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To: Members of the Executive Board

From: The Secretary

Subject: Kyrgyz Republic - Enhanced Structural Adjustment Facility -
Policy Framework Paper, 1994-96

Attached for consideration by the Executive Directors is the policy framework paper under the enhanced structural adjustment facility for the Kyrgyz Republic which, together with the Kyrgyz Republic's request for the first annual arrangement under the enhanced structural adjustment facility (to be issued shortly), will be brought to the agenda for discussion on a date to be announced.

Mr. van den Boogaerde (ext. 38869) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Commission of the European Communities (CEC), the European Bank for Reconstruction and Development (EBRD), and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

KYRGYZ REPUBLIC

Enhanced Structural Adjustment Facility

Policy Framework Paper, 1994-97

Prepared by the Kyrgyz Authorities in Collaboration With the
Staffs of the Fund and the World Bank

May 31, 1994

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I. Introduction

1. Upon achieving independence in August of 1991 the Government of the Kyrgyz Republic inherited an economy that was highly dependent on trade with other former Soviet Union (FSU) countries and budgetary transfers from the Union. The disintegration of the Union disrupted traditional trade and payments links, resulting in shortages of critical inputs and the loss of markets for highly specialized Kyrgyz enterprises. There was also a substantial realignment of relative prices--particularly for energy products--applied to trade with FSU partners. This resulted in a sharp deterioration in the Kyrgyz Republic's terms of trade, the effects of which were exacerbated by the cessation of budgetary transfers from the Union, which had been a major source of financing for the budget and the balance of payments.

2. The Republic's ability to respond to these adverse developments was hampered by the lack of a framework within which market forces could develop and take over. Budgetary problems were exacerbated by the continuing decline in economic activity and a weakening of tax administration and enforcement mechanisms. Furthermore, as a relatively small member of the ruble area, the Kyrgyz Republic found it difficult to pursue an independent financial stabilization effort, although efforts to do so were made during the first half of 1992.

3. During late 1991 and 1992 the Kyrgyz Republic initiated steps to transform the economy from one dominated by central planning and administrative control of resource allocation to one in which economic decisions are determined primarily by market forces and consumer preferences. A number of far-reaching changes to the legal system were carried out, including the adoption of a foreign investment code that guarantees the rights and property of foreign investors and laws on concessions on the exploitation of natural resources. Also, substantial progress was made on price liberalization, and the two-tier banking system established in June 1991 was strengthened with the adoption in December 1992 of a comprehensive central bank law, which provided for an independent central bank, and a commercial banking law.

4. To enable the Republic to assume full responsibility for the pursuit of financial stabilization policies, an independent national currency, the som, was introduced in May 1993. At the same time, a stabilization and structural adjustment program was initiated with support from the Fund through an 11-month stand-by arrangement and the Systemic Transformation Facility. Further assistance came from a World Bank import rehabilitation credit, cofinancing of this credit by Japan's Overseas Economic Cooperation Fund, large grants from the United States, and aid from other bilateral and multilateral donors.

II. Progress Under the 1993 Adjustment Program

5. Under the adjustment program for 1993, monthly inflation was targeted to decline to low single digit figures by year end, the fiscal deficit was to be held to about 7 percent of GDP, and the external current account deficit (including official transfers) was projected at 18 percent of GDP (20 percent excluding official transfers), with a gross official reserve build-up of US\$23 million. The program included tight financial policies to rapidly build confidence in the new national currency, the Som, and other significant financial and structural reforms. In particular, banks were allowed to set interest rates freely, and refinance credit, foreign exchange, and treasury bill auctions were initiated. Further price liberalization was envisaged, the system of state orders for important agricultural and industrial products was to be phased out, and an ambitious privatization program that had begun in 1992 was to be intensified.

6. Despite considerable progress in a number of areas, some setbacks were encountered during the implementation of the program. Monthly inflation, which declined during the summer, accelerated sharply to approximately 33 percent during September-October 1993, due primarily to large increases in administered prices in August and the excessive extension of new credits through the budget to the agricultural and industrial sectors in late September. However, very tight monetary policy from mid-October onward resulted in a steady decline in monthly inflation rates to about 5 percent in April 1994. The 1993 general government deficit (including on-lending to enterprises) was held to 8.2 percent of GDP on a cash basis. However, general government revenues were less than expected and tax revenues fell to 6 percent of GDP in the fourth quarter, compared with about 10 percent of GDP in the first half of 1993. The cash deficit was held to its level by significant expenditure compression and by the accumulation of budgetary arrears, particularly during the last quarter of the year. Real GDP is estimated to have declined by approximately 16 percent during 1993, reflecting in part the continued disruption in the trade and payments systems among FSU nations and the collapse in the demand for Kyrgyz manufactured products in neighboring countries. Performance varied widely across sectors, with industrial output estimated to have declined by 25 percent and agricultural production to have fallen by only about 8 percent.

