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**Report No. 20900**

**PERFORMANCE AUDIT REPORT**

**THE KYRGYZ REPUBLIC**

**REHABILITATION CREDIT (RC)**  
**(Credit 2491-KG)**

**and**

**PRIVATIZATION AND ENTERPRISE SECTOR ADJUSTMENT CREDIT (PESAC)**  
**(Credit 2639 -KG)**

**August 28, 2000**

*Operations Evaluation Department*

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## Currency Equivalents

Som per US \$1, Period Averages

1993	=	5.9	1996	=	12.8
1994	=	10.8	1997	=	17.4
1995	=	10.8	1998	=	20.8
			1999	=	42.7 (Sept. 99)

**Government Fiscal Year:** January 1 – December 1

## Abbreviations and Acronyms

APEAC	Agricultural Privatization and Enterprise Adjustment Credit
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
CIS	Commonwealth of Independent States
CPA	Country Procurement Assessment Report
FXC	Foreign Exchange Component of the RC
ERRA	Enterprise Reform and Resolution Agency
ESAF	Enhanced Structural Adjustment Facility
ESW	Economic and Sector Work
FINSAC	Financial Sector Adjustment Credit
FSU	Former Soviet Union
FY	Fiscal Year
GOSKOMINVEST	State Committee for Foreign Investments and Economic Assistance
GOK	Government of the Kyrgyz Republic
GDP	Gross Domestic Product
ICE	International Competitive Bidding
ID	Institutional Development
ICR	Implementation Completion Report
IDA	International Development Association
IMF	International Monetary Fund
LLMEs	Large Loss-Making State Enterprises
MOF	Ministry of Finance
NBK	National Bank of the Kyrgyz Republic
OED	Operations Evaluation Department
PR	President's Report
PESAC	Privatization and Enterprise Sector Adjustment Credit
PIC	Pre-Identified Imports Component of the RC
RC	Rehabilitation Credit
SDR	Special Drawing Right
SOE	State-Owned Enterprise
SPF	State Property Fund
SSE	Small Scale Enterprise
STF	Systematic Transformation Facility of the IMF
TA	Technical Assistance
TAC	Technical Assistance Component of the RC
TACIS	Technical Assistance for the CIS from the European Union

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Operations Evaluation

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## MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

### **SUBJECT: Performance Audit Review on Kyrgyz Republic Rehabilitation Credit (Credit 2491-KR) and Privatization and Enterprise Sector Adjustment Credit (Credit 2639-KR)**

This is the Performance Audit Report (PAR) on these two credits, each for an amount of US\$ 60 million equivalent. The Rehabilitation Credit (RC), approved in May 1993, was the Bank Group's first operation in the Kyrgyz Republic. It was fully disbursed and closed in December 1996, six months behind schedule. The Privatization and Enterprise Sector Adjustment Credit (PESAC), approved in June 1994, was the first of a series of adjustment operations. It was fully disbursed and closed on schedule in December 1995. Both credits were extended at a time when the country's economy was in virtual free-fall.

The main objective of the RC was to support the government's overall reform program and provide balance of payments support. The project included a technical assistance (TA) component of \$7 million intended to support studies and consultant services, \$33 million earmarked for a positive list of "critical imports" and \$20 million for other imports, using a "negative list" component. The last two components were intended to provide quick-disbursing balance-of-payments support. While no formal policy conditionalities were involved, a condition of Board presentation was the conclusion of an IMF-supported stabilization program. The RC's President's Report included a "Memorandum of Economic Reform Policies" laying out in general terms the government's reform program.

RC implementation provided resources that were important to the stabilization program, served as an instrument for developing a market for foreign exchange, provided an entry point for policy dialogue, sent a signal to the Government and incipient private sector that the Bank would be a major supporter of the reform program, and catalyzed assistance from other donors. During the period of project implementation, the government moved ahead with its reform program at a satisfactory pace.

On the other hand, RC implementation involved some weaknesses: the positive list proved cumbersome to administer and did not successfully earmark funds for "critical" imports, owing to the ad hoc way in which expenditure priorities were set; neither the budget nor the price system served to ration resources efficiently; and TA was under-managed and failed to realize its potential to design and fund important studies, advisory services, and institutional strengthening measures.

The RC's outcome is rated as marginally satisfactory, institutional development impact as modest and sustainability uncertain. Both Bank and Borrower performance were satisfactory under difficult country circumstances in which both parties were on steep learning curves. Lessons of the RC are (i) resources cannot be expected to be used well when prices are distorted and budgeting and expenditure control systems are weak; and (ii) flexible "umbrella" TA programs call for strong management and supervision.

The main PESAC objectives were to accelerate and improve the quality of privatization, by allowing strategic investors to gain majority shares, and to reduce/remove the economic and financial burden on the economy of some 29 large loss-making state enterprises. Other objectives included removing distortions and barriers to private sector development and improving the social safety net system.

The positive aspects of PESAC's outcomes were: substantial privatization took place in a more open and transparent way than previously; some significant new laws were drafted (with USAID playing a useful complementary role); and progress continued during project implementation in stabilization and liberalization.

The weaknesses of PESAC's outcomes were: strategic investors did not materialize and privatization has led to little deep restructuring, and hence little improvement in enterprise performance. The majority of privatized enterprises remain under the control of the same managers that directed them as state-owned entities. Many of the large loss-making enterprises continue to constitute a drag on the economy.

PESAC's outcome is rated as marginally satisfactory, its institutional development impact as modest, and sustainability as uncertain. Bank and Borrower performance are nevertheless rated as satisfactory, as the somewhat disappointing outcome was caused in large part by the inherent difficulties in attracting strategic investors to a country greatly handicapped by its remote geographical location, its small market, high transaction costs and distortions in its economic structure inherited from the Soviet period.

Lessons are: (i) because profit incentives to restructure privatized enterprises have been swamped by dis-enabling factors in the business environment, it is all the more crucial that steps be taken to improve that environment (as recommended by FIAS and the Bank's 1999 Private Sector Review); (ii) stronger enforcement of rules is needed to prevent inside-dealing and other forms of corruption; and (iii) stronger trigger mechanisms are needed to force warranted liquidations and bankruptcies.

Robert Picciotto  
By Gregory Ingram

# CONTENTS

<b>Ratings and Responsibilities .....</b>	<b>i</b>
<b>Preface .....</b>	<b>iii</b>
<b>1. Introduction .....</b>	<b>1</b>
<b>2. Objectives and Design of the Credits .....</b>	<b>2</b>
The "Fit" Between the Projects and bank Strategy .....	2
Objectives and Design of the RC .....	3
Main Strengths and Weaknesses of the RC Design.....	4
Objectives and Design of PESAC .....	4
Main Strengths and Weaknesses of PESAC's Objectives and Design.....	6
<b>3. Implementation and Outcome .....</b>	<b>7</b>
Projected vs. Actual Outcomes.....	8
Poverty, Inequality and Unemployment .....	8
The Rehabilitation Credit .....	10
PESAC Implementation and Outcomes.....	11
<b>4. Bank and Borrower Performance .....</b>	<b>19</b>
The RC: Bank Performance.....	19
The RC: Borrower Performance.....	19
PESAC: Bank Performance.....	20
PESAC: Borrower Performance.....	20
<b>5. Institutional Development Impact.....</b>	<b>21</b>
<b>6. Sustainability .....</b>	<b>22</b>
Commitment to Reform.....	22
Popular Support .....	22
Implementation Capacity.....	22
Economic Growth.....	23
Donor Support .....	23
Conclusion.....	23
<b>7. Lessons of Experience.....</b>	<b>24</b>
<b>Annexes</b>	
A. Basic Project Data Sheets .....	27
B. Kyrgyz Republic at a Glance .....	31
C. Key Economic Indicators, 1991-1999 .....	33
D. PESAC Conditionalities .....	34
E. Executive Summary of the Bank's 1999 Private Sector Review .....	37
F. Comments from the Borrower.....	47

This report was prepared by Robert P. Armstrong (Consultant) and reviewed by Laurie Effron (Task Manager). Dinara Seijaparova and Betty Casely-Hayford provided administrative support.



## Ratings and Responsibilities

### Performance Ratings

	<i>RC (Credit 2491)</i>		<i>PESAC (Credit 2639)</i>	
	<i>EVM</i>	<i>PAR</i>	<i>EVM</i>	<i>PAR</i>
<b>Outcome</b>	HS/S*	MS	HS	MS
<b>Sustainability</b>	Likely	Uncertain	Likely	Uncertain
<b>Institutional Development Impact</b>	Substantial	Modest	Substantial	Modest
<b>Bank Performance</b>	Satisfactory	Satisfactory	HS	Satisfactory
<b>Borrower Performance</b>	Satisfactory	Satisfactory	HS	Satisfactory

\*The ICR for the RC had two outcome ratings: HS for "policy outcome" and Satisfactory for the outcome of the pre-identified imports and TA components. It was the HS rating that was recorded in the OED database.

EVM = Evaluative Memorandum

PAR = Performance Audit Report

HS = Highly Satisfactory

MS = Marginally Satisfactory

### Key Project Responsibilities

<i>RC</i>	<i>TM</i>	<i>Division Chief</i>	<i>Director</i>
Appraisal	Kutlu Somel	K. Yurukoglu	Russell Cheetham
Completion	Nancy Cooke	K. Yurukoglu	Yukon Huang
<i>PESAC</i>	<i>TM</i>	<i>Division Chief</i>	
Appraisal	Aynur Sumer	Michael Gould	Russell Cheetham
Completion	Aynur Sumer	Michael Gould	Yukon Huang

ICR for RC was prepared by: Nancy Cooke

ICR for PESAC was prepared by: Aynur Sumer



## **PREFACE**

This is a Performance Audit Report (PAR) on the Rehabilitation Credit (RC) for an amount of US\$60 million equivalent and on the Privatization and Enterprise Sector Adjustment Credit (PESAC) also for an amount of US\$60 million equivalent. The RC, approved in May 1993 and closed in December 1996, was the Bank Group's first project in Kyrgyzstan. PESAC, approved in June 1994 and closed in December 1995, was the first of a series of policy-based, quick-disbursing, adjustment operations.

The findings, evaluation criteria, and ratings for both projects in this PAR differ from those in the ICRs and Evaluation Memoranda (EVMs). The ICR for the RC rated the pre-identified imports and Technical Assistance components as satisfactory and the policy outcome as highly satisfactory; the EVM for the RC retained a highly satisfactory rating for the outcome. For the PESAC's outcome, both the ICR and the EVM rated it as highly satisfactory. For reasons explained in this report, the PAR finds the outcome of both the RC and the PESAC to be marginally satisfactory.

The PAR is based on the Implementation Completion Reports (ICRs) prepared by the Europe and Central Asia Regional Office (dated May 30, 1997 for RC and June 16, 1997 for PESAC), President's Reports for the projects, the legal documents, summaries of Board discussions, project files, related economic and sector work, and discussions in/from Washington with Bank and IMF staff and others.

An OED mission visited the Kyrgyz Republic in May 1999 to discuss the effectiveness of Bank's assistance with government officials, representatives of civil society, and other donors. The kind cooperation and assistance of all those who contributed information, reflections, and insights are gratefully acknowledged.

Comments from the Borrower are in Annex F to this report.



## 1. INTRODUCTION

1.1 Kyrgystan<sup>1</sup> became independent and joined the CIS in 1991. It joined the IMF in May 1992 and the Bank<sup>2</sup> in September 1992. Both the RC and PESAC, approved in 1993 and 1994 respectively, were launched at a time when the economy was in free-fall.

1.2 Between 1990 and 1994, real output in agriculture fell by 45 percent and industrial output fell by 60 percent. These declines were far more severe than in the Central European countries. Explicit budgetary subsidies from the Soviet Union averaging 10-13 percent of GDP before independence had ceased and by 1994 the terms of trade deteriorated by 40 percent and the volume of trade declined to only 40 percent of its 1990 level. The balance of payments, budget, and all sectors of the economy were in extreme crisis. Inflation in 1992-93 averaged about 1000 percent and poverty increased markedly.

1.3 In the face of these shocks, Kyrgyzstan became an early and relatively active reformer. Even before it joined the Bank, progress had been made on the political front in moving towards democratization and on the economic front in taking initial steps towards becoming a market economy. Kyrgyzstan's failure to make progress in macroeconomic stabilization in 1992 was largely for reasons beyond the government's control.

1.4 Thus, at the time of Kyrgyzstan's joining the Bank in September 1992, the country was deemed by the Bank and other donors to be aidworthy. The RC was to be the Bank's first lending operation and PESAC the Bank's first adjustment operation.

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<sup>1</sup> The country's official name has been changed from the Republic of Kyrgyzstan to the Kyrgyz Republic. Since many Kyrgyz officials and others still refer to the country as Kyrgyzstan, that name will be used interchangeably with the more formal name of Kyrgyz Republic

<sup>2</sup> All lending to Kyrgyzstan to date has been IDA lending. Any references in this report to World Bank (or Bank) should be understood to mean only IDA activities.

## 2. OBJECTIVES AND DESIGN OF THE CREDITS

### The “Fit” Between the Projects and Bank Strategy

2.1 An important question regarding the objectives and design of both credits is how well these “fit” with the Bank’s country assistance strategy.<sup>3</sup> The Bank’s involvement in Kyrgyzstan began in 1992 with a number of economic missions leading to a CEM and a Bank-led CG meeting in December 1992. Preparatory work on the RC began in May 1992, several months before Bank membership.

2.2 The initial months—indeed the initial years—of the Bank’s involvement in Kyrgyzstan entailed steep learning curves all around. The Bank started in 1992 to learn about Kyrgyzstan and its particular political, social and economic structures, its institutions, and its ways of doing business. Similarly, the Kyrgyz authorities started learning the ways of both market capitalism and foreign aid donors. And while some lessons of experience regarding how to manage the transition were starting to appear, it was unclear how robust and how replicable across countries those lessons might be. Reforms were well underway by 1992, but neither the authorities nor the donors purported to have a blueprint for undertaking the transition.

2.3 Thus, when preparation of the RC began in May 1992, the Bank had neither a country team nor a “country assistance strategy” within which to frame the project’s design. Rather, both the strategy and the project emerged more or less simultaneously up to April 1993 when the President’s Report (PR) for the RC was issued. That PR contained a substantial section entitled “IBRD/IDA Country Assistance Strategy” that was subsequently referred to as the first (de facto) CAS for Kyrgyzstan.

2.4 The second CAS for Kyrgyzstan was not prepared until 1995. The 1993 PR/CAS therefore set the strategic context for the PESAC as well as the RC. A key statement in that document was the following: *“As the situation evolves and greater understanding of the country is gained, the most important task for the [Bank’s country assistance] program is to remain open to new ideas and to have the flexibility to adapt to changing conditions.”* In other words, the approach adopted was a “process” rather than a “blueprint” approach in which Bank lending and non-lending services were to be “concentrated” upon:

- macroeconomic stabilization through balance of payments support
- enterprise restructuring, privatization and financial sector reforms
- social safety net
- institution building and reinforcement of the Government’s implementation capacity, including establishment of an agency to manage external assistance
- sectoral operations in agriculture, infrastructure, mining and environment.

2.5 The RC concentrated upon the first and fourth of these objectives. PESAC was concentrated upon the first three.

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3 This PAR does not directly address the question of how appropriate was the Bank strategy to the country’s needs throughout the 1990s. That will be the central question addressed in a forthcoming OED CAE on Kyrgyzstan.

