cent of total ex/imports**

Exports		
	2015	2018
Switzerland*	39.0	39.6
Kazakhstan	15.8	16.1
Russian Federation	10.9	13.0
United Kingdom*	0.1	9.4
Uzbekistan	6.6	6.2
Turkey	5.8	3.6
China	2.5	2.8
United Arab Emirates	6.9	2.7
Tajikistan	1.7	0.8
Belgium	1.5	0.8
Total	90.8	95.1

<sup>6</sup> Gold accounted for 39 per cent of Kyrgyz exports in 2018.

<sup>7</sup> Mineral fuels accounted for 13 per cent of Kyrgyz imports in 2018.

Imports		
	2015	2018
China	25.3	40.2
Russian Federation	31.3	24.8
Kazakhstan	16.7	9.7
Turkey	4.0	6.0
Uzbekistan	1.5	3.7
USA	3.0	2.7
Belarus	1.3	1.5
Germany	2.3	1.0
Korea, Republic of	1.3	0.7
Ukraine	2.2	0.7
Total	88.8	91.1

\* Gold exports

Source: Trademap, authors' calculations.

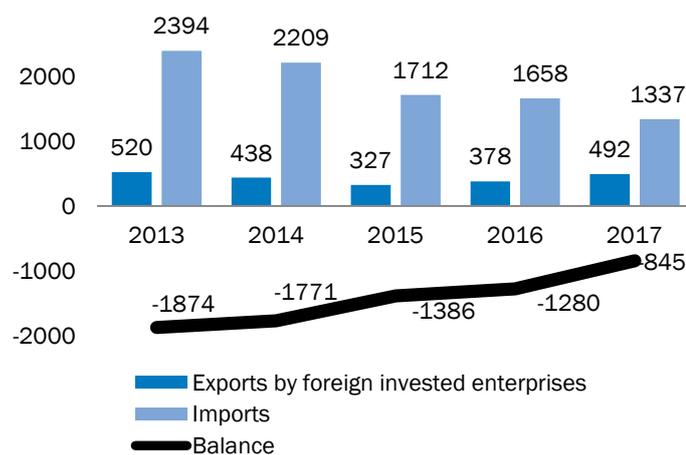
**The largest redirection in exports after joining the EEU has been to Russia.** Russia's share in the Kyrgyz Republic's exports rose from 10.9 per cent in 2015 (table 2) to 16.1 per cent in 2018.<sup>8</sup> Some of the increase in Russia share, especially on apparel and footwear, is likely the result of more accurate accounting of the transit trade through Kazakhstan. However, EEU accession led to a substantial increase in Russia's and Kazakhstan's combined share in exports from 27 per cent to 29 per cent, and in non-metal, non-ore exports and from 35 per cent to 58 per cent<sup>9</sup>. On the import side, China overtook Russia as the main import source despite the Kyrgyz Republic's EEU membership. The opening up of Uzbekistan led to significant increases of Uzbekistan's market share in several products. Turkey also gained, mostly due to deliveries of machinery, pharmaceuticals and apparel.

<sup>8</sup> At the same time, Kazakhstan's share excluding precious metals and ore decreased from 22.8 per cent in 2015 to 20.2 per cent in 2017, Uzbekistan's from 14.4 to 13.8 per cent; China's from 4.7 to 4.4 per cent. Turkey's share also fell, from 15.9 to 7.3 per cent, with an especially strong decline in vegetables and fruits. Russia gained in 8 of Kyrgyzstan's 10 main products, China in 4, Uzbekistan in 3, Kazakhstan only in 2. Russia lost only in one product, China and Uzbekistan in 3, Kazakhstan in 8 products. Turkey's share increased in 2 products and fell in 6.

<sup>9</sup> Trademap data.

**Foreign-invested companies were behind much of the export increase since EEU accession.** However, exports by foreign-invested companies, although rising since 2015, have remained below 2013 readings. FDI, technology and skill transfer, connectivity needs to be stepped up to push exports up more substantially. There is also progress in local sourcing: imports of foreign-invested companies declined during the last five years, reflecting the investment cycle and more accurate recording of imports, but also more local supplies (chart 7).

**Chart 7: Foreign trade of foreign-invested enterprises, US\$ million**



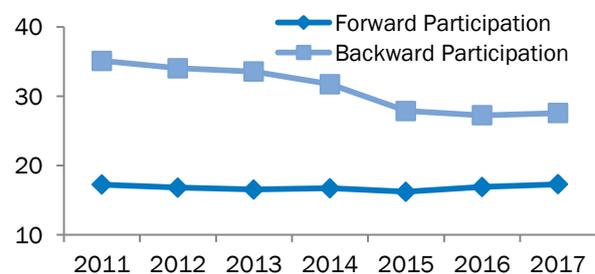
Source: National Statistics Committee of the Kyrgyz Republic.

**However, the main benefit of the EEU accession so far has been the equal treatment of Kyrgyz Republic citizens, when employed in another member country of the EEU.** According to official reports, there were about 800,000 Kyrgyz citizens working abroad in 2017 while unofficial estimates indicate that this number reaches around 1.2 million. EEU membership exempts Kyrgyz workers from obtaining permits, provides the social safety net of the recipient country and removes quotas for the migrant workers. This is expected to further increase the number of migrants searching for job opportunities abroad given that the population is growing while job creation within the country is not keeping pace.

**Despite improvements, The Kyrgyz Republic's foreign trade remains hampered by low competitiveness, and the lack of proper infrastructure and skilled workforce.** The Kyrgyz Republic has had a negative trade balance since 1998, with a deficit of US\$ 2.9 billion in 2018. Kyrgyz businesses report stiffened import competition and lack of support and high costs for switching to the new regulations of the EEU. To smooth the Kyrgyz Republic's adaptation to EEU requirements, Russia and Kazakhstan provided grants to the Kyrgyz Republic to build technical infrastructure on the borders and bring customs controls in line with EEU standards.

**Higher integration into global and regional value chains will be needed to overcome the Kyrgyz Republic's low productivity growth.** Participation in global value chains (GVCs) is still low in 2017 and has even worsened in the last years. Today's total GVC participation adds up to 44.9 per cent, which is below the level of 52.4 per cent in 2011.<sup>10</sup> Even though the Kyrgyz Republic has a higher share of backward participation (sourcing foreign intermediate inputs for its exports), the value has been constantly declining since 2011, whereas the forward participation stagnated on a low level over time (chart 8).<sup>11</sup>

**Chart 8: Global value chain integration (%)**



Note: Backward participation describes the foreign value-added part of gross exports, whereas forward participation

<sup>10</sup> GVC Participation index is a sum of the share of foreign value-added in gross exports and the share of domestic value-added in third countries' exports of gross exports. This index value gives an indication of the integration into global value chains for a specific country.

<sup>11</sup> Backward participation describes the foreign value-added part of gross exports, whereas forward participation indicates the domestic value-added part of gross exports that is used in third countries' exports.

indicates the domestic value-added part of gross exports that is used in third countries' exports.

Source: EORA-UNCTAD (2018).

**The Belt and Road Initiative (BRI) presents ample new opportunities for increasing the transit potential of the country and increasing integration into global value chains** through the development of transport and logistics infrastructure. The initiative involves bringing substantial inward investment in the Kyrgyz Republic to improve infrastructure connectivity and energy reliability as well as to promote commercial linkages. For instance, China's Exim Bank is financing the construction of the North-South road and the reconstruction of the Bishkek Power Station. However, debt sustainability aspect of projects within the BRI should be carefully considered, given that most of them are financed via credit instruments. Already around 40 per cent of the Kyrgyz Republic's public debt was owed to China as of end-2018, highlighting growing fiscal risks related to further BRI projects.

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## 4. Key obstacles to private sector development

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### 4.1. Well-governed: governance and business environment challenges

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**The Adoption of the “National Strategy for Sustainable Development of the Kyrgyz Republic for 2018-2040” (NSSD 2040) marked a milestone for comprehensive and long-term government planning.** Previous development strategies and programs were designed for 3- or 5-year periods, with the NSSD 2040 succeeding a National Strategy for Sustainable Development for 2013-2017. The NSSD-2040 rests on programmes and measures to digitalise the economy, to improve the business environment, to improve the effectiveness of public administration, and to create better opportunities for all in education and training. Recent policies for private sector development focused on tax administration reforms, the improvement of customs regulation, reforming antitrust laws as outlined in the Program for Private Sector Development for 2015-17. The “Development Program of the Kyrgyz Republic for the Period 2018-2022” declared SME development as one of the main priorities of economic policy and targets an increase in the share of SMEs in GDP to at least 50 per cent by 2022.

**The Digital Transformation programme launched in June 2017 aims to make all government services electronic** and is an important item on the anti-corruption agenda, aiming to eliminate personal interactions with the authorities and increase transparency and accountability. The launch of e-licensing for SMEs (“e-patent”) from 1 October 2018 is among the first tangible results of the Programme.