7. In 1993 the external current account deficit (16 percent of GDP, excluding official transfers) was less than originally projected due to lower than expected imports. This resulted largely from continued delays and shortfalls in foreign financing from multilateral and bilateral donors, reflecting in part administrative problems on the recipient and donors' side (which now have been largely overcome). Despite a decline in import volume, the trade balance with the FSU deteriorated as expected in 1993, largely on account of increased prices for energy products. External debt (including liabilities to the Fund and the balances on correspondent accounts that were converted into medium-term loans) increased very rapidly to about US\$285 million (18 percent of GDP) in the course of 1993.

8. Deposit interest rates--freely set by banks--remained substantially negative in real terms throughout 1993, although auction determined refinance rates rose rapidly from 110 percent per annum in May to 260 percent in October 1993. In late October, the refinance credit auctions were suspended. Commercial banks accumulated large overdrafts with the National Bank of Kyrgyzstan (NBK) as outstanding refinance credits became due. The worsening financial position of commercial banks was largely due to the inability or unwillingness of enterprises to repay maturing credits. For 1993 as a whole only 20 percent of total NBK credits to the banking system were passed through the auction system.

9. Interbank foreign exchange auctions were held on a weekly basis, with the exchange rate of the som depreciating from Som 4 per U.S. dollar in May to Som 8.03 per U.S. dollar at year end. In real terms, the som appreciated by approximately 50 percent against the U.S. dollar during the last quarter of 1993. The nominal exchange rate continued to depreciate in early 1994 to Som 12.3 per U.S. dollar in April/May 1994. While the exchange rate against the Russian ruble has remained relatively stable in nominal terms at about rub 150 per som since mid-1993, the som has appreciated strongly in nominal terms against newly introduced currencies in neighboring countries.

10. Significant adjustments were made to administered prices for bread, rents, and other items during 1993. The maximum retail margins imposed on all goods after the introduction of the som were lifted on imported goods in August 1993 and on most domestically produced goods in November 1993. In March 1994, all retail margins were eliminated except for that on bread.

11. The system of state orders remained in effect during 1993 in order to mobilize goods needed to meet obligations under clearing arrangements with other FSU countries and to supply the armed forces, hospitals, old age homes, etc. with basic foodstuffs and other necessities. However, the functioning of this system was hampered in many instances by artificially low procurement prices, insufficient financial resources by the Government to meet its purchasing commitments, and a lack of payments discipline. This contributed to the problems of the agricultural sector in particular. The system of state orders was abolished in early 1994 and was replaced by a system of state needs under which Government procurement of a limited range of goods will be effected through freely negotiated contracts with suppliers.

12. By the end of 1993, the Government had privatized 33 percent of state-owned fixed assets, very close to its target of 35 percent. The form of enterprise privatization, however, was dominated by the formation of closed joint stock companies and the transfer of shares to the labor collectives of the enterprises. This has not led to the creation of more effective management structures that would focus on cost cutting and labor shedding. The Government recognizes the shortcomings in the privatization program to date and, as described below, has already begun to take steps to correct this situation.

III. Medium-Term Objectives and Adjustment Strategy, 1994-97

a. Macroeconomic objectives and strategy

13. In the long term the Kyrgyz Republic appears to have good potential for development. It has a wide range of minerals that can probably be exploited on an expanded scale--gold, antimony, mercury, uranium and rare earth metals. Substantial expansion of hydroelectric capacity may also be warranted, and the country's geology suggests potential for developing oil and natural gas production. There are good possibilities for raising yields of agricultural crops through better irrigation and cultivation practices and improved incentives. Despite the remote location, there may be potential for the development of tourism. Most importantly, the Kyrgyz Republic benefits from high literacy rates and a relatively well developed human resource base (although the latter is being undermined by the emigration of various ethnic groups, despite the best efforts of the Government).

14. The Government recognizes, however, that it will take some time for these important assets to provide the basis for renewed growth. A combination of external shocks including disruptions in trade and a large deterioration in the external terms of trade has dominated the short-term outlook. The targeted gradual turnaround in output growth under the reform program from about minus 5 percent in 1994 to about 5 percent in 1997 (Table 1) requires: (i) a low-inflation environment in which domestic savings and investment can increase steadily; (ii) the development of a dynamic private sector; (iii) substantial improvements in the performance in all sectors of the economy based on a fundamental restructuring; and (iv) a financially solvent public sector. It will be important to promote domestic savings and attract foreign direct investment as a source of scarce capital and technology. Economic transformation will also require relatively large scale concessional external financing over the medium term.