## Objectives and Design of the RC

2.6 The RC had the same objectives and design as a number of other rehabilitation loans to FSU countries in the early 1990s. These were low/no conditionality, balance-of-payments support operations with both positive and negative lists. They were intended to encourage and support fledgling reform programs. The RC also had a TA component. Common initial conditions of countries receiving these loans were, as in Kyrgyzstan, large external shocks, rapid GDP decline, fiscal crisis, rapid inflation, and increasing unemployment and poverty in institutional settings characterized by huge reform needs and limited implementation capabilities.

2.7 Relative to the other countries, Kyrgyzstan was among the hardest hit by terms of trade and Soviet subsidy losses. It was also one of the earlier and more committed reformers in terms of both economic and political liberalization. For example, reforms undertaken in 1992, before the RC, included a quick start on privatization (mainly SSE in trade and services), removing barriers to private sector participation in trade and distribution, tax reforms (in appropriate anticipation of the collapse of the revenue base), and substantial price de-control.

2.8 As with the other rehabilitation loans, the RC was intended to be mainly a quick-disbursing operation, without tranching and associated conditionalities, in support of a fledgling reform program outlined in a "Memorandum of Economic Reform Policies" attached to the PR. This Memorandum did not include a policy matrix.

2.9 **Components:** Of the \$60 million credit, \$33 million was designated for "pre-identified imports" (the positive list), \$20 million for the "foreign exchange component" (the negative list), and \$7 million for a TA component.

2.10 The notion was that, even though no real budgetary or procurement systems were in place and resources were fungible, IDA could earmark \$33 million for selected specific "critical imports" to maintain production in key SOEs. The \$20 million component was intended to "stimulate foreign exchange markets and enhance private sector [as well as public sector] access to foreign exchange" by providing foreign exchange through auction sales in the interbank market.

2.11 The TA component was intended to constitute a flexible source of funds for studies and advisory services in a number of areas including enterprise restructuring/liquidation, privatization, agriculture, mining, financial sector reform, legal reform, PSD, and health sector policies. As such it was a multi-sector "umbrella" TA component.

2.12 **RC Conditionalities:** There were no formal policy conditionalities. The de facto and prior conditionalities were that (i) the government continue to make progress on privatization and other key reforms, which it did; and (ii) an IMF stabilization program be in effect at the time of Board presentation, which it was.

2.13 The RC's submission for Board approval was delayed in 1992 because the ruble zone was in disarray and it became an IMF condition that Kyrgyzstan establish its own national currency, the som, before Board presentation of the IMF program. Establishment of the som and Board approvals of the IMF Standby and the Bank's RC all took place in May 1993.

## Main Strengths and Weaknesses of the RC Design

2.14 In OED's judgment, the main **strengths** of the RC's design were:

- importance of RC's resources for the stabilization program
- RC's role in making a place for the Bank at the policy table
- RC's role in catalyzing assistance from other donors
- provision of TA resources that could be allocated flexibly to key areas where policy advice and institutional development were needed, including establishment of GOSKOMINVEST, the new agency for managing foreign assistance and investment
- focus on strengthening procurement capabilities

2.15 The main **weaknesses** of the RC's design were:

- an inherent inability of either the government or IDA to ensure in 1993-94 that the quick-disbursing RC resources would be well used in a context where budgetary processes and controls were extremely weak, where prices were highly distorted, and where many enterprises seeking to acquire additional resources were neither financially nor economically viable.
- earmarking resources for a positive list in this context, thereby trying to micro-manage those resources rather than improving macro-management through the budget and other instruments
- insufficient recognition of the difficulties of managing effectively an umbrella TA operation of this sort.
- the lack of performance indicators

2.16 **Quality at entry:** By normal Bank standards, on balance the quality at entry was poor. The quick-disbursing components of the project were geared more to keeping afloat a foundering economy than to restructuring and downsizing into a more viable economy. RC was more a life-support than a rehabilitation operation, and the project documents did not identify the substantial risks that the RC's resources might be hijacked or largely wasted, for example by financing inputs of enterprises that no longer had a market for their production, or find their way into capital flight or consumption by the relatively rich.<sup>4</sup> On the other hand, it must be recognized that "normal" standards are not fully applicable to a situation in which the Borrower, as a newly independent country, was struggling to formulate a reform program with limited policymaking capacity, weak and inappropriate institutions, and little exposure to international institutions or the ways of market economies. On the Bank's part, staff faced a poverty of economic, financial and institutional analysis/information and considerable logistical difficulties and cultural and linguistic differences. In those circumstances, with the economy in free-fall, it was appropriate to support the reform program without specific policy conditionalities and tranching, and it was appropriate to try to improve the information base and foster institutional development through the project's TA components.

## Objectives and Design of PESAC

2.17 As the Bank's first adjustment operation in Kyrgyzstan, PESAC was mainly geared, as its name implies, to accelerate the pace and improve the quality of privatization and enterprise sector

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<sup>4</sup> The questions of whether and how the project could/should have been designed differently to mitigate these risks, and of which risks proved to be the most real, are discussed in Sections 3 and 4.

adjustment. Key elements included (i) accelerated implementation of mass (voucher) privatization; (ii) making room for strategic investors to be majority owners of privatized enterprises; and (iii) establishment of the Enterprise Reform and Resolution Agency (ERRA) as an autonomous agency to restructure/liquidate up to 30 large, loss-making enterprises (LLMEs). Important complementary objectives were to support substantial trade and price liberalization measures that would improve private sector development.

2.18 As the PESAC ICR pointed out, before the PESAC was approved in 1994 Kyrgyzstan had moved rapidly on some fronts of privatization but “little progress had been made to transform either the newly privatized enterprises, or those which were still state-owned, into efficient economic entities. The (then) existing privatization strategy, based on transferring large blocks of shares to existing managers and workers collectively was not conducive to improving efficiency in privatized enterprises, as it gave control to those [insiders] who were most inclined to resist painful restructuring and labor shedding.”

2.19 The insiders (labor collectives and managers) were also found to be stripping assets, neglecting asset maintenance, and awarding themselves bonuses and other benefits. All this “contributed to a widespread perception of unfairness with a potential to jeopardize political support for privatization.”

2.20 PESAC’s principal objectives, as articulated in the PR, were to: reduce the role of the state through privatization; improve the governance of enterprises; reduce economic and financial costs of large and inefficient SOEs through liquidation or passive restructuring; improve the enabling environment for PSD by reducing market imperfections, price and trade distortions and barriers to entry and exit; and ease the social costs of adjustment.

2.21 An extremely important element of the Government’s “new privatization strategy” adopted in 1993 was the provision that competitive methods would be used for all forms of privatization, with small-scale enterprises to be privatized through competitive bids and cash auctions and medium- and large-scale enterprises to be privatized according to a formula by which (i) 5% of shares would be allocated to members of workers’ collectives; (ii) at least 25% of shares would be auctioned off against vouchers; and (iii) up to 70% of shares would be offered through competitive tenders to strategic investors.

2.22 *Conditionalities:* PESAC’s conditions for Board presentation and second tranche release are in Annex D. Among the more important second tranche conditions were:

- quantitative targets for both voucher and auction privatizations managed by the State Property Fund (SPF);
- enforcement of a “hard payment” system for 29 loss-making SOEs put under ERRA (to be reflected in no further accumulations of inter-enterprise arrears or debt to the banking system or Government);
- preparation of “viability assessments” of the ERRA enterprises, to guide decisions on whether and how the enterprises were to be restructured or liquidated.

2.23 *TA Requirements:* A substantial amount of TA was required to help achieve the conditionalities, particularly in ERRA and SPF. Since PESAC did not itself include a TA component, it was expected that the TA requirements would be financed partly from the RC’s TA component and partly from USAID’s large program of TA (largely for implementing the voucher privatization program) in the SPF.

## **Main Strengths and Weaknesses of PESAC's Objectives and Design**

2.24 The main **strengths** of PESAC's design were:

- its aim to improve the quality (and not just the quantity and speed) of privatization
- recognition that the ultimate aim of privatization is constructive restructuring
- recognition that strategic investors who would require majority ownership would be crucial
- appropriate limiting of ERRA to "passive" rather than active restructuring, with due regard for imposing hard credit as well as hard budget constraints
- recognition of the social and political implications of privatization and of SOE downsizing and liquidations
- mainly well-conceived conditionalities (except the quantitative privatization targets)
- good coordination with USAID program of TA

2.25 The main **weaknesses** of PESAC's design were:

- unrealistic assumptions about institutional developments associated with the privatization process, including the evolution of ownership of the privatized assets
- insufficient attention to corporate governance and competition policy issues
- ERRA's criteria for selection of firms to include and to be allowed to leave ERRA
- ERRA's insufficient insulation from political pressures, and its lack of firm deadlines for liquidation or privatization of its enterprises.

2.26 **Quality at Entry:** On balance, the quality at entry was best-practice by the standards prevailing when the project was approved in 1994. At that time, the Bank was mainly emphasizing in its privatization projects the objective of accelerating the speed of privatization on the assumption that privatization of whatever quality would create political/economic constituencies that would displace the old nomenclature and resist backsliding into communism.

2.27 PESAC was commendable in focussing equally on the quality of privatization and on the ultimate objective of restructuring. It did not however exhibit "institutional insight" by identifying the risks, for example, that strategic investors might not materialize in the face of Kyrgyzstan's unfavorable investment climate, that investment companies might not play their intended role, or that "insiders" might continue to be retain ownership after privatization--what we know now, with the benefit of hindsight, would turn out to be major risks.

### 3. IMPLEMENTATION AND OUTCOME

3.1 This section includes descriptions of the evolution during the 1990s of some key economic and social variables, in order to set the context of how the economy has performed over the decade. This information is not meant to imply a direct causal link between changes in these variables (such as poverty and income distribution) and the RC and PESAC.

3.2 Since May 1993 when the RC and the first IMF stabilization program were approved, Kyrgyzstan has made significant progress on macroeconomic stabilization and in some areas of structural reform. The first three-year ESAF, launched in 1994, was succeeded by a second ESAF in 1998.

3.3 On the Bank side, following the PESAC's approval in FY94, succeeding adjustment operations were made for agricultural sector privatization (FY95), financial sector adjustment (FY96), budgeting and fiscal management reform (FY97) and social sector adjustment (especially pension reform) in FY98. Another "consolidation" adjustment operation is under preparation.

3.4 Implementation of these programs and projects contributed to reductions in the budget deficit from an average of 14 percent of GDP in 1992-95 to about 10 percent in 1996-98, a decline in inflation from over 1000 percent in 1992 to under 20 percent in 1997-98 (and under 10 percent in 1998 until the Russian crisis hit the Kyrgyz economy) and achievement of substantial real growth in 1996 and 1997 after many years of decline (GDP fell by more than half between 1992 and 1995 alone).<sup>5</sup> (See Table 3.1 and Annex C).

3.5 In the structural areas, privatization of small enterprises was completed quickly, the banking sector was restructured, budgetary procedures were improved, a large number of key laws to create a market-based economy were passed, and the Constitution was amended to allow full private ownership of land.

3.6 At the same time, however, the country has become highly dependent on foreign aid, the deficit on the external current account remains high, the foreign debt burden is increasing rapidly, the fiscal deficit is problematic, implementation of structural reforms is incomplete, the rule of law is still weak, and the shadow economy is estimated to constitute about half the entire economy. Poverty is pervasive and income distribution has widened markedly. In some respects, too, performance deteriorated in 1999 as allegations of high-level corruption and other factors led to government turnovers and delays in decision-making.

3.7 The RC and PESAC themselves had only small effects on the above outcomes. In OED's judgment, the ICRs for both projects tended to attribute to these projects, directly or indirectly, too much credit for a variety of positive outcomes. By the same token, care must be taken not to attribute too much "blame" to individual projects for shortcomings (e.g. in the outcome of privatization) that are the consequence of many factors. For any adjustment operation, of course, the ultimate objectives are fostering economic growth and poverty reduction. But since

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<sup>5</sup> In the latter half of 1998 and in 1999, well after both projects had closed, there was a deterioration in indicators of growth, poverty, inflation, and fiscal balances. This is discussed in the section on sustainability.

individual projects such as these can have only very marginal impacts on these ultimate objectives, their performance needs to be judged mainly in terms of the extent to which more proximate and intermediate objectives were realized. The following review of the implementation and outcomes of the RC and PESAC projects is selective. Particular attention in the succeeding discussion is given to the outcomes of the privatization and ERRA components of PESAC.

### **Projected vs. Actual Outcomes**

3.8 The PRs for both the RC and PESAC contained projections of only a few macro-level variables. Table 3.1 shows the actual outcomes compared with what was projected. The striking finding here is how optimistic were the projections, relative to the realities, for turning around the GDP decline and reducing fiscal and external deficits. The RC projections were made in 1993 and the PESAC projections in 1994. Yet while the RC PR projected 1994 GDP growth at between –1 percent and +1 percent and the PESAC PR projected 1994 GDP growth at –5 percent, the actual growth for that year was –20 percent.

3.9 One lesson to be drawn from the exceptionally large discrepancies between what were projected as likely outcomes and what were the actual outcomes is that, for transition countries such as Kyrgyzstan, macroeconomic projections are prone to an exceptionally high margin of error. This reflects a number of factors including the country's susceptibility to unpredictable exogenous shocks, shortcomings of national accounts and other data, and a basic lack of knowledge about how the economy really functions.

### **Poverty, Inequality and Unemployment**

3.10 *Poverty:* Kyrgyzstan was one of the poorest republics in the FSU, and poverty has undoubtedly worsened since independence along with the large falls in GDP and social welfare expenditure. A recent poverty study estimated that in 1997 52 percent of the population lived below the poverty line, with 19 percent in extreme poverty.<sup>6</sup> Over 80 percent of all poor and close to 90 percent of all extremely poor people live in the rural areas.

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<sup>6</sup> "Update on Poverty in the Kyrgyz Republic, Discussion Draft", DECRG, World Bank, Feb. 1999; According to another source ("Presentation by the Prime Minister on Preparation of the CDF", June 9, 1999), "about 70 percent of the population...lived below the poverty line."

**Table 3.1: Projected vs. Actual Outcomes**

	1992	1993	1994	1995	1996	1997	1998
GDP Growth, annual real,	percent						
RC	-24 est	-16	-1 to 1	3 to 5			
PESAC			-5	0	3		
Actual	-14	-16	-20	-5	7	10	2
Inflation end year,	percent						
RC <sup>a</sup>	1660	380	50 to 30	..	..	..	..
PESAC <sup>b</sup>	..	..	..	..	..	..	..
Actual <sup>c</sup>	1260	767	96	32	35	15	18
Fiscal Balance	percent of GDP						
RC	-15	-7	-7 to -5	-5 to -4			
PESAC	..	..	-7	-6	-6		
Actual	-17	-14	-12	-17	-9	-9	-11
Current Balance	percent of GDP						
RC	-6	-20	-18	-13 to -5 <sup>d</sup>			
PESAC	..	..	-8	-7			
Actual	-6	-17	-11	-17	-24	-8	-22
Change in Gross Reserves (\$m)	US\$m						
RC	..	18	20		30 to 40		
PESAC	..	27	19	28	21		
Actual	..	..	50	27	6	75	-6
Direct Foreign Investment (\$m)	US\$m						
RC	..	2	2		10 to 30		
PESAC	..	..	15	25	25		
Actual	..	10	45	96	46	83	29

<sup>a</sup> retail prices<sup>b</sup> GDP deflator<sup>c</sup> CPI% increase, end year<sup>d</sup> range for 1995-98<sup>e</sup> 1997

3.11 *Inequality*: The Gini coefficient for 1997 was estimated at 0.41. The data on trends are inconsistent, but in the late 1980s the Gini coefficients for socialist economies averaged 0.23 points and a new study suggests that Kyrgyzstan's Gini coefficient **increased** by over 0.25 points, i.e. by more than in any other transition country. Levels and trends such as these have large implications for political and social stability.