**Despite the government’s efforts to stimulate private sector development, the business environment has remained challenging.** The government has succeeded in reducing the number of permits and licenses for doing business from 500 to 98 in recent years, and the time spent on inspections from 30 to 15 working days,<sup>12</sup> but overall progress in implementing reforms is limited. The

Kyrgyz Republic ranked 70 out of 190 countries in the ease of doing business, according to the World Bank’s *Doing Business 2019* report. This is a slight improvement from 2018, but large gaps remain in paying taxes, getting electricity, and enforcing contracts.

**The business community is trying to improve the delivery of public services through maintaining an active dialogue with the government.** Over a hundred of business associations are present in the Kyrgyz Republic. Major ones are the Chamber of Commerce and Industry, the National Alliance of Business Associations, the American Chamber of Commerce, and the International Business Council. They organise about 20 per cent of SMEs, according to the estimates of the Chamber of Commerce and Industry. A larger coverage of SMEs is made difficult by the ubiquity of the informal economy. The associations actively participate in the discussion of various laws and regulations, and provide inputs to national strategic planning exercises, such as the NSSD 2040. The dialogue between the public and private sectors in the country, including through the Council for Development of Business and Investment under the Prime Minister, is among the most effective in the region. A high number of business initiatives raised through the Council has been transformed into regulatory frameworks. A similar instrument has been established under the Parliament, to have a proper channel of communication for the businesses with the Parliament, but for now it is lacking similar trust and requires further capacity building to be an effective partner for the business.

**Notwithstanding the relatively strongly developed public-private sector dialogue, the trust in government institutions by the business community has remained rather low.** Frequent changes in the government (on average every 10 months since independence), political volatility and discontinuity translating into frequent changes of regulation and project partners in the government, limited capacity and resources of government institutions and lack of coordination of support

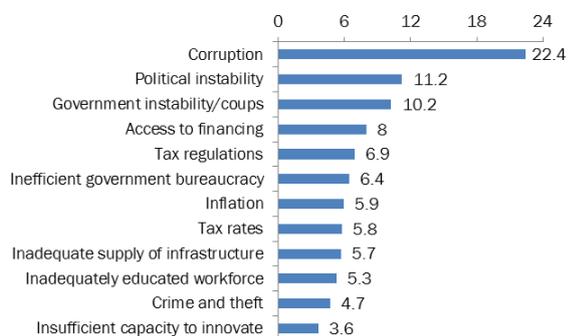
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<sup>12</sup> Joint statement by NBKR and Government  
<http://www.nbkr.kg/DOC/29092017/000000000048277.pdf>

mechanisms make business planning difficult, projects and investments costly, and allow vested interests to distort procedures in their favour, thus discouraging entrepreneurship.

**Efforts to improve the business environment are strongly hampered by corruption.** Despite some improvement in the Kyrgyz Republic’s rank in Transparency International’s Corruption Perception Index from 150 (out of 179 countries) in 2007 to 132 (out of 180 countries) in 2018, corrupt practices are overwhelmingly regarded as the key obstacle to private sector development. Corruption hinders consistent application and adequate implementation of the law. This imposes an additional tax on businesses and tends to increase the cost of doing business.

**Chart 9: Most problematic factors for doing business**



Source: World Economic Forum, Executive Opinion Survey 2017.<sup>13</sup>

**President Jeenbekov, elected in late 2017, made anti-corruption a main focus of his programme.**

Among the most immediate effects have been multiple corruption cases opened and arrests made of prominent politicians, including the former Prime Minister and mayor of the city of Bishkek, as well as other politicians and businessmen. This had an unwanted effect of nearly freezing the government decision-making, both at the reform as well as at the

investment levels, which has an immediate adverse effect on investors, particularly in the public sector.

**Quotes from a representative of a business association:**  
**“Private sector development is hindered by complicated tax and customs regulations. It is very difficult for SMEs to understand all the regulations and the requirements. Complicated rules also generate corruption and this, in my opinion, is the greatest barrier to business operations. In general, government bodies are open to the suggestions from business associations, but our initiatives are progressing very slowly. I think the main problem is the frequent change of the government, which does not allow for the prompt resolution of business issues.”**

**Tax administration is complicated, not least due to frequent changes to legislation.**

The combined average tax and social contribution rate stands at 29 per cent of income, according to the Paying Taxes 2018 report from PwC and the World Bank Group. This compares to a similar 29 per cent in Kazakhstan, the largest economy in Central Asia, but is below the regional average of 33 per cent for Central Asia and Eastern Europe. However, the time needed to comply with tax payments is estimated at 225 hours versus 178 hours in Kazakhstan. The Kyrgyz Republic performs the worst on the number of types of tax payments out of all Central Asian and Eastern European countries with a total of 51 payments compared to 16 regionally. It is also the furthest from the regional frontier for the post-filing index, measured as time to claim a VAT refund and correct a mistake in corporate income tax returns.

**Weak rule of law and inadequate protection of property rights also continue to weigh on doing business.**

The impartiality of courts remains a major issue and judicial decisions showing a bias towards the government and entities in which the state has a substantial stake. Court decisions are not easily accessible by the public, which limits the

<sup>13</sup> From the list of factors, respondents to the World Economic Forum’s Executive Opinion Survey were asked to select the five most problematic factors for doing business in their country and to rank them between 1 (most problematic) and 5. The score corresponds to the responses weighted according to their rankings.

transparency and accountability of the judicial system. As a result, the Kyrgyz Republic ranks below average on both judicial effectiveness and property rights scores in the 2018 Index of Economic Freedom (22.1 and 50.2 out of 100, respectively). However, progress was made in 2018 with the establishment of a Business Ombudsman to review complaints of businesses over abuse of state authority. The relevant decree was signed in December 2018. The Business Ombudsman's activity is financed by international development partners. The Business Ombudsman and its deputies are selected unanimously by three votes – the Government, the international partners and business associations. This is a significant step towards improving the business environment; however, the key to success of the institution will be in the implementation.

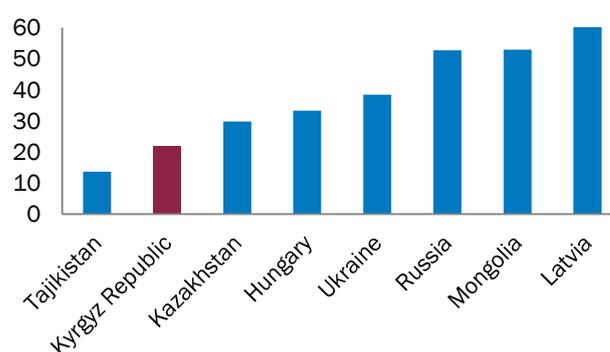
## 4.2. Resilient: Access to finance

**With credit to the private sector equalling around 22 per cent of GDP, financial intermediation is rather shallow.** For SMEs, loans from commercial banks and microfinance are the primary source of external financing. There are no official data to determine the share of loans extended to SMEs, but interviews with financial institutions suggest that more than half of banking sector loans are directed to SMEs (in Kyrgyz definition).

**The financial system remains small and is dominated by banks.** As of December 2018, total assets in the banking sector equalled 39.8 per cent of GDP<sup>14</sup> which is low by international standards. Fourteen of the country's commercial banks are controlled by foreign groups (65 per cent market share by assets) and three are state owned (25 per cent market share).<sup>15</sup> Non-bank financial institutions (NBFIs) hold approximately 9 per cent of total assets of the financial sector.<sup>16</sup> Several microfinance institutions (MFIs) have recently obtained banking

licenses and the 3 largest now account for 13.2 per cent of the sector.<sup>17</sup> Financial institutions continue to be constrained by limited funding sources and lending opportunities.

**Chart 10: Domestic Credit to the private sector (% of GDP), 2017**



Source: World Bank's World Development indicators

**Access to finance continues to be an issue because of insufficient equity and insufficient assets that qualify as collateral.** Central bank-imposed collateral requirements are relatively high. The Regulation on assets classification requires that loans be covered by collateral of at least 120 per cent of the loan amount to be classified as 'normal' assets in terms of risk level. However, this is the minimum amount and in reality collateral requirements demanded by commercial banks can be higher. Around 40-50 per cent of SMEs fail to obtain a bank loan due to prohibitively high collateral requirements.<sup>18</sup> This challenge is particularly acute for SMEs in agriculture, particularly in the south, which have assets in rural areas and thus face valuation issues. To alleviate collateral constraints, a credit guarantee fund has been established and has provided 675 guarantees amounting to KGS 780 million (US\$ 11 million) as of January 2019.<sup>19</sup> While its portfolio has grown over the past 1-2 years, its size is still too small to have a major impact.

<sup>14</sup> National Bank of the Kyrgyz Republic

<sup>15</sup> Kyrgyz Republic Banking System Overview, EBRD, September 2017

<sup>16</sup> Financial stability report, National Bank of the Kyrgyz Republic, November 2017

<sup>17</sup> Kyrgyz Republic Banking System Overview, EBRD, September 2017

<sup>18</sup> Concept of Development of Guarantee Funds of the Kyrgyz Republic until 2020

<sup>19</sup> Kyrgyz Guarantee Fund, <http://gf.kg/en/about/informatsiya-po-vydannym-gara/> (on 11 Oct 2018)

However, a limited capital structure poses a challenge to further expansion.