3.12 *Unemployment* is a serious problem notwithstanding an official average of only around 3-4 percent. This number includes only workers receiving unemployment benefits. Household survey data point to an unemployment rate of about 20 percent, a figure that would be higher still had there been as much downsizing of government and SOEs as efficiency objectives warrant.

## The Rehabilitation Credit

3.13 The main problems in the RC's implementation were that: (i) the PIC component (the positive list) proved very difficult to administer (which should have been predictable); (ii) as the ICR acknowledges, it is unlikely that the RC affected the overall composition of imports, owing to the ad hoc way in which expenditure priorities were set; and (iii) the TA component of \$7 million was under-managed, and failed to realize its potential to design and fund important studies, advisory services, and institutional strengthening measures. On the policy side there was, as noted above, good progress on stabilization and liberalization and less progress on other fronts, but in the absence of policy conditionalities there were few policy implementation issues per se. The project did however open the door to a general policy dialogue that was intensified in the course of preparation of succeeding adjustment operations that did entail policy conditionalities.

3.13 According to the RC's PR, the RC "would allow increased production and capacity utilization through the provision of resources to finance critical imports of inputs, raw materials, spare parts and services." In reality, the funds being fungible, it is difficult to ascertain to what extent the RC financed "critical" imports, or "not-so-critical" imports or international reserves accumulations.<sup>7</sup> Based on interviews with government officials involved in allocation decisions in 1993-94, a consideration of the "counterfactual" (i.e. the situation in the absence of the RC) suggests that the credit's proceeds found their way into some combination of "not-so-critical" imports and reserve accumulations.<sup>8</sup>

3.14 Because of the implementation difficulties, actual use of the PIC was only \$14 million against an allocation of \$33 million. The unused portion was (appropriately) shifted from the positive to the negative list. In the event, delays in implementation of both the positive list and TA components caused the cumulative disbursements at end-FY 94 to be only \$39 million, as compared to targeted disbursements of \$55 million. The credit was however fully disbursed by FY97, with only a six-months delay in credit closing.

3.15 With regard to the RC's TA component, this was supply-driven, with little ownership on the GOK side. As mentioned above, the TA component represented an umbrella "process approach" project that was appropriate in principle but in practice called for strong management and supervision on both sides. This strong management and supervision was not forthcoming, and quality control suffered in consequence.<sup>9</sup> TA resources from the RC were also used for consultants in ERRA, the supervision of whom was taken over by PESAC. Both Bank and Government officials expressed their satisfaction with the diagnostic studies done by these consultants, but not with the business plans.

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<sup>7</sup> At the time, Kyrgyzstan did not have external debt servicing obligations and capital flight seems not to have been an important issue.

<sup>8</sup> In the bidding for scarce forex resources, those SOEs with greatest political "clout" reportedly got additional resources via the IMF and Bank operations that made additional fungible resources available, and in many case those resources served mainly to allow the SOEs to continue production for inventory rather than for sale. The growth effect of such allocations was negligible whereas the welfare effect, via permitting the wage bill to be met, was undoubtedly positive.

<sup>9</sup> Experience elsewhere has shown that intensive supervision is required for such umbrella projects, preferably with substantial participation by a Resident Mission. The Bank did not have a Resident Mission in place in Bishkek until 1995, and the part-time consultant hired to assist with TA supervision was not able to provide the amount of advice and supervision that the project required.

3.16 The PR had envisaged that the project's TA resources would be used for helping the government to design and implement structural reforms in key areas including enterprise reform, privatization and private sector development, the financial sector, social safety net, policy and legislation development in agriculture, mining, procurement, and development of private and public sector capacities in technical and economic analysis, including project preparation, evaluation and implementation. In the event, only a small part of this ambitious agenda was realized. This was partly due to the availability of grant funds from other donors for these purposes. But the TA provided by other donors reportedly had the same management problems as those provided by IDA.

3.17 **Rating the Outcome:** The preceding analysis has identified a number of strengths/successes and weaknesses/shortcomings in both the design and implementation of the RC. As to the RC's outcome, this has to be assessed in the context not only of "before-after" but also of "with-without" the project, i.e. the counterfactual. On balance, it appears that the RC had a slight but positive effect on the pace of policy reform, a very modest impact on institutional development (see discussion in Section 5) and only a marginal effect on production and welfare through the resource transfers.<sup>10</sup> On balance, the outcome is rated "marginally satisfactory", in contrast to the "highly satisfactory" rating of the EVM (it should be noted that the ICR for the RC had two outcome ratings: "highly satisfactory" for the "policy outcome" and "satisfactory" for the outcomes of the positive-list imports and TA components). The main benefit of the quick-disbursing components seems to have been the "signaling effect" that donors would provide substantial resources if the government continued to implement a reform program along donor-approved lines. In retrospect, however, it seems that this objective—insofar as it was an appropriate objective—could have been achieved at substantially lower cost.

### **PESAC Implementation and Outcomes**

3.18 In assessing the outcome of the PESAC project, OED's focus is mainly on whether the project served (i) to reduce significantly the role of the state; (ii) to foster restructuring of the privatized enterprises that would improve enterprise performance (as measured by various indicators of restructuring and firm performance); (iii) to impose truly hard budget and credit constraints on the large loss-making enterprises and so eliminate their drag on the economy, whether via liquidation or privatization (as indicated by their profit and loss accounts, indebtedness and other financial indicators; and (iv) to improve the enabling environment for PSD (as indicated by evidence on private investment, foreign direct investment, entry of strategic investors, surveys of businessmen, etc.).

3.19 **Major Sources of Findings:** A study<sup>11</sup> issued in April 1999 provides an extensive assessment of the outcomes to date of both the policy and institutional reforms and the

<sup>10</sup> The Region has commented, "The Department believes that OED's assessment of the RC's contribution to policy reform as 'slight but positive' (paragraph 3.17) does not do full justice to the richness of the policy dialogue that was carried out under the RC umbrella. This work shaped future Bank operations in many areas, notably, banking sector restructuring and land and agrarian reform. The ICR does not lay claim to full credit for revamping the policy agenda, but does acknowledge its contribution to building its foundation. Moreover, the Department believes that the contribution of the technical assistance component is similarly under-recognized. The PPAR itself notes the achievements of the ERRA program but does not take adequate note that the TA for this endeavor was financed and administered under the RC umbrella. Nor does the PPAR adequately, in the Department's view, recognize the significant contribution to the legal reform process, through its support for the development of a significant body (more than 20 laws and codes) of new economic legislation."

<sup>11</sup> "Kyrgyz Republic: Private Sector Review in the Transitional Era", World Bank Report No. 18121-KG, April 1999. 146pp. The Executive Summary of this report is provided as Annex H of this PAR.

privatization program supported by PESAC. That study's findings were to a large extent based upon a survey of 233 privatized enterprises comprising a sample from a list of 1200 enterprises that had gone through coupon auction. Greenfields private firms were also surveyed but enterprises still majority-owned by the state were not.<sup>12</sup> Another valuable study<sup>13</sup> that did survey Kyrgyz SOEs as well as privatized firms (thereby facilitating some counterfactual analysis) also constitutes an important source for this PAR.<sup>14</sup>

**3.20 The Privatization Program and Associated Legal/Policy Reforms.** Before PESAC, Kyrgyzstan had implemented a small-scale privatization program without much donor involvement. The second stage, supported by PESAC, was a mass privatization program for most medium and large-sized enterprises. A third stage was the privatizing of very large and special enterprises on a case-by-case basis. The small-scale privatization program, which sold off thousands of small businesses and properties, was essentially completed before PESAC. Mass privatization started with a voucher privatization program, but cash auctions were used to complete the process.

**Table 3.2: Mass Privatization Program, 1994-97**  
(numbers of enterprises privatized)

	<i>1994-95 Program</i>	<i>1996-97 Program</i>
Small-Scale enterprises		
Number in program	257	95
Number sold	257	58
Medium-Large Enterprises		
Number in program	855	377
of which:		
Number in coupon auction	833	293
Fully or majority privatized	619	307

3.21 Table 3.2 above shows that considerable privatization took place in the mid-1990s, especially under the 1994-95 program supported by PESAC. By the completion of the mass privatization program in mid-1997, 926 medium and large companies had been placed in full or majority private ownership, with an additional 164 less than 50-percent privatized. By the end of 1997, the private sector came to represent roughly 60-65 percent of GDP, the highest among all CIS republics, comparing favorably to Russia, Kazakhstan (both at 60 percent), Ukraine (50 percent), Uzbekistan (45 percent) and Tajikistan (20 percent).

3.22 Implementation of the voucher privatization was assisted by experts provided by USAID. TA provided by USAID for legal reform was also highly instrumental to the legal reforms targeted by PESAC, e.g. drafting of a company law and several other laws, as PESAC had no TA component of its own.

<sup>12</sup> For this reason, it is not possible to provide as much counterfactual analysis as would be desirable, e.g. to address the question: if PESAC and privatization had not happened (in other words if the privatized firms were still state-owned), how would the outcome(s) likely have been different, if at all?

<sup>13</sup> S. Djankov, "Ownership Structure and Enterprise Restructuring in Six Newly Independent States", *Comparative Economic Studies*, Spring 1999.

<sup>14</sup> Another survey of firms in Kyrgyzstan and other transition countries was made by EBRD for its 1999 Transition Report. Results were not, however, available in time for inclusion in this PAR.

3.23 Table 3.3 below shows the structure of ownership, by sector, brought about by the privatizations to 1998.

**Table 3.3: Sectoral Outputs by Form of Ownership, 1998**

Sector	State Non- state Total				State Non-state Total			
	Mixed Private		Private	Total	Mixed Private		Private	Total
	Million soms				Percent of total output in sector			
Industry	1,295	11,472	7,629	20,396	6	56	37	100
Agriculture	390	2,224	6,508	9,122	4	24	71	100
Construction	169	612	602	1,383	12	44	44	100
Transport and Communications	801	1,704	191	2,695	30	63	7	100
Trade and Catering	297	874	15,319	16,489	2	5	93	100
Total	2,951	16,886	30,249	50,086	6	34	60	100

Source: World Bank Resident Mission Calculations based on Natstatcom data.

3.24 In assessing the implementation and outcomes of PESAC in particular and the privatization program that it supported in general, it will be useful to consider in turn the main achievements and main shortcomings, with a view to then “striking the balance” and assigning an outcome rating to the project.

3.25 In general it may be said that the implementation of the PESAC – associated privatization program was carried out fairly successfully but that the outcome has been disappointing. Among the positive aspects of implementation were that:

- PESAC conditionalities were met and the project was disbursed in full and nearly on schedule
- substantial privatization took place during PESAC implementation (see Table 3.2)
- the privatization process was made more open, fair and transparent
- voucher auctions were well organized; 95% of the population received vouchers, of which 80% were used to buy shares
- de-monopolization actions were taken in wholesale trade and trucking
- some significant new laws were drafted (company law, land leasing, joint stock company law, state procurement, bankruptcy)
- progress was achieved during project implementation in stabilization and liberalization, also as noted above

### 3.26 The PESAC Outcomes

Among the more positive outcomes of the PESAC associated privatization program were that:

- subsidies to SOEs were reduced as firms were privatized<sup>15</sup>
- Kyrgyzstan avoided abuses such as Russia’s giveaways and loans-for-shares scheme
- IDA facilitated considerable learning about privatization and private sector development
- privatization was accompanied by some improvements in corporate governance
- privatization led to some firm-level restructurings, largely “defensive restructuring”<sup>16</sup> via output reductions, labor shedding and asset sales.<sup>17</sup>

<sup>15</sup> Unfortunately, no quantitative estimates of the net fiscal or productivity effects of privatization are available.

- the extent of restructuring achieved in Kyrgyzstan compares favorably with that of Russia, Ukraine, and some other CIS countries
- because of trade liberalization, there was much greater access to consumer goods.

Among the less successful or negative outcomes were that:

- strategic investors didn't materialize
- most enterprise shares intended to be available to outsiders were purchased by enterprise management or by individuals and legal entities affiliated with management, i.e. there was mainly insider privatization<sup>18</sup>
- sales proceeds from privatization were inevitably small
- markets for coupons and stocks didn't develop
- while investment funds were not significant (only about one-fifth of vouchers are in the funds), their role is not clear and their accounts are not transparent
- privatization of public utilities (where strategic investors are far more likely to materialize than elsewhere) was delayed
- privatization slowed since 1997, partly owing to unrealistically high reservation pricing, i.e. the government's refusal to sell companies at market prices
- unfulfilled expectations about the benefits of privatization have led to public disappointment and frustration about the outcome of the reform program in general
- serious shortcomings in corporate governance
- very importantly, failure to enforce contracts and new laws
- **most importantly, privatization has led to little deep restructuring, and it is not entirely clear whether there have been positive, negative or neutral net benefits from privatization**

3.27 This last point is the most crucial one for an evaluation of the outcome of the privatization process fostered by the PESAC project. For the key issue is not how much privatization took place, but whether the privatized firms became more successful (efficient, profitable, viable) after privatization, or not. The 1999 Bank Private Sector Review, found that:

3.28 "There are important sectors still run by state-owned monopolies, where competition could be an important stimulus for private sector development. **Little restructuring<sup>19</sup> has taken place at the majority of privatized enterprises, which remain largely under the control of the same managers that directed them as state-owned entities.** (Emphasis added). Foreign investors, who could offer new technologies, modern management methods and access to world markets, are present in only a handful of companies, and the securities markets lack sufficient liquidity to facilitate ownership change. Many new commercial laws have been adopted, but the judicial system is weak and court decisions are often unenforceable, and licensing requirements

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<sup>16</sup> "Defensive restructuring" is distinguished from "deep restructuring" that entails new products or upgrading old products, which in turn entails changes/innovations in management, technology, entrepreneurship, etc.

<sup>17</sup> The 1999 Private Sector Review found that, on average, employment at Kyrgyz firms has fallen by approximately half since their privatization.

<sup>18</sup> Reasons for this were: lack of cash available to the investing public, lack of installment sales arrangements (greater than two months, high minimum sales prices (not eliminated until late in the program), and lack of attractiveness of many companies owing to the nature of their business and/or their high debt levels.

<sup>19</sup> Measures of restructuring covered in the survey included changes in enterprises' cash flows and product offerings, organizational changes, management changes, and changes in corporate governance.

are often excessive. The system of corporate taxation is excessively burdensome and tax administration is frequently perceived as arbitrary. Coupled with managers' fear of outsiders and loss of control, these factors have contributed to the general lack of investment and growth in Kyrgyz firms"(page 2).

3.29 These findings point to a "before/after privatization" conclusion that privatization in Kyrgyzstan has not led to significant changes/improvements in performance of the privatized firms. But what about a "with/without privatization" counterfactual? Would the outcome possibly have been (even) worse in the absence of privatization?

3.30 On this point, Djankov's analysis leads to the conclusion that firm-level performance of the privatized companies was neither better nor worse than the performance of comparator firms that remained as SOEs. In other words, this research suggests that "privatization didn't matter much" for countries such as Kyrgyzstan, as distinguished from Central European countries where privatization was positively correlated with restructuring and improved performance.

3.31 There would seem to be three main reasons, in addition to the ownership structure, why the restructuring needed to render privatization a success in Kyrgyzstan hasn't happened. The first is that there remains a poor overall business and investment climate which includes factors such as the legal framework and enforcement, in the context of which incentives to managers (who are also mainly the owners) to strip assets may swamp incentives to take risks entailed in producing new products or improving the quality of old products. The second is that Kyrgyzstan's geographic isolation, its small market, high transport and other transaction costs, are unfavorable in comparison to other transition countries, especially those much closer to Europe. The third is that Kyrgyzstan's "initial conditions" of industrial structure were unfavorable, given that much of its industry was geared to production of defense and other products aimed at the Soviet market largely disappeared after independence. It was of course a central PESAC objective to foster private sector development both through privatization and through the liberalization and other policy reforms geared to improve the enabling environment. But this is not to say that PESAC is accountable for Kyrgyzstan's failure to make better progress in improving this environment. As noted above a combination of factors, some exogenous, are to blame for the disappointing outcome, and it was undoubtedly unrealistic to expect much restructuring or improved performance in light of the constraints. This does not however change the fact that the outcome has been disappointing. In the light of these considerations, the outcome of the non-ERRA components of the project is found to be (at best) marginally satisfactory.

3.32 **The ERRA Exercise.** When ERRA was formulated as a core component of PESAC, opinion was divided about the desirability of setting up such agencies to handle the disposition of the larger loss-making and highly-indebted SOEs. SOE downsizing or liquidation was seen as potentially politically volatile and their privatization, if feasible, was seen to require "passive restructuring" involving a shedding of their debts and social expenditures (e.g. on schools, clinics and other social programs).

3.33 The dispute revolved around whether agencies could function effectively as "prisons" or "isolation wards", serving through hard budget constraints and other measures to diminish or eliminate their burden on the budget and their crowding out effect on credit and make at least some of them viable for privatization; or whether they were likely to turn into "Club Meds" in which "member" SOEs would fend off liquidation and enjoy more benefits (such as access to loans for working capital) than non-members.

3.34 The direct costs were described in an ERRA report<sup>20</sup> as follows:

**Table 3.4: ERRA Costs by Major Category**

<i>Expenditure Category</i>	<i>\$ millions</i>	<i>% of Total Expenditure</i>
Environment/Safety	1.4	5
Administrative Leave	2.2	7
Social Fund	5.4	18
Social Services	5.8	20
Termination/Wage Arrears	5.0	17
Technical Assistance <sup>21</sup>	0.5	2
Working Capital Loans	9.2	31
Total	29.5	100

3.35 The biggest part of the program was for social expenditure, including the payment of wage arrears and termination benefits, and for working capital loans. The total costs of about \$30 million (as of late 1996) were equivalent to half of the PESAC credit.<sup>22</sup> While the ERRA program was formally terminated in 1997, as of mid-1999 four enterprises had left the ERRA program, the liquidation process was fully completed at eleven enterprises and nearly completed at three and uncompleted at ten.

3.36 Some clear **positive outcomes of ERRA**, particularly during the period of PESAC implementation,<sup>23</sup> were:

- increased high-level attention to and understanding of the financial and economic status of the large, indebted, loss-making enterprises and the need to reduce their drag on the economy
- an initial acceleration in the processes of downsizing and liquidating enterprises
- improved transparency, aided by competent technocratic administration of ERRA
- initial imposition of truly hard budget and credit constraints
- layoffs of 35,000 workers (to date)
- reduced social hardship (and possible avoidance of political unrest) stemming from closures (some temporary) and downsizings, facilitated by ERRA resources allocated to pay wage arrears, separation benefits and other social costs.

<sup>20</sup> "Enterprise Restructuring and Liquidation", Project Implementation Report, Agency for Direct Foreign Investment, a Division of the State Property Fund incorporating ERRA, Bishkek, October 1996.

<sup>21</sup> Total RC TA expenditures were about \$6.9 million, and reportedly a much larger share than the \$0.5 million for TA shown in this table was spent on TA for ERRA. The consultants' diagnostic studies and business plans, etc. probably cost much more than this. This seems to be a major inconsistency which remains to be resolved.

<sup>22</sup> The PR for PESAC did not purport to earmark PESAC funds to finance ERRA. But it was understood that some portion of the additional counterpart funds generated from PESAC would be allocated for ERRA, and in this sense it can be argued that PESAC financed ERRA.

<sup>23</sup> PESAC's role in ERRA effectively ended in June 1995, when its second tranche was disbursed. Subsequent IDA adjustment operations contained conditionalities to keep the pressure on ERRA to move ahead with its viability assessments and liquidations. APEAC included a conditionality requiring ERRA to cease funding of five enterprises.

3.37 Some **shortcomings and less positive outcomes of ERRA** were:

- inconsistent inclusion or exclusion of enterprises into and from the isolation program
- delayed liquidation of many enterprises (partly owing to a reluctance of ERRA's consultants to recommend liquidation)
- few tangible improvements in operational performance in most enterprises
- insufficient removals of non-performing SOE managers
- little improvement in business skills or the business culture with the ERRA firms
- failure to attract any strategic investors to the ERRA firms
- inadequate monitoring and evaluation
- inability of local authorities to adequately finance and maintain divested social services
- financial indicators of ERRA firms, such as rescheduled debts, operating losses, and payables exceeding receivables, suggest weak performance of the restructured firms

3.38 Data on the status of the ERRA enterprises still in operation do not translate easily into a coherent story, but on the whole they seem to confirm judgments formed largely on the basis of the OED mission's interviews that ERRA's achievements fell short of expectations.<sup>24</sup> The paramount objective of cutting operational losses and making the firms "viable" was achieved only partially, and it is not satisfactory that such losses are being financed through continuing arrears accumulations. ERRA was intended to be a model of financial discipline that would send a signal to other SOEs that the imposition of hard budget constraints would be closely monitored and there would be penalties for failure to pursue reorganization. This has not happened.

3.39 **Considering the Counterfactual:** Ideally, an assessment of the net impact of ERRA would include a statistical "with/without assessment" comparing performance (in terms of a number of restructuring indicators such as profitability, labor shedding, and reductions in subsidies relative to state revenue) in the ERRA enterprises and in a group of comparator enterprises of similar characteristics. Only with such a formal analysis can one arrive at robust conclusions about the net developmental impact of ERRA, and answer the question of whether the same (or better or worse) outcomes would likely have been achieved had ERRA never existed.<sup>25</sup> The 1999 report of the Ministry of Industry on the ERRA enterprises does not provide a robust comparative analysis, but it suggests that there was not much difference in the outcomes (as measured by various performance indicators) between ERRA and non-ERRA enterprises. The same conclusion emerged from interviews with Bank and Kyrgyz officials, i.e. that ERRA didn't have a net negative effect, as the Romanian isolation program seems to have had, nor did it have much net positive impact.

3.40 One lesson of the ERRA experience would seem to be that the exit mechanisms need to be hardened. A main weakness of ERRA was that it did not proceed far or fast enough with liquidations. In Bulgaria the isolation program sets clear deadlines for liquidation unless a company is privatized within a stipulated time frame. Such deadlines can have a salutary effect

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<sup>24</sup> One interpretation of the ERRA story is the enterprises were on the whole doing well until the Russian crisis of 1998 set back the progress achieved. It is certainly true that this shock was significant and had repercussions such as making the dollar-denominated debts of the enterprises far more expensive in some terms. But the data show that the results for 1996 and 1997 were also not very satisfactory.

<sup>25</sup> An example of this type of analysis is provided in an article by Simeon Djankov entitled "The Enterprise Isolation Program in Romania", *Journal of Comparative Economics*, 27, 1999. That analysis concluded the Romanian isolation program may have actually delayed restructuring of the enterprises, i.e. had a net negative developmental impact. It would be useful for some donor to commission a similar study to be made of the Kyrgyz isolation program, i.e. the ERRA exercise.

on enterprise managers who may otherwise avoid taking steps to improve operational efficiency. In the case of the ERRA enterprises currently experiencing losses and having debt servicing problems and tax arrears, consideration should be given to such mechanisms.

**3.41 Rating the PESAC Outcome:** On the policy front, the PESAC outcome may be considered to have been satisfactory, as considerable progress was made during the PESAC period on the stabilization and price and trade liberalization fronts. (The IMF took the lead on the stabilization program). On the institutional development front, progress was more mixed, as contracts and laws were unevenly enforced, and progress on the ID front lagged behind progress in privatization per se. Partly owing to the efforts of IDA and USAID, the quality of privatization improved in terms of process (it became more transparent), but not in terms of outcome (it did not lead to deep restructuring). So the outcome of privatization is considered marginally satisfactory. Similarly, the ERRA outcome was not demonstrably better than would have been the case in the absence of ERRA, so in the absence of evidence to the contrary, outcome is considered to be marginally satisfactory. Overall, therefore, the outcome of the PESAC operation is considered marginally satisfactory.

## 4. BANK AND BORROWER PERFORMANCE

### The RC: Bank Performance

4.1 This PAR has found that the RC had serious design defects, (low “quality at entry”), some serious implementation problems, and weak supervision, especially of the TA components. In particular, the “positive list” was ill-considered, the TA was ad hoc and under-managed, and there was high turnover amongst Bank staff involved in preparing and supervising the project, a situation that prevented the supervision process from amounting to much more than monitoring. Hence, the RC was in several respects a “loose” operation. These considerations would ordinarily warrant a “less than satisfactory” rating for Bank performance.

4.2 OED recognizes, however, that the period of the RC’s preparation and implementation was far from an “ordinary” time. In Kyrgyzstan in 1992 and 1993, extraordinary demands were placed on scarce Bank staff with limited country knowledge and no roadmaps for designing and sequencing Bank operations to support the (then) unprecedented political, economic and social transitions that Kyrgyzstan was embarking upon.

4.3 In these conditions, the Bank proved responsive, flexible and pragmatic and the RC played a constructive role in supporting the critical early phase of stabilization through the provision of foreign exchange, which facilitated successful introduction of the new currency and, along with funds from other sources, enabled Kyrgyzstan to maintain higher consumption levels than would otherwise have been possible, while accumulating international reserves. The project didn’t really help “rehabilitate” the economy but Bank staff took a justified risk in taking this plunge. The RC proved to be an important “learning instrument” on both sides and had “externalities” in that regard. On balance, Bank performance on the RC is therefore rated as satisfactory.<sup>26</sup>

### The RC: Borrower Performance

4.4 The Borrower’s performance also has to be evaluated in the context of the times and in the light of extenuating circumstances. As described previously, during the period of RC implementation considerable progress was made on stabilization and liberalization, i.e. in fulfilling the intents in the “Memorandum of Economic Reform Policies”. Procurement arrangements were problematic, but this was more a problem of project design than of unsatisfactory borrower performance. And it was inevitable that there would be delays in matters ranging from consultant TORs to disbursements and audits owing to Borrower’s unfamiliarity with Bank procedures and practices. In fact, the Borrower proved too be a quick learner in most respects, and its overall performance is rated as satisfactory.

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<sup>26</sup> In arriving at this rating, consideration was given to how OED rated Bank performance in similar rehabilitation credits made to other CIS countries in the early 1990s.

### **PESAC: Bank Performance**

4.5 Because OED has found outcome to be marginally satisfactory, it does not follow that the performance of either Bank staff or Government officials was deficient. In retrospect, some assumptions of the model of rapid mass privatization, as applied in Kyrgyzstan and other transition countries, were flawed. It was expected that rapid privatization would (along with progress in stabilization and liberalization) lead to (i) substantial efficiency gains that would in turn lead to economic growth; and (ii) demands by new stakeholders in the market economy for legal and institutional reforms that would, inter alia, ensure sound corporate governance.

4.6 Things haven't worked this way. Neither strategic investors nor investment companies materialized as expected, and the PR made no mention of the risks of asset stripping, perverse incentives, weak implementation of the new company, bankruptcy and other laws, or of how a dis-enabling business environment could swamp incentives for new capitalists to build wealth in their enterprises. Bank staff and Western advisers can be judged, in retrospect, to have been lacking in "institutional insight". But the same can be said of the vast majority of Western and Eastern European experts and advisers, and OED was itself not prepared to recommend preferred alternatives.<sup>27</sup> So by the standards of its time, PESAC's design could be considered "best practice" and its supervision fully adequate.

4.7 The project's marginally satisfactory outcome can be only partly attributed to Bank performance. Many factors other than Bank performance are responsible for the outcome. PESAC represented just one small time slice, albeit a significant one, of the overall privatization process.

4.8 On balance, OED rates Bank performance on PESAC as satisfactory, notwithstanding the disappointing outcome.

### **PESAC: Borrower Performance**

4.9 OED finds that the Borrower's performance in preparation was fully satisfactory. The Government was commendably motivated to accelerate and improve its privatization process and to reduce the drag of its large loss-making SOEs. Ownership was strong albeit narrowly confined to a small group of technocrats and the top political leadership.

4.10 As for covenant compliance, this being an adjustment operation, it is important to note that the Government's compliance with IMF program conditions was fully satisfactory during the period of PESAC implementation. Compliance with PESAC's own covenants was satisfactory and second tranche release was effected with a delay of only three months. Privatization was indeed accelerated and ERRA did indeed take useful actions during the period of PESAC implementation. The project's marginally satisfactory outcome can be attributed in some part to failures of the enabling environment that were in the power of the Government to correct, but the adverse "initial conditions", that were not in the power of the Government to offset, were also important factors. On balance, OED rates Borrower performance on PESAC as satisfactory.

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<sup>27</sup> OED did however issue a 1994 report that recommended against SOE restructurings before privatization.

## 5. INSTITUTIONAL DEVELOPMENT IMPACT

5.1 The definition of institutional development (ID) is “changes in the rules of the game,” inclusive of policy reform, organizational change and/or capacity building. By this definition, the policy and organizational changes **supported by** both the RC and PESAC between early 1993 and mid-1995 were substantial. “Rules of the game” were changed in fundamental ways in terms of replacing a central planning system with a market system, in expanding the role of the private sector, and in public sector management. It is another matter, however, to ascertain how much ID may be **attributed to** the projects.

5.2 The RC was directly associated with significant organizational changes, viz. establishment of Goskominvest to manage foreign aid, introduction of a new system for international procurement, and providing funds for ERRA consultants. The ICR for the RC rated the ID impact of the RC as “substantial” mainly because of the “expertise gained in management of TA and aid coordination, generally, and in international procurement, specifically.” OED agrees with the ICR’s judgment that the project implementation unit did build capacity in terms of management, technical, financial and procurement skills. But many of these skills have since been lost to the agencies where they are most needed.

5.3 In OED’s view the ID impact of the RC was well below its potential, for reasons described in section 3. Hence, OED believes that a rating of “modest” for ID impact is appropriate.

5.4 The ICR for PESAC rated the ID impact as “substantial”, noting that the project “initiated the development of legal, regulatory and institutional environment conducive to PSD”, “turned around” the ERRA enterprises and “thus contributed to improvement in resource allocation, productivity and real growth in GDP”, laid the foundation for a new enterprise culture in a market environment”, and “sent clear signals that a new era was underway in which adherence to strict financial discipline, intolerance to enterprise arrears and the application of insolvency legislation toward unviable enterprises would be the rule.”<sup>28</sup>

5.5 OED's view is that these assertions overstate the extent to which a "new enterprise culture" and an "institutional environment conducive to PSD" have been established, as well as the extent to which the ERRA and privatized enterprises have been "turned around".<sup>29</sup> As for local capacity building, consultants to ERRA did provide useful training to ERRA staff but ERRA has since been disbanded and few of those staff were absorbed into the SPF. On balance, therefore, OED rates the ID impact of PESAC as modest.

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<sup>28</sup> PESAC ICR, paras 32-33.

<sup>29</sup> Reference previous paras, Fine, Aslund, McNulty, Djankov reports.