### Quotes from entrepreneurs

“For local SMEs it’s important to provide an access to capital to finance their growth ambitions. Currently available financing sources are mainly loans from commercial banks. However, there is a large deficit of risk capital for SMEs. Development of private equity, mezzanine and venture capital financing mechanisms would partially provide such risk capital.”

**Microcredit and microfinance institutions (MFI) account for a relatively high share of the financial market, primarily funding firms in agriculture, trade and construction.** Around 10 per cent of total outstanding loans are provided by MFIs.<sup>20</sup> They serve around 250,000 clients. Women represent 56 per cent of the client portfolio. Although most of the loans are unsecured, the sector’s NPL share was historically at most 5 per cent. One of the legal constraints limiting the expansion of the portfolio is a provision requiring those who wish to get a loan exceeding the equivalent of US\$ 720 to obtain a notarised consent of the spouse, while the spouse in many cases happen to be working in Russia. In order to promote the development of MFIs and ensure their sustainability an action plan for development of the microfinance sector in the Kyrgyz Republic for 2018-2021 was adopted by the National Bank of the Kyrgyz Republic. It aims to increase MFI sector assets to 5 per cent of GDP and cover 4.9 per cent of the population by 2021.

**In order to facilitate the accession of the Kyrgyz Republic to the EEU, the Russian-Kyrgyz Development Fund (RKDF) was established.** With a capital of US\$ 500 million (which is expected to increase to US\$ 1 billion in coming years), the RKDF

provides local and foreign currency financing on below-market terms to SMEs via commercial banks and to large businesses directly. Mining, agriculture, textile, infrastructure, transport and housing are identified as priority areas for investment by the RKDF. There is also a state agricultural programme, implemented through the banking sector, which provides funding at 6-10 per cent to farmers and cattle-breeders.

**While the presence of the RKDF facilitates access to finance through large volumes of cheap lendable funds and low minimum hurdles for direct lending, this also distorts market prices.** Interest rates have fallen partly due to the availability of preferential funding provided by the RKDF, which lends directly to enterprises requiring a loan of at least US\$ 1 million and also co-finances SMEs through 13 partner commercial banks. Provision of funding at subsidized interest rates distorts market price signals and can potentially result in misallocation of financial resources, e.g., in overinvestment in otherwise unprofitable projects.

**Financing opportunities are also limited by the lacking breadth of financial products.** New products could help alleviate financing constraints on both ends of the SME spectrum. Medium-sized businesses that intend to grow could benefit from more diversified funding structures that go beyond plain vanilla bank loans. Risk capital in particular is missing. A fund that is trying to address this gap, Highland Capital,<sup>21</sup> has been recently set up and, if successful, could provide a positive demonstration for such activities in the Kyrgyz economy. Digitalisation could improve businesses’ access to finance in future. Mobile penetration rates have nearly doubled in the last 10 years, reaching more than 120 per cent by 2017, which is in line with the regional average. This suggests that mobile banking could be an important mean to reach out to borrowers in rural and remote areas. While some

<sup>20</sup> According to the National Bank of the Kyrgyz Republic data

<sup>21</sup> A Bishkek-based investment management firm focused on providing equity and quasi-equity financing to SMEs to help them institutionalize and expand their operations. It is run by team of investment professionals from the Kyrgyz Republic.

MFIs have made attempts to make the borrowing process for small loans easier and accessible via mobile phones, limitations in terms of e-signature or PIN and TAN systems prevent a broader roll-out.

**Capital markets are at a very early stage of development.** Market capitalization is around US\$ 340 million. To comply with the EEU requirements, a new capital market development strategy is being developed; however, success is very much dependent on improvements to the business environment and the rule of law.

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### 4.3 Integrated: Connectivity and infrastructure

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**Measures are being taken to improve the road infrastructure, but budgetary pressures limit the scope of projects.** Road transport accounts for 95 per cent of cargo transportation and passenger flow. The country has a road network of 35 thousand km, and upgrading the existing road network is a priority as it constitutes the backbone of the transport network. Efforts for rehabilitation and reconstruction are however constrained by budgetary pressures and debt limits. While the focus remains on rehabilitating existing roads and constructing new connections, road maintenance remains challenging. The Ministry of Transport is in charge of maintaining approximately 4 thousand international roads, 5500 km national roads and 9 thousand provincial roads through its 57 maintenance and repair units. The rest of the road network is maintained by local government agencies. However, maintenance operations are underfunded and one third of the main network is in poor conditions. While there are small scale efforts to enhance private sector involvement in maintenance operations, progress has been limited to date.

**Despite its small scale, the railway network requires significant upgrading.** The technical and gauge standards of the Kyrgyz rail network, stretching across 420 km, are based on Russian norms, which is compatible with the other CIS countries. However, these standards are not aligned

with China, hampering the development of efficient logistics services between the two countries. Despite high hopes, the China-Uzbek railway construction is delayed due to different technical regulations of the EEU and China – which needs to be resolved before further steps are taken. While differences in legislations do not seem to be a key issue in the negotiations, support is required to align the Kyrgyz legislation with the main regional partners to achieve more efficient railway services, and eventually improve connectivity. The technical discrepancies between Chinese and Kyrgyz rail networks could also be alleviated by effective transshipment facilities, which do not exist currently. Overall, an integrated/intermodal logistics approach is not utilized, as the planning capacity at national and regional level is limited, and upgrading requirements to the infrastructure remain significant.

**The needs of the logistics sector remain high, on both hard and soft infrastructure.** Cross-regional integration is hampered by the deficiencies in the logistics sector, including issues with border crossing points (BCPs). Conformity assessment at borders, especially for sanitary and phytosanitary measures, is not to the expected standards due to limited human capital. Despite on-going technical assistance programmes and the WTO TFA implementation process, progress remains limited - requiring a long compliance timeline. On the other hand, there are opportunities that could support the development of the logistics sector including improved standardization and clearance for trucks and drivers, which could improve the situation between Kyrgyz Republic and its neighbours. The cross-border logistics sector is very much dependent on security issues, as well as bilateral relations, leaving the sector exposed to shocks. Diverging practices at border crossing points, and different prosecutions at different country borders constrain the development of regional trade and demonstrate the need for a well-functioning regional cooperation mechanism.

**Standards and certification are a major issue for businesses and there is little administrative support for firms aiming to export.** International certifications required for export activities, such as

ISO or HACCP are not widespread and inhibit firms' ability to take advantage of trade agreements. The EU reports that GSP+ usage remains below potential and that a functioning accreditation system in particular for agricultural produce is lacking.<sup>22</sup> Only one state-run laboratory for comprehensive testing exists in the country and is not readily accessible for businesses and even less for smaller farmers due to geographic distances and limited capacity. In addition, reliable information on requirements for exports is difficult to obtain and enforcement at the border can be variable.

**Development of the aviation sector is limited to major economic centers.** The country has four international and seven domestic airports, but the development of the aviation sector is structured around the main economic centres of the country, i.e., Bishkek, Osh, and Karakol. The most advanced airport is in Bishkek, i.e., Manas Airport, with development works on-going to further enhance the transit and traffic potential of the airport. There are plans to construct a cargo terminal at Manas airport under a PPP structure; while this has been on the agenda for a while, with differing views of several stakeholders, there is still no consensus on the issue. There is also work at national level to implement the fifth freedom of air, which would allow foreign airlines to land, and take off from Kyrgyz Republic, and then continue to a third country. This will likely increase the transit traffic at Manas airport. Yet, this should be accompanied with further improvements to air safety and improved navigation services, in line with the on-going work in cooperation with ICAO. On the other hand, the prospect for further development of regional airports is limited as there is not enough traffic for economically justified investments.

**Municipal infrastructure, especially the water sector has significant investment needs.** Current infrastructure is mostly outdated, with limited maintenance. The total investment needs in the

water sector amount to US\$ 450 million, including US\$ 200-250 million for rural areas. Given the small state budget allocation to the sector, the role of DFIs for upgrading the infrastructure is clear. Tariffs in the sector are below cost-recovery levels in most cases. Despite the agreement of all stakeholders on the need for a tariff reform, progress is slow as the issue is highly sensitive due to social implications.

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## 4.4 Competitive/inclusive: skills

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**The private sector, and SMEs in particular, suffer from the shortage of adequately educated workforce.** The results of the 2014 BEEPS survey show that skill gaps were, in the Kyrgyz Republic (among all EBRD countries of operations), regarded as the most problematic (chart 11). In a more recent survey, conducted by the Chamber of Commerce and Investment in 2017, 39 per cent of respondents identified the limited availability of qualified workforce as an obstacle to SME operations. The Kyrgyz Republic ranks 75th out of 157 countries in the World Bank's new Human Capital Index, published in October 2018 (chart 12). This is in the middle globally, but below its main trading partners. The Kyrgyz Republic ranks 80 in the achievement of harmonised test scores.<sup>23</sup>

**A disconnect between the needs of the labour market and employee's competencies is observed not only in high-skilled jobs but also in low-skilled jobs** e.g. in textile, agribusiness etc. Vocational education and training (VET), suffers from outdated infrastructure and curricula, insufficient funding, and deterioration in teaching quality. Annually, more than three thousand students of primary vocational education do not manage to find employment, as reported in the NSSD-2040. To address qualification gaps, the Education Development Strategy for 2012–2020 was adopted in March 2012 with a view to increasing the effectiveness of educational policies,

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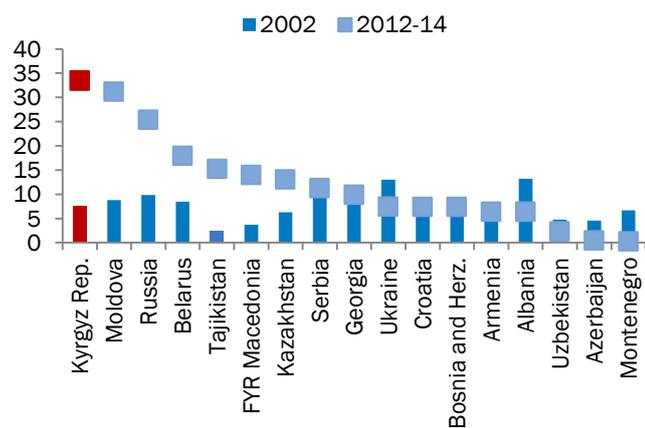
<sup>22</sup> European Commission 2019: Joint Staff Working Document on the EU Special Incentive Arrangement for Sustainable Development and Good Governance ('GSP+') assessment of the Kyrgyz republic covering the period 2016-2017; Document ref. SWD(2018) 27 Final.

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<sup>23</sup> International student achievement tests from several multi-country testing programs were adjusted to allow for comparison.

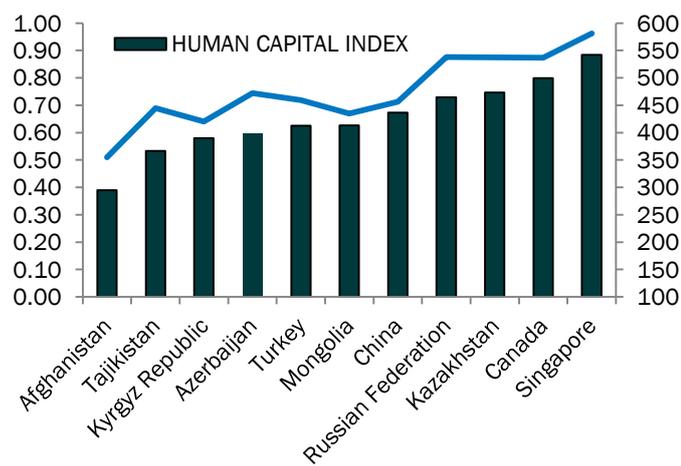
providing high-quality inclusive education and reducing skills mismatch resulting from VET system.

**Chart 11: Percentage of SMEs, which report skills and education of the available workers as problematic**



Source: EBRD/World Bank BEEPS.

**Chart 12: Human capital Index 2018, selected countries**



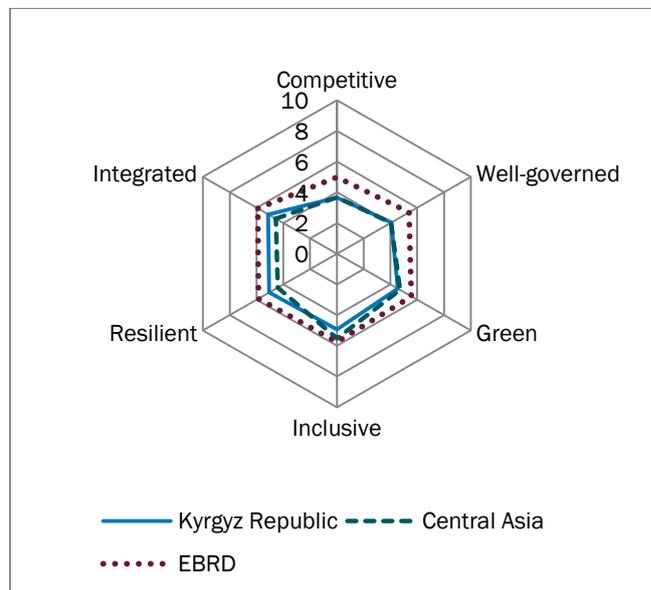
Source: World Bank.

# 5 Qualities of a sustainable market economy

**The Kyrgyz Republic ranks 31 out of 37 countries of operations** in the EBRD's Assessment Transition Quality (ATQ) scores. This index is based on a simple average of scores for the six transition qualities: competitive, well governed, integrated, inclusive, resilient, and green. The Kyrgyz Republic scores below the EBRD countries' of operation average in all six transition qualities, but slightly better than other Central Asian countries in "integrated" and "resilient". The scores are backward looking; a strong commitment to future reforms and their implementation would help the country catch up on regional comparators.

The following pages provide brief snapshots of each quality.

Chart 13: Kyrgyz Republic's Transition Qualities



Source: EBRD calculations

Note: The level of development within each of the qualities is measured from 1 to 10, with 10 representing the frontier.

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## Competitive [ATQ = 3.66]

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**Ease of Doing Business 2019: 70th out of 190 countries, up by 7 places from the previous year**

**EBRD Knowledge Economy Index 2017: 31st out of 38 EBRD Countries of Operations.**

The Kyrgyz Republic is currently ranked 33<sup>rd</sup> out of 38 CoOs in the competitive quality index. The score of the country reflects a performance that is aligned with the average of the Central Asian countries. The difficult business environment for SMEs, the challenges businesses face in complying with international standards, and the low labour productivity and quality of education represent major hindrances to competitiveness. Despite this, the country is more open and integrated into global value chains compared to Central Asian peers and has potential for more exports.

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### Market structures and institutions for competition

The favourable distance to frontier score on tariff rates on imported goods evidences a relatively **high degree of openness to international markets**, despite a slight decline observed since 2010.

However, **difficulties in complying with international standards limit the Kyrgyz exports** to more advanced markets. The number of ISO 9001 certifications in per cent of the country's population was close to 0 in 2010-2016.

While visibly improving over 2010-2017, the Kyrgyz SME environment remains weak, as measured by the **EBRD SME index** (it captures the strength and role of SMEs in each of the EBRD's countries of operation), which is below the Central Asian average. The low performance can be mainly attributed to the existence of high barriers to entry and obstacles in access to financing, especially non-banking sources. Despite this figure, the business environment for

SMEs - as measured by the aforementioned index – has been visibly improving over the period 2010-2017.

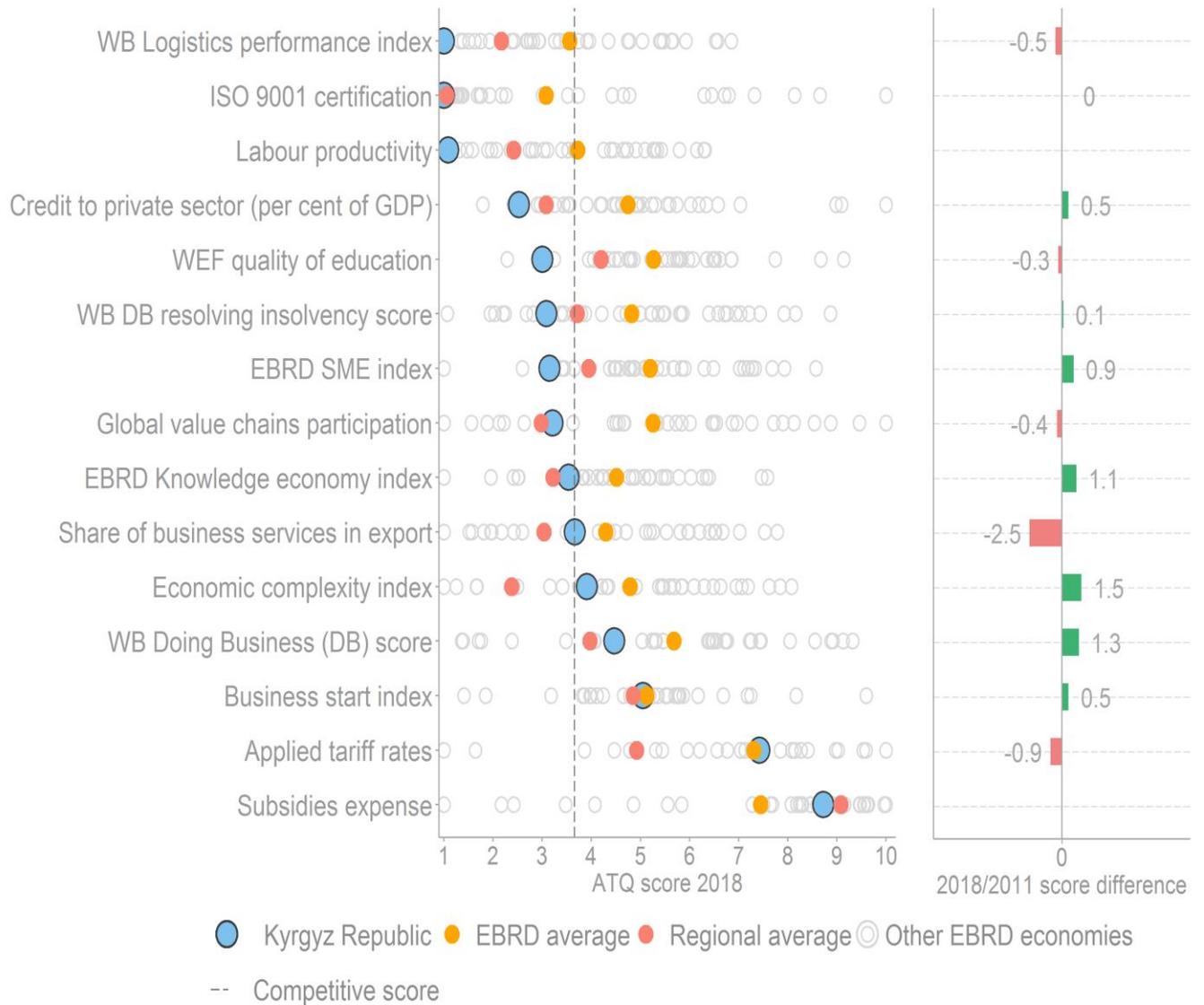
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### Capacity to generate value added and innovate

**Labour productivity is low.** Large fragmentation and weak automatization prevent productivity growth in agriculture as well as in other sectors. The **shortage of skilled labour, emigration and the weak quality of education** also constrain productivity.