## **6. SUSTAINABILITY**

6.1 Important “sustainability indicators” for the reforms supported under these two operations are: (i) the country's commitment to, and popular support for, reform; (ii) the government's reform implementation capacity; (iii) a broad-based recovery in output; and (iv) strong donor support. It is useful to consider each of these indicators.

### **Commitment to Reform**

6.2 In the early and mid-1990s the Kyrgyz government—at least in the core team of its high-level leadership—did appear to be strongly committed to reforms supported under these operations, especially in comparison to other Central Asian states of the FSU. The generally good track record of the reforms on trade and price liberalization and the early privatization testifies to the commitment, although it may be questioned to what extent these reforms were donor-driven.

6.3 In the past few years, however, there has been some wavering in the strength of this commitment, as evidenced by a near-halting of privatization, appointments of officials at various levels who appear not to give high priority to implementing further reforms, problems of corruption, and slow progress on associated institutional reforms.

6.4 Some reforms continue, and it is particularly commendable that Kyrgyzstan was admitted in 1999 to the WTO. Moreover, there seems little danger of backsliding on key reforms already undertaken. Nevertheless, with elections in 2000, there remains considerable uncertainty about the strength of the current government's commitment to continue to undertake politically difficult reforms involving expenditure reductions, tax administration, civil service reform, and enterprise restructuring, all of which have an impact on the sustainability of the reforms undertaken, especially under the PESAC.

### **Popular Support**

6.5 The renewal of the government's popular mandate in elections held in 1996 was considered a significant indicator of the sustainability of reform. But true “ownership” of the liberalization and privatization reforms has been limited to a small proportion of the population. Some progress has been made in broadening the base of stakeholders into civil society. On the other hand, Parliament has been obstructing important reforms, and there is popular discontent over declining living standards for most of the population and increased inequality in income distribution. Increasingly, too, questions are being asked by Kyrgyz citizens about what benefits are to show for all the foreign aid received, and debt incurred, since 1993. The near-term strength of popular support would therefore appear to be uncertain.

### **Implementation Capacity**

6.6 Many informed observers of the Kyrgyz scene perceive that the “implementation capacity constraint”, defined here mainly in terms of the quality of public sector management, is a serious one. Although educational skills are plentiful in Kyrgyzstan, there remains a huge mismatch between the skills developed in the Soviet system and those required for dynamic private sector development and effective public sector management.

6.7 Although the government is implementing some donor-funded projects with reasonable effectiveness, it is weak when it comes to implementing core state functions of applying the rule of law, curbing corruption, and administering a fair tax system, all of which are important for providing an enabling environment for PSD. Improving public sector management by a combination of measures to rationalize the utilization of existing capacities, pay civil servants a living wage, and impart new skills and a new ethos to the bureaucracy is a *sine qua non* for sustainability of outcomes related to liberalization and privatization. There is a strong need for future ID reforms and related TA support to be framed in a more strategic context.

### **Economic Growth**

6.8 Renewed growth would itself make some reforms such as enterprise restructuring more feasible and would improve the budgetary situation while at the same time allowing more resources to be spent on needed social and economic infrastructure and on social protection. The strong economic growth of 1996-97 was not maintained as the Russian crisis and continued decline in the price of gold (Kyrgyzstan's main export) severely affected export revenues, contributing to a sharp depreciation in the currency and a collapse of confidence in the banking sector. The current situation is characterized by low growth (projected at 1 percent in 1999), rising inflation (est. 20 percent in 1999), and high deficits.

6.9 Private investment remains low and foreign direct investment is negligible. Given that agriculture accounts for half of GDP and has the clearest comparative advantage, it is essential that growth in this sector become more dynamic. There has been some pickup in agricultural growth, but so far there has been too little farm restructuring and significant distortions remain in agricultural input and well as output markets. The economy remains vulnerable to shocks.

### **Donor Support**

6.10 Strong donor support does seem likely to continue, although some bilateral aid is likely to diminish unless there is a near-term improvement in governance.

### **Conclusion**

6.11 If this section has seemed to "emphasize the negative", it could give the impression that OED considers sustainability unlikely. This is by no means the case. The emphasis here on causes for concern is mainly intended to offset some of what OED considers to have been the too-unqualified optimism of the ICRs that Kyrgyzstan is already on a sustainable path of rapid growth. Kyrgyzstan has made commendable progress on many fronts, and it seems unlikely that past reforms will be reversed. On the other hand, the considerations mentioned above lead OED to rate sustainability of both projects as uncertain.

## 7. LESSONS OF EXPERIENCE

7.1 The following lessons emerge from this review of the RC and PESAC operations:<sup>30</sup>

- **Profit incentives to restructure privatized enterprises can be swamped by dis-enabling factors in the business environment** including distortions and inequities in the tax system, official corruption, and bureaucratic interferences. Kyrgyzstan is already handicapped more than most transition countries by its geographical location, its small market, high transaction costs, and distortions in its economic structure inherited from the Soviet period. These factors make it all the more crucial that its business environment be an enabling one.

Corollary: The government and donors alike should give high priority to implementing recommendations of the 1999 Private Sector Review and other recommendations such as in the FIAS report.

- **Exit incentives are important to get needed restructuring of enterprises incurring persistent losses.** Such incentives, i.e. to accelerate liquidation and bankruptcy procedures in troubled enterprises in both the public and private sectors, have not been effective in Kyrgyzstan.

Corollary: Consideration should be given to making exit decisions less discretionary by adopting trigger mechanisms for initiating bankruptcy and liquidation procedures.

- **Lessons from Kyrgyzstan's privatization and isolation program experiences are not yet as well-identified as they need to be** to guide future actions to liquidate, restructure and privatize SOEs, and to achieve post-privatization restructuring, in Kyrgyzstan. Out of the dozens of interviews conducted and many reports reviewed in preparation for this PAR, surprisingly few clear and robust lessons could be identified, and many of the best-articulated lessons (e.g. concerning correlations between ownership structures and restructuring behaviors) were contradictory.

Corollary: Rethinking privatization to identify lessons from the disappointing experience in most transition countries is now a worldwide growth industry. Such rethinking, with a view to identifying "what next" in completing privatization and accelerating restructuring, is also needed in Kyrgyzstan. To this end, a number of the best-informed observers of, and participants in, the Kyrgyz privatization process and in ERRA could be invited/commissioned by the Government, with donor support, to prepare short papers setting forth their perspectives on the lessons and their implications for future action. These papers could usefully be presented and discussed at a Symposium on "Lessons of Privatization in Kyrgyzstan", to which it would be useful to invite a few privatization and isolation program specialists from other countries.

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<sup>30</sup> The optique underlying the identification of several of these lessons is heavily influenced by that of Bernard Black et al in their paper entitled "Russian Privatization and Corporate Governance: What Went Wrong?", Stanford Law School Working Paper No. 178, Sept. 1999. It is of course recognized that there are huge differences, as well as significant similarities, between the Russian and Kyrgyz experiences with privatization and corporate governance.

- **Serious “transparency” and “ownership” problems in Kyrgyzstan are closely interrelated.** Many Kyrgyz citizens perceive the main outcome of the RC to be increased debt, and the main objective of the PESAC to have been to “kill” Kyrgyz enterprises. This is not just a Bank public relations problem. The broader problem is that neither the citizenry at large nor the Parliament in particular have been well informed about, much less feel themselves to be stakeholders in, the reform process. “Ownership” has been strong at the top and weak below. There is a danger that it may become weaker unless growth accelerates and poverty declines.

Corollary: The Government and donors alike need to do more to acquaint the citizenry and Parliament with the objectives, rationales and modalities of government reforms and donor programs, and most importantly to widen the debate on policy options. The participatory approach of the CDF process should help to serve this purpose

- **Postponed privatization and restructuring in infrastructure is proving costly in many ways,** including adverse effects on the public finances, on production, and on the investment climate.

Corollary: Prompt action on these fronts is imperative.

- **Many government agencies and functions are still more inimical to, than supportive of, PSD. The government remains to be “re-engineered” though a comprehensive civil service reform that addresses this problem head-on.** There remains a serious mismatch between actual governmental functions and interventions (many of which are dysfunctional and inimical to PSD) and governmental capabilities.

Corollary: Designing and implementing such a reform should have high priority, both because the government is failing to deliver quality services where they are most needed (e.g. in the social sectors) while at the same time corrupt and extortionary activities (e.g. unofficial taxation and ad hoc fees) are harmful to the business climate, discouraging foreign and domestic investment, and hurting the country’s growth prospects.

- **Achieving both strengthened PSD and improved public sector management will call for continuing use of substantial amounts of TA which needs to be better managed and better coordinated by both the government and donors.**

Corollary: The CDF should explicitly address a number of TA issues, including, prioritization, absorptive capacity, various instruments and their relative effectiveness, supervision and quality control, and aid coordination. A strategy and action plan is needed for maximizing the relevance, efficacy, and cost-effectiveness of TA.



**Kyrgyzstan- Rehabilitation Credit No. 2491-KG****Cumulative Estimated and Actual Disbursements**

	FY93	FY94	FY97
Appraisal Estimate (US \$M)	10.00	55.00	60.00
Actual (US \$ M)	0.00	39.29	62.30
Actual as % of estimate	0.00	71.00	104.00
Date of final disbursement	April-97		

**Project Dates**

Steps in Project Cycle	Original	Actual
Identification (Executive Project Summary)	April-92	April-92
Preparation	June-92	June-92
Appraisal	October-92	October-92
Negotiations	April-93	April-93
Board Presentation	May-93	May-93
Signing	June-93	May-93
Effectiveness	June-93	July-93
Project Completion	June-96	December-96
Loan Closing	June-96	December-96

**Staff Inputs (Staff Weeks)**

Stage of Projects Cycle	Planned		Actual	
	Weeks	US\$	Weeks	US\$
Preparation to appraisal*	49.0	142.2	48.0	142.2
Appraisal*	58.3	188.4	58.3	188.4
Negotiations through Board approval*	4.3	12.8	4.3	12.8
Supervision	125.6	449.1	113.8	319.8
Completion	--	--	1.6	18.0 <sup>1)</sup>
Total	236.2	792.5	178.0	681.2

\* Planned and Revised data unavailable; actual data used instead.

<sup>1)</sup> As of end March 1997

## Mission Data

Stage of Projects Cycle	Month/Year	No. of Persons	Days in Field	Specialization <sup>1</sup>	Performance Rating <sup>2</sup>		Types of Problems <sup>3</sup>
					Implementation Status	Development Objectives	
Through Appraisal	(1) April-92	21	15	E, R, P, F, A, G, N, I, M, L, S, O, H, C, B, K			
	(2) June-92	15	17	E, B, D, A, L, F, P, L, T, C, H, I			
	(3) October-92	4	7	E, L, C			
	(4) January-93	5	14	E, C			
Appraisal through Board approval	October-92	5	11	E, L, B, F			
Supervision	November-93	4	7	X,B,F	S	S	F,T
	June-94	2	10	X,F	S	S	F,T
	February-95	3	10	X,M,B	S	S	F,M
	July-95	2	3	X,B	S	S	F,M
	November-95	2	10	X,RX	S	S	F
	April-96	4	5	X,B,R,RX,L	S	S	F
	November-96	2	6	X,RX	S	S	
Completion	March-97	2	9	X,E,RX	S	S	
Total							

Note: some specialists (e.g., the lawyer, and PESAC Task Manager, etc.) reviewed components related to their scope of work during other operational missions.

1 - Key to Specialized Staff skills

E = Economist/ Macroeconomic  
B = Disbursement Specialist  
D = Debt Specialist  
A = Agriculturist  
L = Lawyer  
F = Financial Sector Specialist  
P = Private Sector Development Specialist  
L = Telecommunications  
T = Transport Sector Specialist  
C = Procurement

H = Health Sector Specialist

I = Irrigation

X = Country / Operations Officer

K = Accountant

O = Labor Markets

S = Social Safety Net Specialist

M = Mining Specialist

R = Research Analyst

G = Energy Specialist

N = Industry

RX = Resident Mission Operations Officer

2 - Key to Performance Ratings:

S - Satisfactory

U - Unsatisfactory

3 - Key to Types of Problems

F - Financial

T - Technical

M - Managerial

## Related Bank Credits

Credit Title	Purpose	Year of Approval	Status
<b>PESAC</b>			
Privatization, State Enterprise Reform and Restructuring, Price and Trade Liberalization	Support for a new privatization strategy (1994 - 95); state enterprise reform and restructuring; and price and trade liberalization.	FY94	Completed 6/95
<b>APEAC</b>			
Continuation of Privatization Program and Agricultural Sector Restructuring	Support for restructuring /privatization of the agricultural sector parastatals and continuation of the 1994-1995 privatization program.	FY95	Completed 6/96
<b>FINSAC</b>			
Financial Sector Reform and Continuation of Privatization Program	Support for a comprehensive reform program for the financial sector, and support for (1996-1997) privatization program.	FY96	Completed mid-1997
<b>PSRMAC</b>			
Reform of Budget Preparation and Inter - governmental Finances.	Reform of intergovernmental finances and budgeting systems.	FY97	Completed
<b>SOSAC</b>			
Social Sector Adjustment Credit.	Reforms in pensions, social assistance and sectoral financing.	FY98	Approved, under implementation

# **Privatization and Enterprise Sector Adjustment Credit (PESAC) No. 2639-KG**

## **Cumulative Estimated and Actual Disbursements**

	FY1995	FY1996
Appraisal Estimate (US \$M)	30.00	60.00
Actual (US\$M)	42.10	63.09
Actual as % of estimate	140	105
Date of final disbursement	December-95	

## **Project Dates**

Steps in Project Cycle	Date Planned	Date Actual
Identification (Executive Project Summary)	-----	May-93
Preparation	November-93	November-93
Negotiations	May-94	May-94
Letter of Development Policy	-----	May-94
Board Presentation	June-94	June-94
Signing	-----	July-94
Effectiveness	July-94	September-94
First Tranche Release	July-94	September-94
Second Tranche Release	March-95	June-95
Loan Closing	December-95	December-95

## **Staff Inputs (Staff Weeks)**

Stage of Projects Cycle	Planned		Revised		Actual	
	Weeks	US\$ '000	Weeks	US\$000	Weeks	US\$ '000
Through Appraisal	63.0	245.7	90.3	408.1	73.4	317.8
Appraisal - Board	27.0	105.3	38.7	174.9	31.5	136.3
Board - Effectiveness	0.0	0.0	0.0	0.0	3.6	9.9
Supervision	43.3	156.2	60.2	295.2	77.2	329.9
Completion	10.0	39.0				
Total	143.3	546.2	189.2	878.2	185.7	793.9

### Mission Data

	Month/Year	No. of Persons	Days in Field	Specialized Staff Skills Represented	Implementation Status	Development Objectives	Types of Problems
Preparation	May-93	12	20	T/E/B/L/P			
Pre-Appraisal	Oct-93	10	20	T/E/B/L/P			
Appraisal	Mar-94	9	29	T/E/B/P/Pr/L			
Board Approval through Effectiveness	Jun-94	3	21	T/P/L			
Supervision II	Nov-94	5	26	T/P/E/L	S	S	T
Supervision II	Mar-95	5	28	T/P/E/L	S	HS	---
Completion*	Apr-97	1	3	T/E	HS	HS	---

Performance Rating: 1=Minor Problems; 2=Moderate Problems; 3=Major Problems

#### Specialization

B = Banking Specialist

E = Economist

En = Environment Specialist

F = Financial Specialist

L = Lawyer

P = Privatization Specialist

Pr = Procurement Specialist

T = Task Manager

Types of Problems: F = Financial; T = Technical; M = Managerial; P = Policy-based