The degree of diversification and refinement of products exported, as captured by the **economic complexity index**, is higher than the average of Central Asian countries. Despite a remarkable improvement over 2010-2017, the country in 2017 was still lagging behind the average performance of the EBRD region. This gives an indication of the potential of the country in relation to the capacity to produce goods effectively and is also reflected into the degree of **participation into global value chains**, which is higher than the regional average

**Kyrgyz innovation system is weak.** Gross expenditures in R&D are among the lowest of the EBRD region (0.12 per cent of GDP vs 0.6 per cent across EBRD region).



Source: EBRD.

Note: Visit <https://2018.tr-ebd.com/reform/> for detailed information on the indicators and sources.

## Well governed [ATQ = 4.06]

The Kyrgyz Republic: 79th out of 180 countries in **Index of Economic Freedom 2019** (The Heritage Foundation), with low scores in government integrity and rule of law indicators.

### The Kyrgyz Republic performs rather poorly in many aspects of governance.

The country is currently ranked 33<sup>rd</sup> out of 38 CoOs in the well-governed quality index. Public governance is hampered by the lack of institutional capacity, vested interests and political volatility. Most recently, the decision-making ability of the government was adversely affected by the reluctance of civil servants to take decisions in the aftermath of the wave of anti-corruption investigations initiated by the President. Companies have been slow in adopting international governance and integrity standards.

**Quality of institutions** scores are low in several sub-indicators, especially in government effectiveness and in political instability. At the same time, for a notable number of indicators such as transparency and disclosure, freedom of media, regulatory quality, the Kyrgyz Republic is performing well above the regional average (though still behind the frontier group).

**On the rule of law**, the Kyrgyz Republic is scoring below the regional average on most indicators, including private property protection and enforcement of contracts.

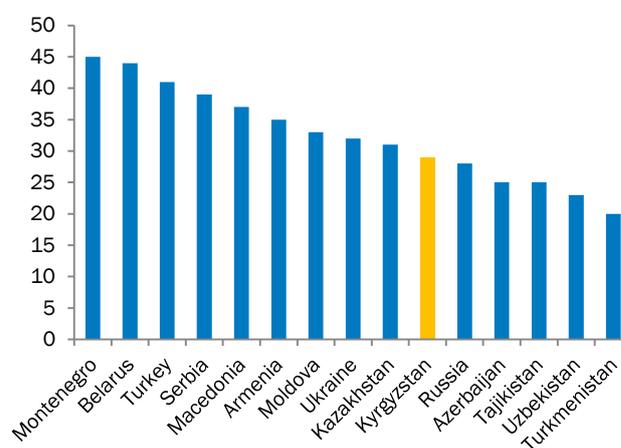
**Corruption** is seen as a major obstacle to private sector development. The country ranks 132nd out of 180 countries on Transparency International's Corruption Perceptions Index.

The EBRD's assessment of **corporate governance legislation and practices** in the KR points to problems with the functioning of the board, the independence of directors, and gender equality on

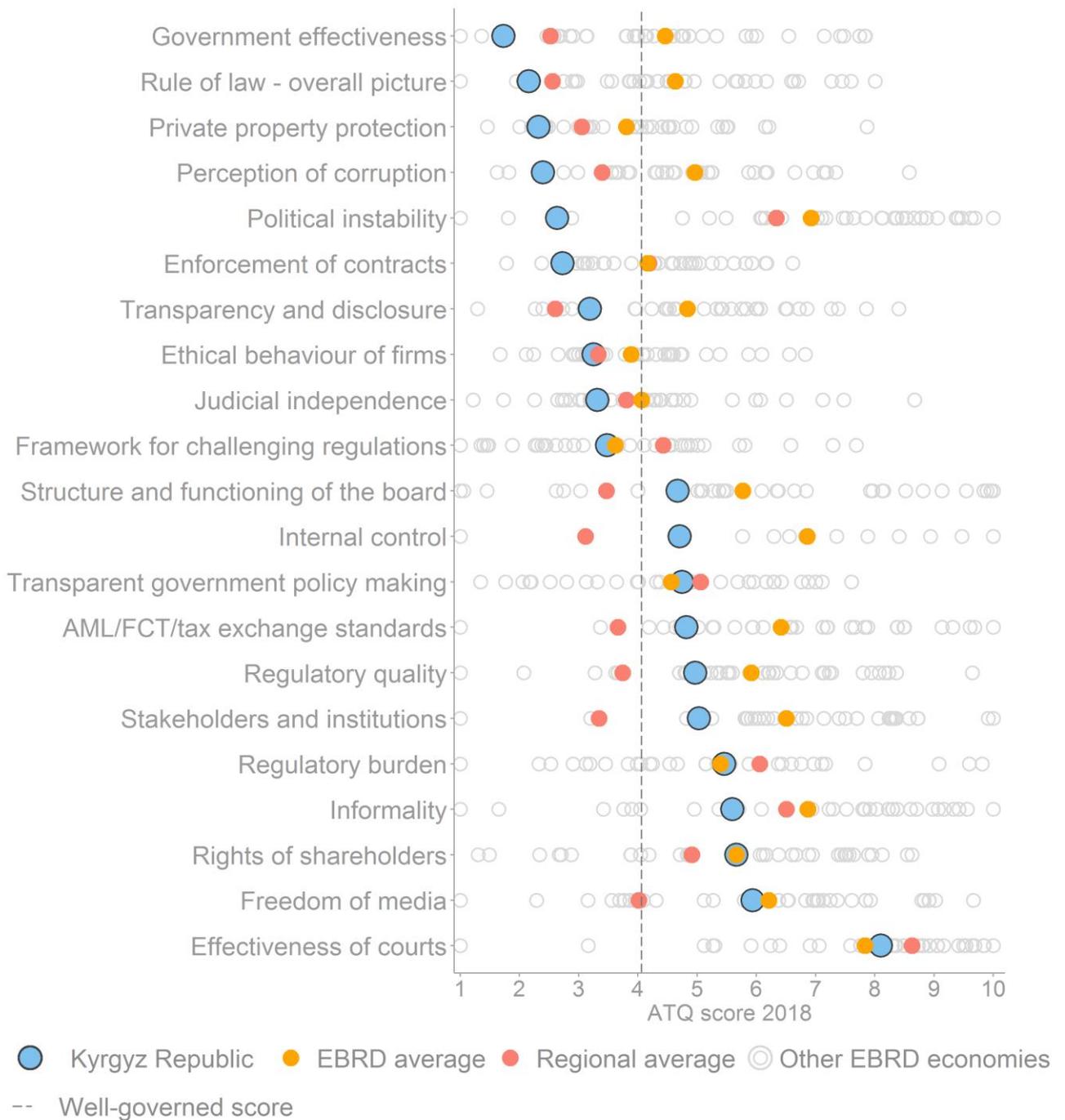
the board; internal control and the functioning of the audit committee; transparency and disclosure are also an issue.

On **business integrity**, the Kyrgyz Republic performs just above the regional average, including on Anti-Money Laundering/Combating the Financing of Terrorism frameworks. At the same time, ethical behaviour of firms remains marginally below the regional average and far below the frontier group.

Chart 14: Corruption Perceptions Index 2018



Source: Transparency International.



Source: EBRD.

Note: Visit <https://2018.tr-ebd.com/reform/> for the list of indicators, data sources and methodological notes.

## Green [ATQ = 4.56]

Seven out of the nine large hydropower plants generate more than 90% of electricity. However less than 1% of the country's huge renewable energy potential is currently used.

Electricity tariff rates were 0.01 EUR/kWh for households and 0.03 EUR/kWh for industry.

Residential (36%), transport (26%) and industry (20%) sectors are the largest energy consumers.

The Kyrgyz Republic has one of the lowest electricity tariffs in the world. This contributes to the inefficient use of energy, severe under-spending on maintenance and new investments, and results in poor supply reliability and quality<sup>24</sup>. Substantial tariff reforms have taken place in the past few years, but have not been implemented consistently due to concerns about affordability and willingness to pay.