\* PESAC audit was completed by an International Auditing Firm in April, 1997

### Related Bank Credits

See table under Key Project Data for Rehabilitation Credit

## Kyrgyz Republic at a glance

9/22/99

## POVERTY and SOCIAL

## 1998

	Kyrgyz Republic	Europe & Central Asia	Low-income
Population, mid-year (millions)	4.7	473	3,515
GNP per capita (Atlas method, US\$)	350	2,190	520
GNP (Atlas method, US\$ billions)	1.7	1,039	1,844

## Average annual growth, 1992-98

	Kyrgyz Republic	Europe & Central Asia	Low-income
Population (%)	0.7	0.1	1.7
Labor force (%)	1.1	0.6	1.9

## Most recent estimate (latest year available, 1992-98)

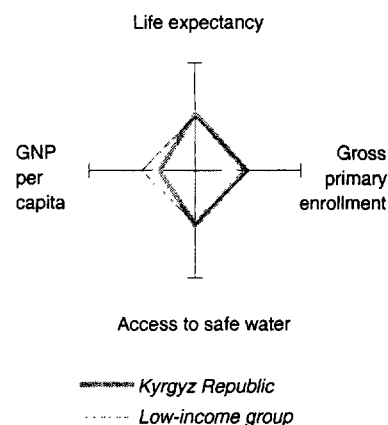
Poverty (% of population below national poverty line,	51	..	..
Urban population (% of total population)	40	68	31
Life expectancy at birth (years)	67	69	63
Infant mortality (per 1,000 live births)	28	23	69
Child malnutrition (% of children under 5)	11	..	..
Access to safe water (% of population)	75	..	74
Illiteracy (% of population age 15+)	97	4	32
Gross primary enrollment (% of school-age population,	104	100	108
Male	106	101	113
Female	103	99	103

## KEY ECONOMIC RATIOS and LONG-TERM TRENDS

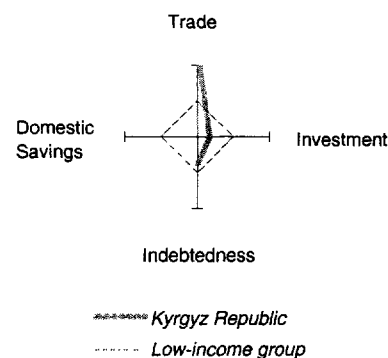
	1976	1986	1997	1998
GDP (US\$ billions)	..	..	1.8	1.6
Gross domestic investment/GDP	..	..	21.7	10.0
Exports of goods and services/GDP	..	..	38.3	37.0
Gross domestic savings/GDP	..	..	13.8	-10.9
Gross national savings/GDP	..	..	13.9	-12.6
Current account balance/GDP	..	..	-7.8	-22.6
Interest payments/GDP	..	..	3.7	4.4
Total debt/GDP	..	..	81.9	96.9
Total debt service/exports	..	..	12.0	18.8
Present value of debt/GDP	..	..	37.6	..
Present value of debt/exports	..	..	96.8	..

	1976-86	1987-98	1997	1998	1999-03
(average annual growth,					
GDP	..	7.2	9.9	1.8	2.0
GNP per capita	..	8.7	6.7	-2.0	2.0
Exports of goods and services	..	15.2	20.1	-11.5	2.0

## Development diamond\*



## Economic ratios\*

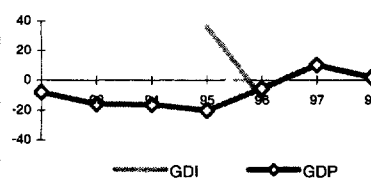


## STRUCTURE of the ECONOMY

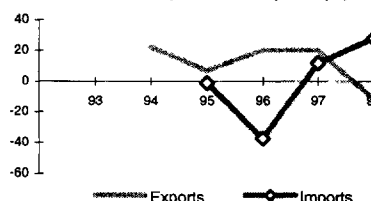
	1976	1986	1997	1998
(% of GDP)				
Agriculture	..	..	44.6	43.6
Industry	..	..	22.8	21.6
Manufacturing	..	..	17.9	18.9
Services	..	..	32.6	34.9
Private consumption	..	..	69.9	93.6
General government consumption	..	..	16.3	17.3
Imports of goods and services	..	..	46.2	58.0

	1976-86	1987-98	1997	1998
(average annual growth,				
Agriculture	..	..	7.0	6.0
Industry	..	..	5.0	5.0
Manufacturing	..	..	..	..
Services	..	..	20.2	-2.6
Private consumption	..	..	..	..
General government consumption	..	..	..	..
Gross domestic investment	..	..	..	..
Imports of goods and services	..	..	11.7	27.7
Gross national product	..	..	..	..

## Growth rates of output and investment (%)



## Growth rates of exports and imports (%)



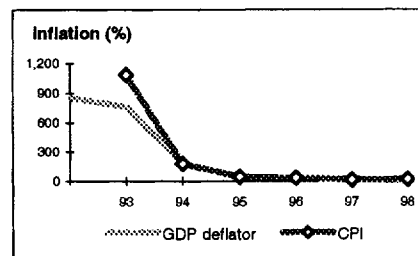
Note: 1998 data are preliminary estimates.

\* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

## Kyrgyz Republic

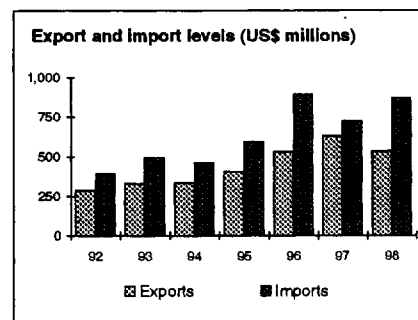
## PRICES and GOVERNMENT FINANCE

	1976	1986	1997	1998
<b>Domestic prices</b>				
(% change)				
Consumer prices	..	..	14.7	18.4
Implicit GDP deflator	..	..	19.3	8.5
<b>Government finance</b>				
(% of GDP, includes current grants)				
Current revenue	..	..	15.8	18.1
Current budget balance	..	..	-5.2	-3.4
Overall surplus/deficit (accrual)	..	..	-9.0	-10.0



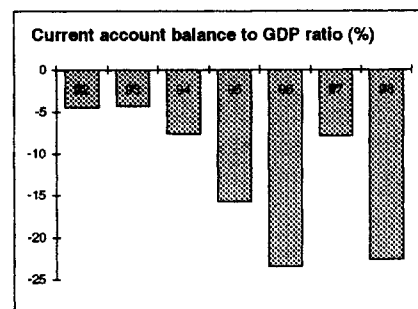
## TRADE

	1976	1986	1997	1998
<b>(US\$ millions)</b>				
Total exports (fob)	..	..	631	535
Electric energy	..	..	83	26
Gold and gold products	..	..	185	192
Manufactures	..	..	204	181
Total imports (cif)	..	..	725	870
Food	..	..	87	89
Fuel and energy	..	..	200	207
Capital goods	..	..	123	173
Export price index (1995=100)	..	..	97	94
Import price index (1995=100)	..	..	97	94
Terms of trade (1995=100)	..	..	100	100



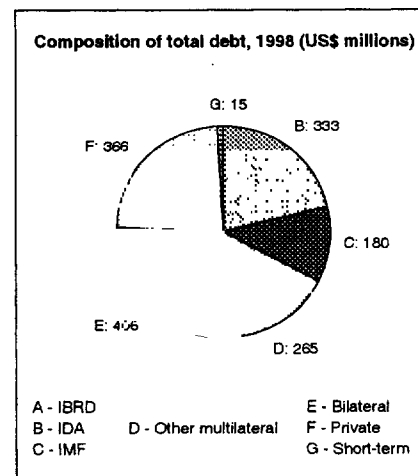
## BALANCE of PAYMENTS

	1976	1986	1997	1998
<b>(US\$ millions)</b>				
Exports of goods and services	..	..	676	598
Imports of goods and services	..	..	817	936
Resource balance	..	..	-141	-338
Net income	..	..	-65	-76
Net current transfers	..	..	68	50
Current account balance	..	..	-138	-365
Financing items (net)	..	..	221	359
Changes in net reserves	..	..	-83	6
<b>Memo:</b>				
Reserves including gold (US\$ millions)	..	..	200	194
Conversion rate (DEC, local/US\$)	..	..	..	..



## EXTERNAL DEBT and RESOURCE FLOWS

	1976	1986	1997	1998
<b>(US\$ millions)</b>				
Total debt outstanding and disbursed	..	..	1,444	1,565
IBRD	..	..	0	0
IDA	..	..	267	333
Total debt service	..	..	81	112
IBRD	..	..	0	0
IDA	..	..	2	2
<b>Composition of net resource flows</b>				
Official grants	..	..	65	48
Official creditors	..	..	172	225
Private creditors	..	..	8	-26
Foreign direct investment	..	..	83	102
Portfolio equity	..	..	25	26
<b>World Bank program</b>				
Commitments	..	..	60	102
Disbursements	..	..	66	66
Principal repayments	..	..	0	0
Net flows	..	..	66	66
Interest payments	..	..	2	2
Net transfers	..	..	66	66



## Kyrgyz Republic: Key Indicators, 1991-1998

	1992	1993	1994	1995	1996	1997	1998	1998 <sup>a</sup>	1999 <sup>a</sup>
GDP Growth ( percent p.a.)	-14	-16	-20	-5	7.1	9.9	1.8	--	2.0 <sup>b</sup>
Fiscal Balance ( percent GDP)	-17	-14	-12	-17	-9	-9	-11	-5	-5
Inflation ( percent CPI, end period)	1,259	767	96	32	35	15	18	6 <sup>c</sup>	33 <sup>c</sup>
Current Account Balance (% GDP)	-6	-17	-11	-17	-24	-8	-22	-24	-17
Total External Debt (% GDP)	--	32	39	51	64	81	96	--	--
Debt/Exports GS ( percent)	--	85	118	167	196	203	252	--	--
Exports (mln US\$), of which	289	337	340	409	531	631	535	255	231
- Power to FSU	--	14	23	64	41	87	28	3	13
- Other to FSU	--	214	200	206	353	260	224	113	83
- Non-ferrous to Non FSU	--	--	52	63	57	216	221	110	108
- Other to Non FSU	--	--	65	77	81	68	62	29	27
Imports, CIF (mln US\$)	396	495	462	595	895	725	869	397	277
Exchange Rate (end period soms per US\$)	--	8.0	10.6	11.2	16.9	17.4	29.4	22.5 <sup>d</sup>	42.9 <sup>d</sup>

<sup>a</sup> January-June, unless otherwise indicated. <sup>b</sup> January-August. <sup>c</sup> January-September. <sup>d</sup> As of October 10.

Source: "Concept Note for a Study on Impediments and Prospects to Growth", ECA Region, October 1999.

**PESAC Conditionalities****A. Conditions for Board Presentation****(i) *Privatization***

(a) Government to amend legislation/regulatory provisions to allow free exercise of individual shareholding property rights by members of labor collectives. Such new laws to be applied retroactively to already privatized enterprises where the SPF holds the two-third majority of the shares enabling it to modify the company charter.

(b) SPF to eliminate from existing and future privatization contracts restrictions on range of business activities to be undertaken by privatized enterprises, and Government to revise the new Privatization Law to the effect that no such restrictions can be placed in any future privatization contracts.

(c) The new Concept Note and the Privatization Law will contain provisions to the effect that any interested part will be able to submit privatization proposals without any prior restrictions on the acceptable form of distribution of shares, beyond those agreed for free distribution to managers and workers (5 percent) and for SMP (voucher) sales (25 percent).

**(ii) *Enterprise Reforms***

(a) Government to establish institutional arrangements (i.e., an Enterprise Reform and Resolution Agency), and provide adequate human and financial resources, for exercising sole authority over the management of the liquidation/restructuring program of these enterprises, including the provision of all technical assistance and financial resources.

(b) Government to issue a decree (i) transferring an agreed number of large loss-making SOEs (LLMEs) under the authority of ERRA, and (ii) announcing that these SOEs should be put under the Care and Maintenance Program no later than September 1, 1994 or at Credit effectiveness, whichever date is the earlier.

(c) Government to agree to exclusively channel all subsidies and financial support to an agreed list of large loss-making enterprises in a transparent way through the state budget. The size of these funds will be limited and fixed, consistent with the macroeconomic program.

**(iii) *Price and Trade Policy Reforms***

(a) Eliminate all restrictions on trade margins, except on bread.

(b) Remove direct price controls on all enterprises other than an agreed list of 9 natural monopolies.

(c) Government to submit to Parliament Anti-monopoly Legislation, satisfactory to IDA, including procedures for the identification of abuses of monopoly power.

(d) Government to remove all export licensing, except on an agreed limited number of goods.

(c) Government to repeal existing legislation on state orders and compulsory domestic supply contracts.

(iv) *Legal and Regulatory Reforms*

(a) Government to submit to legislature the draft Insolvency Legislation.

(b) Government to prepare an Action Plan, which will set out the steps to be taken, including timetable, to amend/enact the required legislation and regulatory measures to liberalize private sector activities, and foster its development, with priority given to laws on lease, JSCs, laws on registration of property rights and registration of companies, and competitive state procurement.

(v) *Institutional Reforms*

(a) Government to prepare and submit to IDA a proposal for the de-monopolization and privatization of the Bread Complex.

(vi) *Social Safety Net*

(a) Government to reduce liability of employers for funding severance pay for laid-off workers.

(b) Government to introduce (a) compressed range of unemployment benefits, and

(c) legislation which provides for 0.5 percent employee contribution to the Employment Fund.

B. Conditions for Second Tranche Release

(i) *Privatization*

(a) Government to conduct a minimum of 4 voucher auctions in at least 2 different oblasts for the shares still held by the State property Fund in privatized joint stock companies, covering a minimum of 10 such enterprises at each auction;

(b) For enterprises still fully Government owned, SPF to implement three sets of privatization auctions, at least in two oblasts, and to invite privatization proposals for a minimum of 70 enterprises included in the 1994-95 Program.

(c) SPF to submit a report to IDA indicating (i) the proportion of enterprises privatized through auctions, bidding and competitive privatization proposals, and (ii) a plan and timetable for future privatization of enterprises, satisfactory to IDA.

(ii) *State Enterprise Reform*

(a) Government to implement the "hard payment" system for all state-owned enterprises under the responsibility of ERRA, which should be reflected in no further accumulation of inter-enterprise arrears, debt to the banking system and/or the Government.

(b) ERRA to complete the viability assessment of at least three large loss-making enterprises under its responsibility, and take a decision on the liquidation or restructuring program in respect of these enterprises.

(iii) *Private Sector Development*

(a) Government to continue to implement its policy of not imposing any compulsory purchase orders;

(b) Government to take all necessary measures on its part to reduce the coverage of its bilateral clearing arrangements with a view of phasing them out completely;

(c) Government to prepare a report on progress made on the implementation of the legislative action plan and a timetable for further legal reform actions, satisfactory to IDA;

(d) Government to implement an action plan for de-monopolizing and privatizing of wholesale trade and transport enterprises including: (i) de-monopolizing and privatizing 4 state-owned enterprises in the wholesale trade area (Kyrgyzzaitorg, Kyrgyznasbelectroptorg, Kyrgyzrasnosbyt, and Metalloptorg); (ii) de-monopolizing 3 holding companies, and (iii) privatizing 10 large trucking enterprises in the transport sector.

(iv) *Environmental Assessment*

(a) The project would be consistent with IDA policy and procedures. Under IDA policies adjustment operations, no environmental rating has been assigned. Nevertheless, in the privatization program, the Government will be required to introduce environmental audits, and begin to develop a legal framework necessary for environmental protection and enhancement through privatized and state enterprise operations.