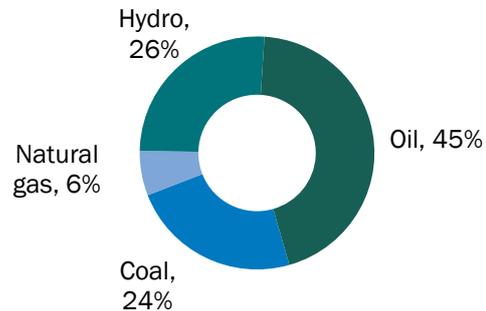
Its energy intensity is one of the highest in the EBRD region and more than twice that of the EU average. With the lack of investment into existing and new hydroelectricity assets, there has been a significant increase of production and consumption of readily available domestic coal in recent years, particularly for heating.

Droughts are projected to become more frequent and severe.<sup>25</sup> Decline in water resources is one of the most severe climate change risks facing country.<sup>26</sup> Much of the water in Central Asia originate from the mountains of Kyrgyz Republic which is channelled downstream to neighbouring countries, which can lead to strained relationships if not managed properly. Domestically, given that the majority of all electricity is from hydro resources, and agriculture depends entirely on irrigation (93 per cent of total withdrawn water<sup>27</sup>), it is imperative that

integrated water management be implemented in line with international best practices.

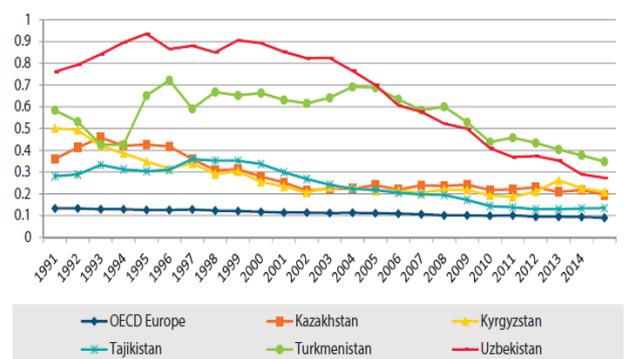
The water and waste water sector is characterised by underinvestment, deficient regulatory environment, weak core competencies, and poor financial and operational performance. Although water-rich in principle, poor infrastructure and poor management practices translate into inefficient water use, compounding spatial and seasonal limitations on water access, and affecting crucial economic sectors, as well as drinking water supplies. Current access to drinking water only covers 60 per cent of the population. Most infrastructure investment in the sector is financed through external funding, but tariffs are low and discussions on increasing tariff remain socially sensitive.

Chart 15: Share of total primary energy supply



Source: IEA, 2016.

Chart 16: Energy Intensity (TPES/GDP PPP)



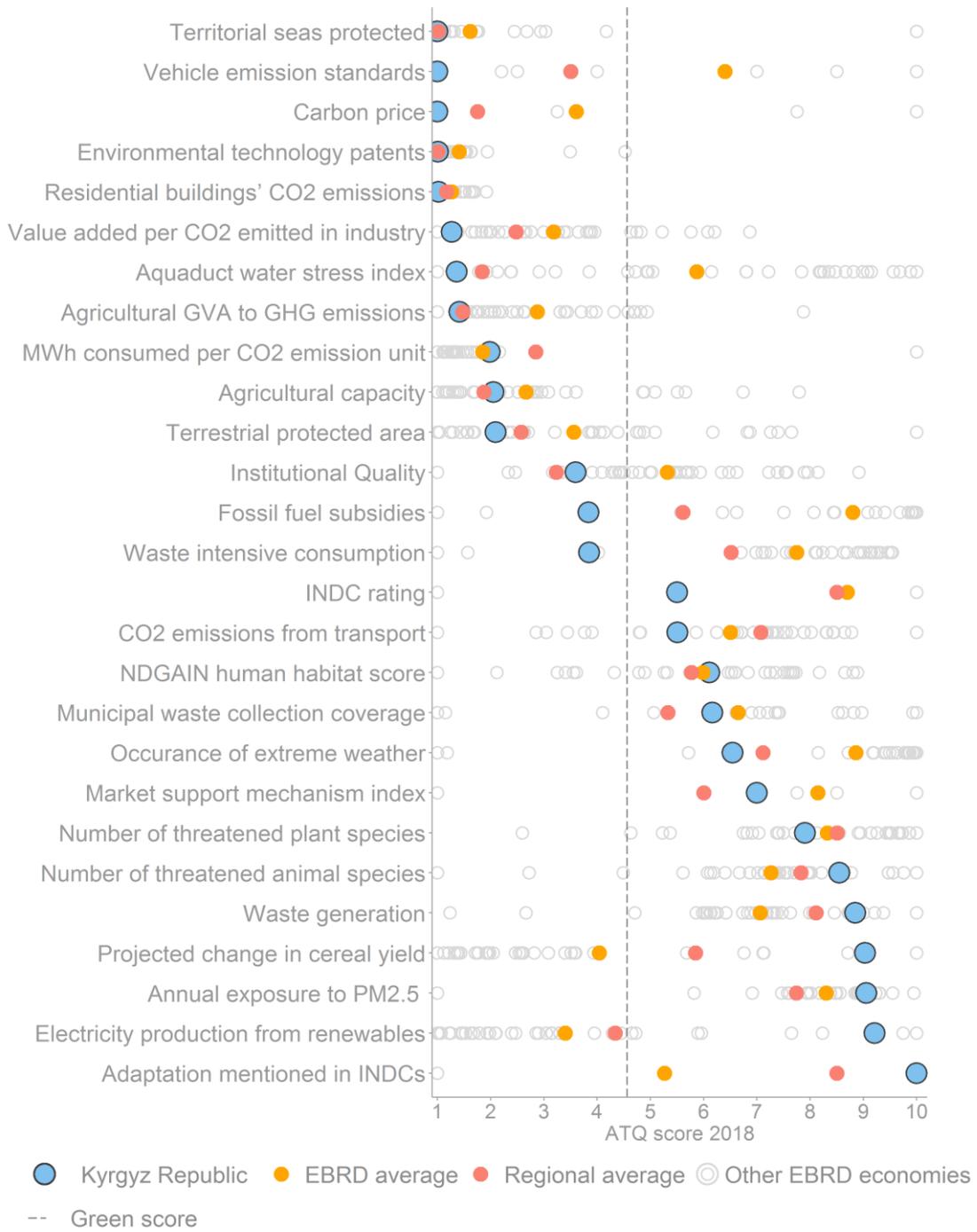
Source: IEA, 2016.

<sup>24</sup> ENERGY SECTOR DEVELOPMENT POLICY OPERATION, World Bank (2018)

<sup>25</sup> <https://www.adb.org/sites/default/files/project-document/79760/45353-001-tacr-01.pdf>

<sup>26</sup> Adapting to Climate Change in Eastern Europe and Central Asia (WB,2010)

<sup>27</sup> FAO, 2006



Source: EBRD.

Note: Visit <https://2018.tr-ebd.com/reform/> for the list of indicators, data sources and methodological notes.

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## Inclusive [ATQ = 4.94]

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**The GINI coefficient in 2017 was 27, indicating a low level of income inequality by international standards (2017, World Bank)**

**122nd in the Human Development Index, scoring higher than Tajikistan but lower than other regional neighbours (UNDP 2017)**

Evaluating the state of economic opportunities for women, young people and people from less-developed regions in the Kyrgyz Republic is complicated by the lack of reliable data. **Available information highlights large inclusion gaps with respect to gender and youth employment.**

**Sectoral shifts during the last three decades increased demand for higher-order analytical and organizational skills, including non-routine cognitive analytical and interpersonal skills.**<sup>28</sup> In 1990, the service, industry, and agricultural sectors each accounted for approximately one-third of GDP. Today, the service sector accounts for more than half of GDP, as compared to 26 per cent for the industry sector.

**Although graduation rates are generally high, about half of the young labour market entrants with at most a secondary general education lack the cognitive, non-cognitive, and technical skills needed to secure quality jobs.** Large variations in skills among those with the same level of education indicate that education is failing too many people.

**Consequently, firms increasingly report that workers are not adequately prepared for the demands of the labour market.** 33 per cent of firms identify an inadequately educated workforce as a major constraint, significantly higher than the Eastern Europe and Central Asia average of 22 per cent.

## **Women's participation in the labour force is low and concentrated in low productivity sectors.**

Female labour force participation stands at 48 per cent compared to 76 per cent for men.<sup>29</sup> The majority of female employment is in agriculture, education and wholesale and retail. More than three-quarters of women who are engaged in agricultural sector do so as unpaid family workers.

**Access to SME finance is limited for women-led businesses.** Female entrepreneurs can only have access to short-term loans (a minimum of US\$500 to a maximum US\$10,000).<sup>30</sup> Lack of collateral limits women's access to bank finance. Women are less likely than men to have ownership and control of key productive assets, such as land assets.

**Women's businesses are small and micro, many of them in low productivity sectors.** The percentage of firms with female ownership is high with 49 per cent compared to the regional average of 35 per cent<sup>31</sup>. However women's businesses are often micro or small scale and concentrated in low productive sectors such as the trade sector, the garment manufacturing sector and other personal services.<sup>32</sup>

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<sup>28</sup>Ajwad, Mohamed Ihsan, Joost de Laat, Stefan Hut, Jennica Larrison, Ilhom Abdulloev, Robin Audy, Zlatko Nikoloski, and Federico Torracchi. 2014. "The Skills Road: Skills for Employability in the Kyrgyz Republic." World Bank, Washington, DC.

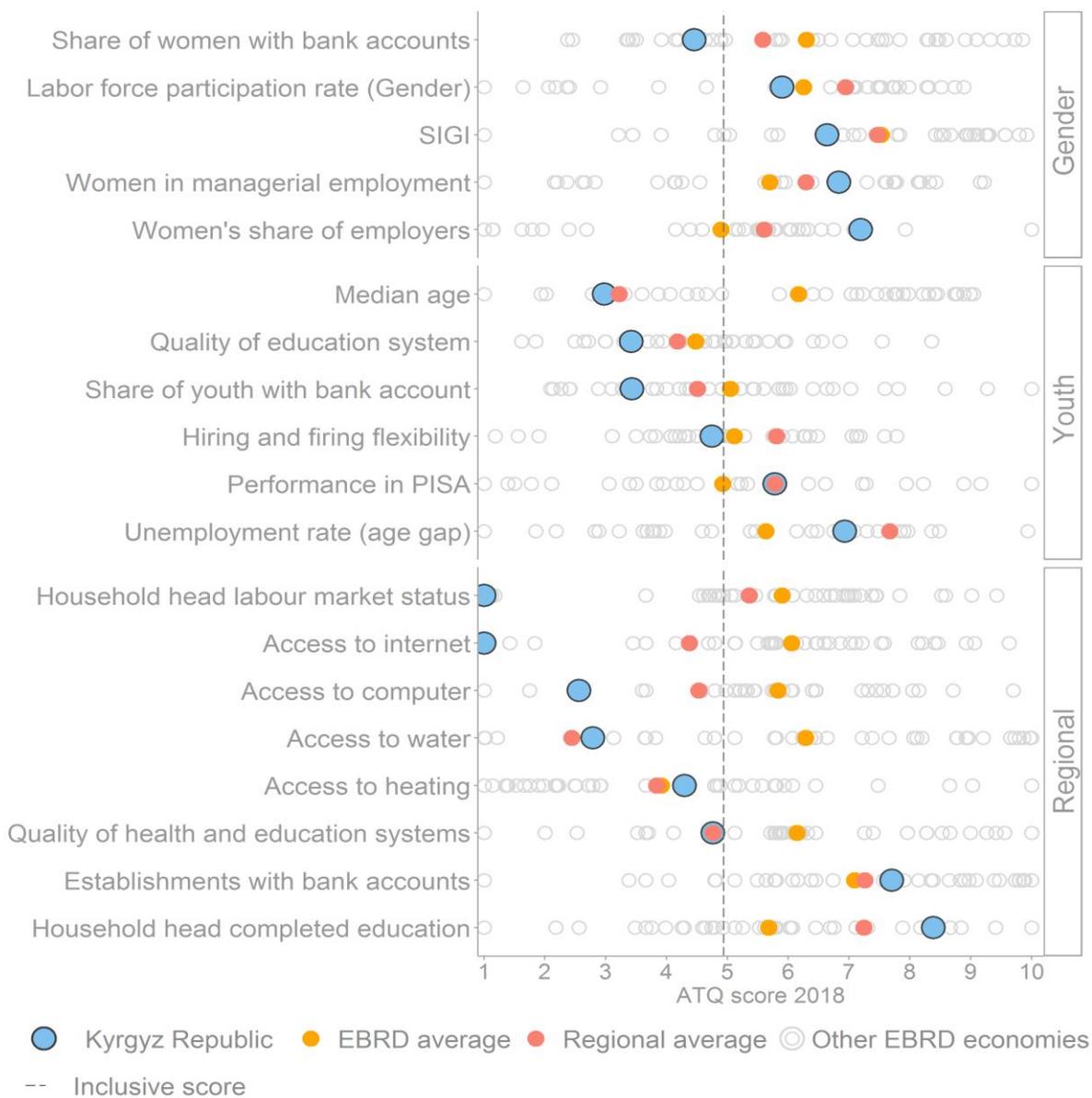
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<sup>29</sup> World Bank (ILO est.)

<sup>30</sup> World Bank, 2011

<sup>31</sup> EBRD BEEPS

<sup>32</sup> UNFPA, NCS, 2016



Source: EBRD.

Note: Visit <https://2018.tr-ebd.com/reform/> for the list of indicators, data sources and methodological notes.

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## Resilient [ATQ = 5.05]

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### Economic resilience

The Kyrgyz Republic is significantly exposed to external shocks due to **reliance on gold production and remittances**.

**Banking sector activity is recovering after the 2015 currency shock**, although vulnerabilities remain. High levels of dollarisation (>50 per cent) led to a significant deterioration of bank balance sheets following the 2015 currency shock. However, new regulatory measures encouraged by the IMF to decrease FX exposure have reduced loan and deposit dollarisation to 38 per cent and 44 per cent respectively as of January 2019. The rise in NPLs peaked in 2016 and since has fallen to 8 per cent (January 2019), although remains a concern. After a slowdown in 2015-2016, credit growth recovered to double digits in mid-2017 and reached 18.1 per cent in January 2019. Banks are adequately capitalised with the sector capital adequacy at 23.7 per cent. However, profitability remains low in the sector with return on assets at 1.4 per cent as of December 2018.<sup>33</sup>

**Some aspects of the regulatory framework have been strengthened under the latest IMF programme**. A new banking law was passed in 2016 which improved the existing regulation framework, although gaps remain vis-à-vis international standards, including in areas such as resolution of problem banks and central bank governance.

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### Energy Resilience

**Investments are needed to let the energy system keep up with growing consumption and take advantage of the export potential**. In particular, assets are old and in poor conditions with 70 per cent of steam and hot water networks older than 25 years, high water losses and 45 per cent of

generation capacity beyond its useful life. In addition, the lack of maintenance and rehabilitation in the sector has caused poor reliability. Equipment is at high risk for collapse.

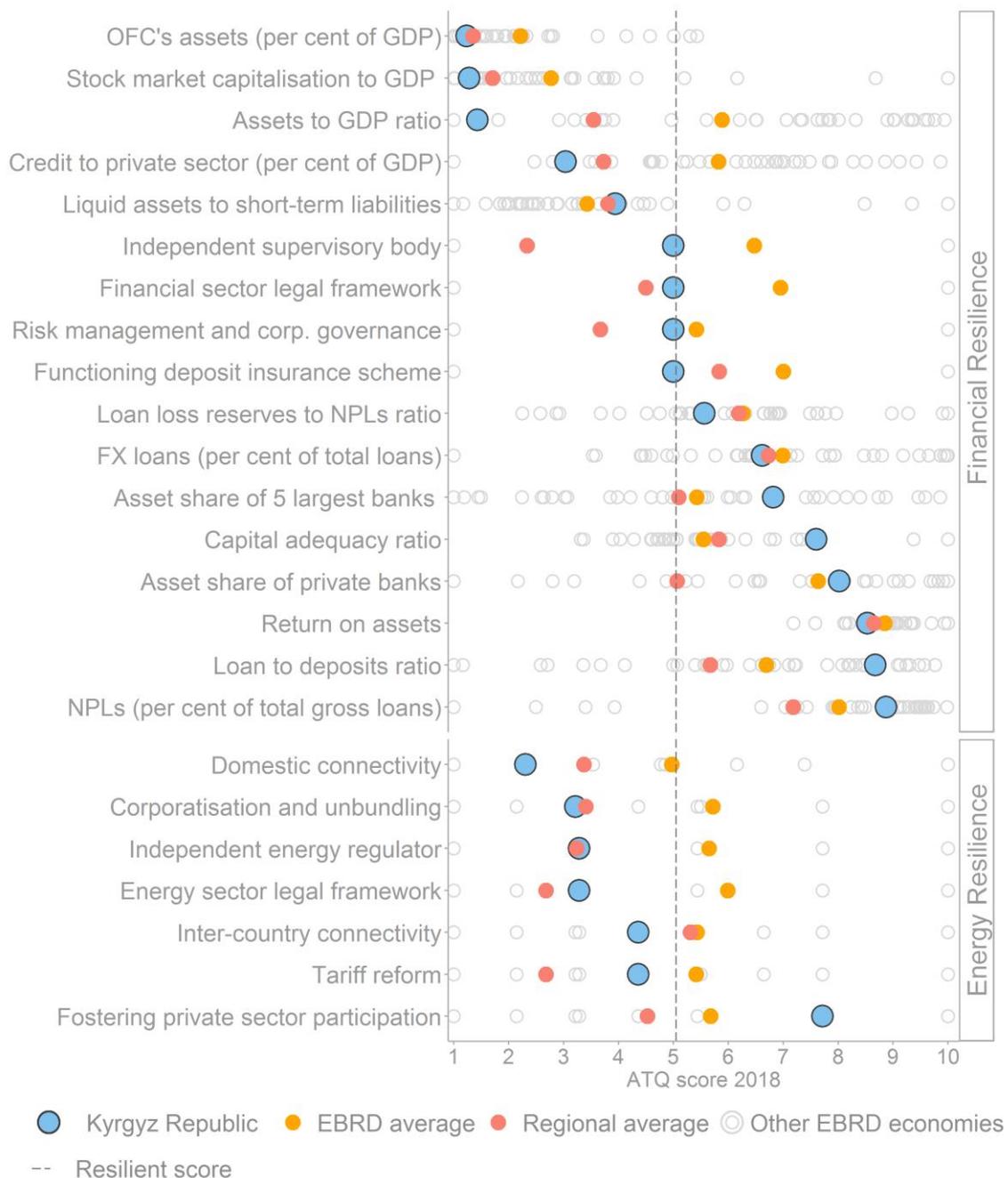
**Electricity and thermal tariffs remain below cost-recovery**. Residential electricity tariffs below 700kWh represent 52 per cent of total consumption and drive the average below cost-recovery tariff (48 per cent of cost-recovery level in 2017). While pumping station and Toktogul district tariffs are also below cost recovery, these tariffs only apply to 5 per cent and 0.4 per cent of consumption, respectively. Finally, large residential consumers and non-residential consumers are in part compensating for the losses with tariffs that are 136 per cent and 193 per cent of cost recovery, respectively.