**Kyrgyz Republic**  
***Private Sector Review in the Transitional Era***

**EXECUTIVE SUMMARY**

1. The nascent private sector in the Kyrgyz Republic requires the rapid development of effective and efficient legal, regulatory, judicial and taxation regimes to provide the foundation for a competitive environment which would encourage the restructuring, diversification, amalgamation and growth of private enterprises. This study offers recommendations for the further development of an enabling competitive environment for Kyrgyz firms.<sup>1</sup>
2. The Kyrgyz Republic embarked in 1992 on a broad program of stabilization and structural reform, including *inter alia* price liberalization, mass privatization and the liberalization of the trade regime. Most prices were liberalized with the removal of all direct and indirect price controls, and on trade policy, all non-tariff barriers to exports and imports were removed. A mass privatization program placed approximately 1,000 primarily medium-sized and large enterprises and several thousand small businesses into private control. By the end of 1997, the private sector accounted for approximately 65 percent of GDP -- the highest among all CIS republics.
3. Following the introduction of the som the national currency, in May 1993, the economy has followed a path of sustained stabilization. Although largely due to investment in the Kumtor gold mine, by 1996 industrial growth had resumed, at a substantial 10.8 percent rate, compared to a decline of 17.8 percent in the previous year. Foreign trade showed a 44.0 percent increase, on top of a 30.0 percent increase in 1995, and the retail trade marked its recovery as well, growing 1.9 percent compared to a decline of 6.0 percent the year before. Despite the depressive effects of the Russian financial crisis in the second half of 1998, the Kyrgyz economy retains the essential reform foundation required for resumed growth.
4. The market-oriented reform policies implemented by the government over the past years have promoted multiple sources for competition in the Kyrgyz Republic. The demonopolization of specific sectors (such as transport and agro-processing), including the dismemberment of formerly vertically and horizontally integrated state companies, has allowed for the creation of competing markets and the liquidation of non-viable firms. The adoption of internationally accepted trade standards have led to the accession of the Kyrgyz Republic to the World Trade Organization (WTO) in 1998, the first republic of the former Soviet Union to do so. Finally, the liberalization of major restrictions to internal trade and foreign investment have created incentives for private entry, and, therefore, to expand and develop new markets.
5. Despite these far-reaching reform efforts, private sector growth has been hampered by a number of factors. Markets are small and dispersed, the cost structure is high and the number of risk-takers small. There are important sectors, still run by state-owned monopolies, where competition could be an important stimulus for private sector development. Little restructuring has taken place at the majority of privatized enterprises, which remain largely under the control of the same managers that directed them as state-owned entities. Foreign investors, who could offer new technologies, modern management methods and access to world markets, are present in only

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<sup>1</sup> The authors consider enterprise financing and restructuring concerns to be derivative issues largely dependent on the establishment of an open, transparent and efficient private-sector environment, and as such are not the primary focus of this study.

a handful of companies, and the securities markets lack sufficient liquidity to facilitate ownership change. Many new commercial laws have been adopted, but the judicial system is weak and court decisions are often unenforceable, and licensing requirements are often excessive. The system of corporate taxation is excessively burdensome, and tax administration is frequently perceived as arbitrary. Coupled with managers' fear of outsiders and loss of control, these factors have contributed to the general lack of investment and growth in Kyrgyz firms.

6. The Kyrgyz mass privatization program, which transferred control of nearly 1,000 medium and large companies to private hands, was designed to encourage ownership by outside investors in order to stimulate restructuring of enterprises. Enterprise managers have, however, not only effectively maintained control of the majority of privatized firms, but have been able to increase their holdings since privatization. This is the result of the purchase of majority positions by enterprise managers directly from the state during the privatization process, more often than not in the absence of interest from outside buyers, and from other investors during the several years following privatization. As management has typically exerted indirect control over the shares held by employees -- even in majority employee-owned firms -- combined management/employee holdings averaging 70 percent today indicate the extent of management's influence.

7. This is not to say that new, outside (non-management) owners have not begun to emerge, albeit on a limited basis, since privatization. Analysis of the results of an enterprise survey of 233 Kyrgyz firms conducted in connection with this study indicates that although outside owners have already had some limited, positive effects on enterprise growth in certain situations, by and large, no strong conclusions can be drawn regarding the possible positive effects on enterprise performance of new, outside owners. Nor can any conclusions be made on the benefits wrought by new owners vis-à-vis ownership by existing management. In fact, real growth in sales and employment has continued to decline, regardless of ownership, although in certain cases -- among exporters, for instance -- real declines have been slowed (at least through end-1997). Even in the few situations in which performance appears to have improved in the presence of a new owner, it is not clear that new owners have simply selected those firms with the best chances of success.

8. While on average employment at Kyrgyz firms has fallen by approximately half since their privatization, small firms have witnessed a much more severe decline. Survey results and enterprise interviews indicate that small firms, typically lacking a "patron" within the government, encounter a greater degree of difficulty in dealing with licensing and regulatory issues than large firms. As they also find it more difficult to access and interpret essential business information and to find the right kind of training for employees, they are faced with greater hardships in understanding legal, taxation and accounting rules. As a result they have less faith in their ability to deal with tax authorities and to utilize successfully the nation's legal and judicial system. Small companies also appear to be more affected by competition from imports which escape import tariffs, and by anti-competitive behavior, such as price-fixing.

9. The relatively rapid growth of *de novo* private firms is, however, an important bright spot on the competitive landscape. *De novo* private firms have experienced a more rapid growth in (nominal) revenue than have former state-owned firms over the last several years, and they have been quick to develop distribution networks and have been more flexible in adapting product offerings to the marketplace. Their affiliation into formal (through common ownership) and informal (through business and personal ties) industrial groupings has been encouraged by the provision of certain benefits important to group members in the present climate. First, group affiliation increases access to financing through a bank or other financial institution affiliated with the group, or through stronger group affiliates which can more easily raise capital. This is

an attractive benefit given the limited sources of finance available to firms today. Second, it provides more effective representation and influence before the state. This is not unexpected in an environment frequently marked by preferential state treatment and a complaint and appeals system largely and effectively based on personal contact. Finally, it provides market clout at a time when most markets are still undeveloped and most producers are still small.

10. Thus the development of industrial groups in the present environment seems inevitable -- but so may be the groups' proclivity for anticompetitive behavior as they gain market and financial strength. As Kyrgyz markets develop and firms become more sophisticated, attention may need to be paid to particular measures or practices which may shield firms from actual or potential competition. For now, however, imports and new entry of firms seem to be providing sufficient discipline in most sectors to constrain the ability of large and/or group-affiliated firms to raise prices or affect other market conditions, and firms have not matured the institutional arrangements necessary to carry out collusive and other anti-competitive practices. Given the lack of a pressing need to focus on monopoly and monopolistic behavior, the state's antimonopoly committee has recently been restructured, sporting a new emphasis on fostering competition. The new commission has, however, yet to abandon counter-productive interventionist practices in attempting to implement its new mandate.

11. The Kyrgyz Republic has taken essential steps toward reforming its tax policies and administration and adapting them to the demands of a market economy. These efforts notwithstanding, revenue collection is still relatively low, as the tax enforcement capability of the taxation administration is limited and small and micro-enterprises continue to opt out of the formal sector. The system needs to be made more transparent, and taxation-based incentives to private sector investment and the development of the securities and real estate markets need to be strengthened. Taxpayers are poorly informed about tax rules, in part because of the many exemptions provided by separate legislation or government resolution.

12. The tax burden on enterprises is substantial, particularly when the effects of turnover taxes -- which are outside the tax code -- and high payroll taxes are considered. Reducing this burden and eliminating case-by-case tax exemptions and the tax-free nature of the Free Economic Zones would discourage tax abuse and raise overall collections.<sup>2</sup> Changes in the VAT refund mechanism and in the high level of government fees are also needed. While a tax patent system has been introduced for micro-enterprises, enabling them to pay a predetermined amount regardless of profit levels, the adoption of simplified tax filing rules for SMEs would benefit reporting and collection. Many Kyrgyz firms are reluctant to merge with others to create economies of scale, driven by a desire to remain in the informal sector (unregistered and non-taxpaying) for fear of arbitrary harassment if they grow too large. Revenue administration agencies pay insufficient attention to improving taxpayer services, training staff and improving how technical functions (such as auditing) are performed.

13. Despite several large, high-profile foreign investments and the establishment of an investment promotion agency, the climate for foreign investment in the Kyrgyz Republic at the enterprise level is not ideal. Enterprises have limited experience or interest in investment by foreigners. Owners frequently overestimate the value of their companies, not understanding the relatively high level of investment risk perceived by foreigners and investment alternatives available to them in other markets. Local managers and owners fear a loss of control and are

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<sup>2</sup> In an effort to eliminate FEZ abuses, the authorities have recently closed three zones and initiated a set of measures to enhance control of the remaining FEZ.

reluctant to disclose enterprise information essential for investor analysis. They are also unwilling to undertake the restructuring foreigners frequently demand as a condition for investment.

14. Foreign investors and local managers alike bemoan the loss of tax holidays available under the old foreign investment law. Without the inclusion of compensatory investment incentives in the tax code, government officials continue to grant tax concessions and privileges in an effort to remain competitive in attracting foreign investment vis-à-vis neighboring countries. Recent debate on reinstating in the FDI law the granting of preferences, including tax preferences such as tax holidays, to foreign investors may prove to be a step backward, as any preferential exemption from profit tax or tax on interest or dividends will simply wind up in the coffers of the investor's home country (since the tax will usually be payable in the home country if a credit is obtained in the foreign country). This will only result in the loss of revenue to the state treasury and a decline in the competitiveness of domestic firms.

15. The privatization of major infrastructure and natural resource enterprises, now in preparation, requires a rational and transparent process to ensure the attraction of foreign investors. Regulation permitting the state privatization agency (SPF) to employ minimum price levels and institute certain investment conditions (such as the forced maintenance of production and employment levels) could imperil the success of these sales. For other companies, such as small and medium companies (including those still awaiting to complete privatization), manufacturing and marketing arrangements between foreign and domestic firms which promote export development may be viable interim alternatives to direct investment. Disputes over valuation and disclosure, the bane of FDI transactions in the Kyrgyz Republic, can thus be lessened as familiarity and trust are nurtured before real investment takes place.

16. Although the Kyrgyz Republic has entered into international trade agreements with its neighbors, enterprises report various difficulties in transporting goods across borders. Vehicles face frequent and extensive delays at border crossings and Customs Union countries often do not recognize duty-free entry of machinery and equipment in transit to the Kyrgyz Republic through their countries, or they require payment of VAT before goods are released. While officials point to inadequate or insufficient documentation on the part of companies, firms complain of arbitrary enforcement and interpretation of rules at borders. Complaint and appeals procedures are insufficiently transparent.

17. Weaknesses in the legal and judicial systems also hamper investment. Foreign as well as domestic investors demand control of enterprises in part due to the difficulties in adjudicating claims in Kyrgyz courts. While most major pieces of commercial legislation are now in place, enforcement of judges' decisions is difficult and a workable system of appeals, though adopted, is still to be perfected. Courts suffer from a perceived lack of transparency, procedural processes that are new and still being worked out in practice, and the absence of experienced judges and other legal professionals trained in the new commercial legislation. A strong legal and judicial system is needed not only for guaranteeing the property rights and responsibilities of all private sector participants, but is essential for encouraging and supporting the restructuring of enterprises, as the legal protection of the rights of creditors and other collateral holders and the enforcement of liquidation and bankruptcy rules are strong incentives for managers to put their houses in order.

18. Despite the adoption of a licensing law in 1997, the system of enterprise licensing -- in particular the lack of appropriate procedures for exacting penalties for violations or of a transparent appeals process -- remains a source of harassment for firms. Abuses in the administration of licenses, frequent changes in government practice and criteria, and the recent

proliferation of licensing requirements -- reflecting the importance of licensing income to many agencies in the absence of sufficient budgetary funding -- provide significant powers to officials to thwart the rational flow of business. Recognizing the gravity of this situation, President Akaev issued a decree in late 1998 ordering the government to deliver to parliament draft legislation intended to simplify registration and licensing activities and protect businesses from unlawful interference from the state.

19. The securities markets in the Kyrgyz Republic have played a limited role in fostering ownership change. Trading on the stock exchange is strictly regulated but almost all trading takes place "off-market," in an unregulated environment fraught with potential risk. As a result, exchange liquidity is particularly low, and for most people who became shareholders during the mass privatization program, opportunities to sell securities are limited. While the largest infrastructure companies most likely to attract investor interest have been earmarked for privatization in 1999 and thereafter, preparations for the first of these have suffered from a lack of coordination among various parties with different interests, or have been conducted in an insufficiently transparent manner. In addition, as the privatization plans for a number of these companies do not call for the transfer of a controlling interest to the purchaser, their attractiveness to potential investors is called into question.

20. Finally, the obstacles firms face in accessing and analyzing essential information affect all enterprise activities. Firms face difficulties accessing not only general economic and market data, but essential information on new laws, regulations, accounting and taxation rules. Regardless of the topic, enterprises report less difficulty, however, in accessing information than in obtaining qualified analysis and commentary. Thus, new laws are frequently printed in the mass media but seldom accompanied by qualified interpretation, and employee training programs are announced but little analysis is available to help managers determine the best programs for their staff. There are few specialty business or trade publications available, and consulting services are seldom accessed. Few enterprises obtain information through electronic mail or the Internet. As a result, managers of small firms in particular are forced to rely on personal and business contacts for information and consultation.

### **Recommendations**

21. Each chapter of this private sector review presents several policy recommendations intended to assist in the further development of an enabling competitive environment for Kyrgyz firms. The recommendations set forth below have been selected from among these as they are the most essential. They include:

#### ***Taxation Policy***

22. The Kyrgyz authorities need to identify the optimal manner in which to implement immediately reforms in the following areas:

- **Tax and customs exemptions.** Extend the coverage of the Tax Code to all enterprises, including those in the FEZ, and ensure coverage of corporate income tax (CIT), VAT tax, and land and local taxes. Similarly, review and reform the import duty regime to cover all enterprises equally.
- **VAT refunds.** Empower the STI to pay VAT refunds directly. Consider establishing a special fund for refunds with money set aside from VAT collections for this purpose.

- **Government fees.** Reassess and reform fees charged by government agencies, with a view to assessing whether each institution (or procedure) is needed, whether its operation should be funded from the budget, and whether the fee amount (if maintained) corresponds to the service provided to the enterprise.
  - **Corporate income tax.** For SMEs, consider simplification of tax calculations and bookkeeping requirements.
  - **Investment incentives.** Encourage private investment by reviewing and modifying rules for loss carry-forwards, inventory valuation, depreciation and other measures.
  - **Capital gains.** Consider reducing the tax rate on capital gains to encourage the development of capital and real estate markets.
23. The following recommendations will need to be sequenced or phased in to take into consideration revenue losses:
- **Turnover taxes.** Phase out turnover taxes. It is a matter of policy choice, based on revenue and economic efficiency consideration, whether to replace these taxes with gasoline taxes, cost recovery policies for road maintenance, higher VAT, or other alternatives.
  - **Payroll taxes.** Use any surplus of the Social Fund (which may arise after 2001) to decrease payroll contributions rather than for increasing benefits.

### ***Tax Administration***

24. To improve revenue collection, authorities should consider the development of an overall strategy which would include the following:

- **Clarify legal ambiguities** obstructing tax administration, such as those that hamper the ability to seize assets or bank accounts.
- **Reduce taxpayer uncertainty** by communicating clearly what the law is and issuing explanations, examples and rulings on specific subjects in a well-disseminated annual publication accompanying filing forms.
- **Re-design taxpayer filing procedures** so that they would be much less costly and demanding on enterprises.
- **Improve training of tax administration staff** so that taxpayers may receive expert and uniform treatment. Develop tax administration manuals for the use of all staff.