**Energy sector companies' debt is high and repayment is made difficult due to below cost-recovery electricity and thermal tariffs**. Energy sector companies' cumulative debt reached KGS 96.7 billion as of the end of December 2017 (19.6 per cent of GDP). This debt has grown quickly (compared to KGS 200 million in 2010), due to large projects (mainly on sovereign basis) including the Datka-Kemin transmission line and rehabilitation of Toktogul. Significant under-spending on maintenance and capital improvements, as well as accumulation of accounts payable, implicitly subsidize the sector.

**The Kyrgyz Republic was a net power importer in 2014-2016**. Without a change in tariffs, the electricity sector is forecasted to have a deficit again by 2021, with that deficit growing to KGS 2.7 billion by 2023. Assuming the heating deficit stays close to its current level (KGS 3.84 billion), an overall sector deficit is forecasted in 2018-2023.

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<sup>33</sup> Major indices in the banking sector. National Bank of the Kyrgyz Republic



Source: EBRD.

Note: Visit <https://2018.tr-ebd.com/reform/> for the list of indicators, data sources and methodological notes.

## Integrated [ATQ = 5.12]

**Trade as a share of GDP: 115.6 per cent,** compared to OECD comparator average of 71.4 per cent

**FDI inflows as a share of GDP: 8.1 per cent,** compared to OECD comparator average of 2.1 per cent

**Portfolio inflows as a share of GDP: 0 per cent,** compared to OECD comparator average of 3.0 per cent

**Quality of overall infrastructure: ranked 112th** (index number) out of 152 countries [WEF GCI 2017-2018]

**Logistics performance index: ranked 108th** out of 160 countries [WB LPI 2018]

**Internet users: 34.5 per cent** compared to on average 86.9 per cent in OECD comparator countries

The external integration of the country is higher than the internal integration driven by the close trade links with neighbouring countries and Russia. The country faces challenges regarding its domestic and ICT infrastructure

### External integration

While **trade is positively impacted by the country's geographic attractiveness and low non-tariff measures** (57, compared to 821 in EBRD and above 2,000 in comparator countries), the number of regional trade agreements is low compared to EBRD average. It should be noted that the country ran a significant trade deficit of US\$ 3.1 billion in 2018.

The **high share of net FDI inflows over GDP is mainly driven by mining-related activities.** However, the number of bilateral investment treaties and

treaties with investment provisions is low (33 in force, compared to 65 in EBRD and 116 in comparator countries). Some of the treaties have been signed, but are not in force yet.

**Level of capital account openness is low** although higher than the regional average, resulting in a marginal share of portfolio inflows to GDP.

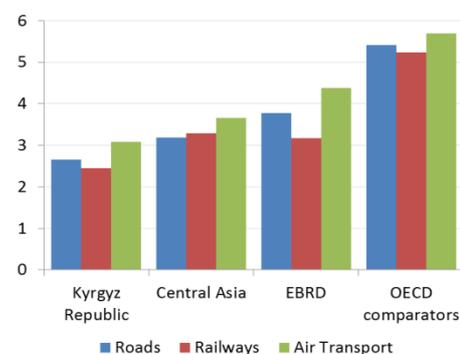
### Internal integration

The **Kyrgyz Republic performs poorly in terms of domestic infrastructure** as measured by the Global Competitiveness Indicators. The situation is worsened by low competence and quality of logistics services.

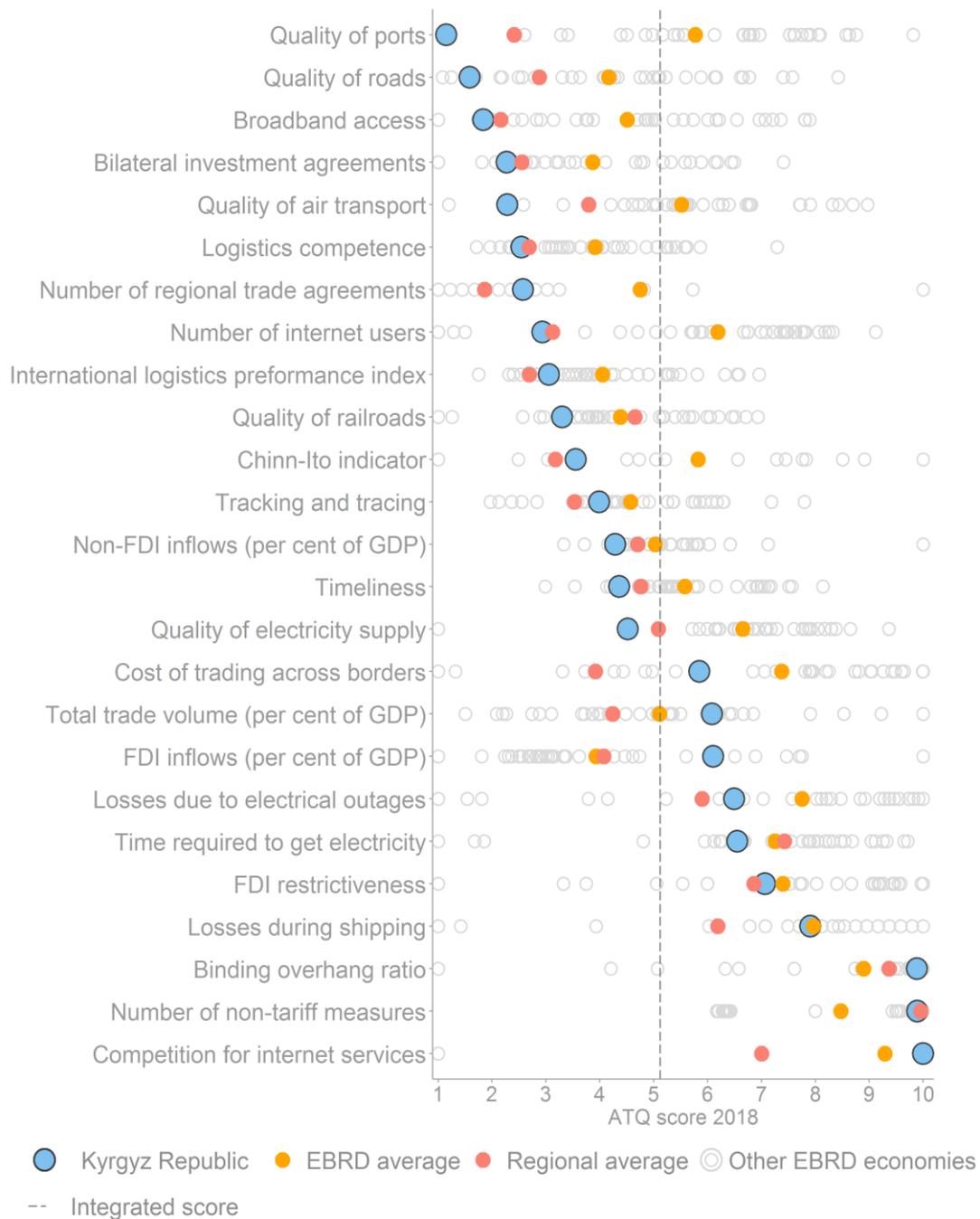
The **country suffers from a low quality of international logistics sector performance** due to inefficiencies in customs and border clearance, quality of trade and transport related infrastructure, and difficulties in arranging competitively priced shipments. Cost of trading across borders is high, but lower than in other Central Asian countries.

The **quality of electricity is low.** Furthermore, the ICT infrastructure is lagging behind EBRD and OECD averages: only 34.5 per cent of people are using the internet, compared to 86.9 per cent in OECD; broadband access is very low.

Chart 17: Quality of infrastructure (GCI 2017-2018)



Source: Global Competitiveness Indicators 2017-2018.



Source: EBRD.

Note: Visit <https://2018.tr-ebd.com/reform/> for the list of indicators, data sources and methodological notes.









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