### ***Export Promotion and Foreign Direct Investment (FDI)***

- **Support FDI promotion by:**
  - ❖ discontinuing case-by-case incentives (while simultaneously introducing investment tax incentives into the tax code);
  - ❖ resisting pressure to re-introduce the granting of taxation and other preference into FDI legislation; and
  - ❖ in the long-run, consider establishing the investment promotion agency as a separate entity, separating it from other non-FDI activities. Until this is feasible, steps should

be taken to separate SCFI operations from donor-related and other activities that are not directly related to FDI promotion.

- **Strengthen export promotion by:**
  - ❖ developing an informational program to help companies identify potential foreign firms for manufacturing and marketing arrangements which would encourage exports and complement efforts to foster FDI;
  - ❖ considering encouraging production and marketing agreements with foreign firms as an interim step to ultimate privatization (except for the large infrastructure companies, for which privatization is essential for enterprise viability);
  - ❖ eliminating bureaucratic delay-causing procedures at border crossings;
  - ❖ initiating a program to review and strengthen the Government's trade policy formulation, design of export strategy and initiation of trade promotion programs; and
  - ❖ resisting attempts to permit customs-free import of capital equipment for foreign companies, given the potential for abuse and negative competitive effects on Kyrgyz firms.
- **Reform the Free Economic Zones (FEZ) by building on actions already taken to reform the FEZ, through:**
  - ❖ phasing out special tax incentives for FEZ enterprises, shifting instead to providing logistical support to function as a platform for processing exports; and
  - ❖ separating management of the FEZ (in particular operation of zone customs units) from zone enterprises, and considering privatization of zone land holdings.
- **Strengthen investment promotion by:**
  - ❖ moving quickly to privatize the large and medium firms earmarked for strategic investment, ensuring that investment conditions (such as maintenance of production and employment levels, and minimum acceptable sales prices) are not employed, that an open and transparent sales process conforming to international tender standards is employed, and that management rights are fully conferred to investors;
  - ❖ ensuring the independence of the investment promotion agency and its ability to use its authority to intervene on behalf of foreign investors faced with licensing, registration and other bureaucratic obstacles; and
  - ❖ resisting attempts to reintroduce special tax incentives to foreign investors as a drain on the state treasury and a disincentive for domestic investment.

### ***Competition Policy And Enforcement***

25. A new strategy for the National Commission for the Protection and Development of Competition (CPDC), the recently reorganized antimonopoly commission, should focus on fostering increased competition. Measures to promote such a strategy include the following:

- **Limit the CPDC to activities that promote competition by:**
  - ❖ eliminating the price monitoring powers of CPDC, which represent a return to state intervention in market prices; and
  - ❖ regulating natural monopolies, including their pricing decisions, through sector-specific regulatory bodies, rather than through the CPDC.
- **Enforce competition policy and eliminate unfair competition through:**
  - ❖ the adoption of a competition advocacy role within the government to provide advice on matters affecting competition conditions;
  - ❖ the collection and processing of complaints from consumers and businesses; and
  - ❖ the investigation of claims of unfair competition based on strict definitions of what constitutes unfair competition, and to serve as the Commission's guidelines.

### *Legal and Judicial*

- **Initiate reform of the licensing process by:**
  - ❖ developing clear definitions of the conditions under which government departments may issue licenses; and
  - ❖ creating uniform procedures for complaint settlements and appeals, including the creation of an ombudsman office to receive and process complaints relating to licensing and illegal interference in firm operations.
- **Initiate judicial reform by creating, in the near-term, a program focusing on:**
  - ❖ developing and publicizing of a routinized system of publishing court opinions and making them accessible to lawyers and others;
  - ❖ creating clear standards for granting and effectuating injunctive relief;
  - ❖ improving the system for enforcement and satisfaction of court decisions, including making marshals responsible to the courts and enabling judges to instruct marshals on how to go about enforcement; and
  - ❖ continuing development of an appeals process that is efficient, insulated from outside influence, fair and final.
- **Initiate administrative reform by adopting an administrative procedure law, equally applicable to all agencies, to ensure transparency and accountability in the law enforcement system. The law would address:**
  - ❖ establishment of principles and procedures equally applicable to all agencies;
  - ❖ development of principles for interpretation of the laws the agencies enforce;
  - ❖ creation of procedures for the timing and manner of responding in writing to individual requests for information or application;
  - ❖ provision of mechanisms for public hearings and comments on rules of the agencies affecting compliance with the law; and
  - ❖ development of processes for internal appeals before higher administrative authorities, as well as guarantees to appeal final decisions before the judiciary.

*Information Dissemination*

- **Encourage development of mass media** by designing intensive training and assistance for broadcast and print media staff in most relevant issues.
- **Improve provision of information** by the state by increasing dissemination of important information through mass media and electronic means to ensure reaching a wide audience.
- **Facilitate training and consultancy provision** by surveying and improving existing training needs and programs provided.

*Securities Markets*

- **Implement measures to expand exchange trading** by:
  - ❖ selling a portion of the shares in large infrastructure privatization on the exchange;
  - ❖ promoting the success of the privatization process by appointing a key individual and steering committee to coordinate the government's efforts and by providing sufficient management rights to buyers to attract investor interest;
  - ❖ moving quickly to establish the new OTC system now under development; and
  - ❖ permit trading in unlisted securities on a separate "board" or market to facilitate trading in the hundreds of companies with small shareholders resulting from mass privatization.
- **Adopt additional securities regulations** to increase disclosure and reporting in order to encourage a reduction in off-market trading.
- **Regulate growth in institutional demand for securities** by:
  - ❖ separating commercial bank lending and investing operations;
  - ❖ revising bank capital adequacy calculations for varying equity risk levels; and
  - ❖ providing for independent management of shares held by the state pension administrator (the Social Fund).



**Comments from the Borrower****Ministry of External Trade and Industry of the Kyrgyz Republic**

June 22, 2000

To: Mr. Rene Vandendries  
Operations Assessment Department  
World Bank

Mr. Mohinder S. Mudahar  
Chief, World Bank Office  
Kyrgyz Republic

Dear Sirs,

This is to submit to you comments by the METI of the KR on the PESAC audit opinion that was prepared by the World Bank Operations Assessment Department.

Sincerely,

E. Omuraliev  
Minister

### Comment on the World Bank PESAC Audit Opinion

Having reviewed the draft audit opinion by the WB regarding the Rehabilitation Credit and PESAC, the Ministry of External Trade and Industry of the Kyrgyz Republic advises the following:

The Audit Report says that in broad the PESAC privatization program was implemented on time, however, the outcome turned out depressing.

The following aspects are viewed as **positive**:

- The significant share of the state-owned property was privatized during the PESAC implementation;
- Project implementation made a positive impact on creation of the legal framework (the Law on Bankruptcy; the Law on Companies and Unions);
- The subsidies were reducing in the course of the privatization;
- The privatization resulted in restructuring of some enterprises, particularly “protected” through reduction of the output, redundancies and selling of shares.

The following aspects are viewed as **negative**:

- Strategic investors did not show up and as a result enterprises have not become efficient;
- Most of the shares were bought by managers of those enterprises or by physical or legal entities related to those managers, i.e. privatization was mostly inside;
- Returns from privatization were small;
- Coupon market and stock market have not developed;
- As the investment funds were small, their role was obscure and accounts were not transparent ;
- Privatization of utilities was postponed and, consequently, the utilities were looted;
- The fact that expectations of economic effect and stabilization of enterprises activity under PESAC did not materialize caused overall disappointment;
- Serious slippage was committed in diagnosis and in corporate governance.

Only few enterprises were restructured as a result of privatization and it is still unclear whether privatization has brought about positive, negative or neutral changes.

The following lessons are discerned based on the analysis of the PESAC implementation:

- Eagerness to restructure the privatized enterprises can be prevailed by such factors as distortion and partiality, subjectivity on the part of the tax system, corruption as well as intervention of bureaucracy into the activity of enterprises.  
The Government together with donors should support implementation of the recommendations reflected in the enclosed the 1999 Private Market Review.
- Intention to quit the market also requires restructuring of enterprises. Efforts to expedite the liquidation and bankruptcy procedures in Kyrgyzstan proved inefficient so far.  
One has to make sure that decision to quit the market should be made on a

voluntary basis.

- The lessons of privatization and isolation programs are not discerned yet. To this end, well-informed observers and privatization participants can be invited to prepare reports reflecting their vision and prospects of the lessons drawn and use them in future.
- There are problems in Kyrgyzstan regarding transparency of the privatization process. The Government jointly with donors needs to raise awareness of the public and the Parliament about the state reforms objectives.
- Costs of suspended privatization and restructuring of the infrastructure are high, including the negative impact on the state financing, production level and investment environment. We urge that the relevant actions should be taken in all these areas.
- Many state agencies still negatively view the development of the private sector. The Government is still not responsive to the need for comprehensive public administration reform. Development and implementation of such reform should have high priority as the Government failed to provide good quality services where needed (e.g. In social sectors)
- Development of the private sector and good governance of the public sector require technical assistance, which should be properly managed and coordinated both on the part of the donors and the Government. We agree with this statement, I believe that during implementation of the CDF we have to focus on those issues as well as on identification of priorities, supervision and control over the quality and aid coordination.

The World Bank report findings indicate an impact of a number of factors on the project implementation.

1. Business and investment environment in Kyrgyzstan is underdeveloped, it is weak and uncongenial;
2. Geographic isolation of Kyrgyzstan, small market and high transport and other costs;
3. The industries faced great difficulties as they used to produce products for defense industry and other products that turned out useless after the market was lost as result of the Soviet Union collapse.

However, despite these factors, the economic effect of the Project was partially satisfactory. The experts, who analyzed the activity of ERLA, concluded that the results of the Agency were not good. Given the fact that PESAC Credit was the first one aimed at reforming and restructuring of the public sector, the results of the PESAC Program are evaluated as partially satisfactory.

Based on the above, we agree with the Audit Opinion on the Project.

КЫРГЫЗ  
РЕСПУБЛИКАСЫНЫН  
ТЫШКЫ СООДА ЖАНА ӨНӨР-ЖАЙ  
МИНИСТРЛИГИ



МИНИСТЕРСТВО  
ВНЕШНЕЙ ТОРГОВЛИ И  
ПРОМЫШЛЕННОСТИ  
КЫРГЫЗСКОЙ РЕСПУБЛИКИ

MINISTRY OF EXTERNAL TRADE AND INDUSTRY OF THE KYRGYZ REPUBLIC

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106, Chu avenue, Bishkek city, 720002. Phone: (0312) 223888, 227856, 228940, 228280. Fax: (0312) 220793, 863488.

№ 01-2/1925  
от 22.06.00г.

На № \_\_\_\_\_ от « \_\_\_\_\_ » \_\_\_\_\_

Управляющему  
по оценке стран и региональным отношениям  
Департамента оценки операций  
Всемирного Банка

Г-ну РЕНЕ ВАНДЕНДРИ

Главе Представительства Всемирного Банка  
в Кыргызской Республике

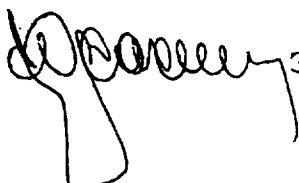
Г-ну МОХИНДЕР МУДАХАР

Уважаемые Господа!

Направляем на Ваше рассмотрение комментарий Министерства  
внешней торговли и промышленности Кыргызской Республики к проекту  
Аудиторского Заключения в части кредита PESAC, подготовленный  
Департаментом Экспертной Оценки Проведенных Операций Всемирного  
Банка.

С уважением,

Министр

 Э.К. Омуралиев

Приложение: Комментарий – 3 листа

BCKG - INCOMING  
DATE RECEIVED 06.22.00  
ASSIGNED TO Genovese  
CC'S TO \_\_\_\_\_  
ACTION REQUIRED \_\_\_\_\_  
RESPONSE DUE BY DATE 6/26

## Комментарий по проекту аудиторского заключения Всемирного Банка, относительно программы PESAC

Министерство внешней торговли и промышленности Кыргызской Республики, рассмотрев проект Аудиторского Заключения Всемирного Банка относительно Реабилитационного Кредита PESAC, сообщает следующее.

Как следует из отчета, в целом, осуществление программы приватизации, связанной с программой PESAC было проведено вовремя, однако результаты оказались неутешительными.

В качестве позитивных аспектов можно отметить следующие:

- Во время осуществления программы PESAC была приватизирована значительная доля государственной собственности
- Реализация проекта положительно повлияла на вопросы создания законодательной базы (Законы о банкротстве, о хозяйствующих товариществах и обществах)
- В процессе приватизации сокращалось предоставление субсидий
- Приватизация привела к реструктуризации некоторых предприятий, преимущественно «защитной» посредством снижения выпуска продукции, сокращения кадров и продажи активов предприятий

В качестве негативных аспектов можно отметить следующие:

- Стратегические инвесторы так и не появились, поэтому большинство предприятий не заработали эффективно
- Большинство акций были приобретены руководством тех же самых предприятий или частными и юридическими лицами, имеющими отношение к руководству, т.е. приватизация была преимущественно «инсайдерской»
- Получения от продажи предприятий в ходе приватизации были неизбежно малы
- Купонный рынок и фондовая биржа так и не развились
- Поскольку инвестиционные фонды были невелики их роль была неясной, а счета непрозрачными
- Приватизация объектов коммунальных услуг была отложена, а в последствии разбита
- Невыполнение ожиданий относительно экономического эффекта приватизации и стабилизации работы предприятий в рамках PESAC привели к общему разочарованию.
- Были допущены серьезные нарушения в диагностике и корпоративном управлении

Приватизация привела к реструктуризации лишь в небольшом количестве случаев и не до конца ясно - были ли в результате приватизации достигнуты позитивные, негативные или нейтральные изменения. На основе анализа реализации программы PESAC извлечены следующие уроки для Кыргызстана:

- Стремление реструктуризовать приватизированные предприятия, может быть вытеснено дисквалифицирующими факторами деловой конъюнктуры, такими как искажение и призрачность, необъективность налоговой системы, коррумпированность представителей официальной власти, а также бюрократическое вмешательство в деятельность предприятий. Правительство вместе с донорами должны дать большое преимущество в осуществлении рекомендаций, изложенных в прилагаемом Обзоре частного рынка за 1999 года.

- Стремление к тому, чтобы покинуть рынок, также требует реструктуризации предприятий. В Кыргызстане стремление ускорить процедуры ликвидации и банкротства проблемных предприятий до сих пор были неэффективными. Следует уделить внимание тому, чтобы процесс принятия решений об уходе предприятий с рынка был более добровольным.

- Уроки, извлеченные в Кыргызстане из опыта приватизации и изоляции, все еще не определены. Для этого наиболее хорошо информированные наблюдатели и участники приватизации могут быть привлечены для подготовки докладов, излагающих их видение и перспективны полученных уроков и будущее их применение

- В Кыргызстане имеют место серьезные проблемы в отношении прозрачности процесса приватизации. Правительство вместе с донорами нуждаются в том, чтобы более широко и детально ознакомить Парламент и граждан с целями государственных реформ

- Издержки отсроченной приватизации и реструктуризации инфраструктуры высоки, включая негативное влияние на государственные финансы, уровень производства и инвестиционный климат

Настоятельно требуются безотлагательные меры по этим направлениям. Многие государственные ведомства все еще скорее непродуктивно относятся к развитию частного сектора. Правительство по-прежнему остается глухим к всесторонней реформе гос. службы