15. The Government's medium-term strategy includes efforts to improve export capacity so as to move progressively toward a sustainable balance of payments position. The program aims at a reduction in the current account deficit (excluding official transfers) from about 16 percent of GDP in 1993 to about 9 percent of GDP by 1997. An improved export performance is expected to result from the recent elimination of all state orders and purchases and export licensing requirements and, over the medium term, from increased investment in export producing industries and infrastructure.

16. With the continuance of current restrictive financial policies, consumer price inflation is targeted to be reduced to about 10 percent per annum at the end of the program period. In particular, domestic credit policies will need to be fully consistent with the achievement and maintenance of a low-inflation environment. This in turn will require a fundamental and lasting improvement in the financial performance of agricultural and industrial enterprises that can only be achieved through privatization and a substantial reorganization of the enterprise sector.

The prevention of new interenterprise arrears hinges on the successful restructuring of the enterprise sector and will be crucial for controlling inflationary pressures.

17. A more stable macroeconomic environment, supported by a deepening of the reforms already underway in the financial sector and positive real lending and deposit rates, should lead to increased confidence in the national currency and a rise in savings of households and enterprises, including an increased demand for money. The increased domestic savings base, including retained profits of enterprises, will be used, in part, to help finance the recovery of government, enterprise, and private sector investment expenditures, which have fallen drastically as a percentage of GDP since 1989.

b. Fiscal policy

18. Fiscal policy is expected to play a central role in the stabilization program. The Government's main medium-term fiscal policy objective is to limit the budget deficit to a level that can be financed with domestic and foreign savings on a noninflationary and sustained basis. The Government is therefore committed to progressively reduce the budget deficit from 8 percent of GDP in 1993 to about 3 percent of GDP in 1997. The net domestic bank financing of this deficit will be limited to at most 1.5 percent of GDP throughout the program period. The targeted reduction in the budget deficit is to be accomplished largely through a strengthening of the revenue efforts, based on the adoption of revenue-enhancing tax and nontax measures and improvements in tax administration and collection. In addition, the Government will improve the targeting of social safety net expenditures and restructure other budgetary expenditures, as explained below:

19. The Government's budgetary objectives extend beyond reducing deficits to more fundamental restructuring of the policies and institutions in the areas of tax policy and administration, expenditure policy (including support to state-owned enterprises and social safety net expenditure), and debt management. The IMF and donors are providing ongoing technical assistance in all these areas. The Government intends to create a more efficient and equitable tax system, better geared to a market economy and the emerging private sector. In particular, the Ministry of Finance has recently been empowered to exercise control over all revenue raising agencies of Government, including the Customs Administration and State Tax Inspectorate (including the regional offices). A Tax Police Department has recently been set up under the direct guidance of the Government. The Government intends to allocate sufficient budgetary resources to the revenue raising agencies so that they can do their jobs adequately. Also, the Government will ensure that collection targets are frequently and appropriately adjusted to take account of inflation and economic growth.

20. The Government will restructure the social safety net to better target benefits and replace unfocused allowances with targeted transfers. It will

also reform the funds comprising the Social Fund to ensure its long-term financial solvency. It will restructure other areas of government expenditures to ensure adequate funding for key areas, such as education, health care, and infrastructure. At the same time, there will be no budgetary transfers to failing enterprises outside the conditional restructuring program described in section IV.b below. The Government will limit increases in the wage bill so as to be consistent with inflation targets and will undertake civil service employment reform, cutting employment by up to 20 percent during the program period. We expect to achieve a reduction of government employment by about 3 percent by end-1994 and a further 10 percent in 1995. Maintenance expenditures and critical public investments will be increased in real terms to create a basis for the recovery. The Government is in the process of setting up an effective treasury system for managing and accounting for its funds and we expect that the treasury will cover all budget transactions nationwide by December 1994. The area of debt management has become a critical part of the Government's responsibilities. The Kyrgyz Republic is firmly committed to meeting its debt service obligations on time, and the debt management unit in the Ministry of Finance will continue to be reinforced to that end. More specifically, new foreign borrowing by the Government or government owned entities and the granting of government guarantees now requires the explicit concurrence of the Minister of Finance.

c. Money and credit

21. As inflation is reduced and positive real deposit interest rates are sustained, increased confidence is likely to be reflected in higher financial savings and a deepening of financial intermediation. Throughout the program period, credit and monetary policies will need to be fully consistent with overall program objectives for growth, inflation, and the balance of payments. Monetary expansion will initially be held below nominal GDP growth and will be further reduced in the event that inflation exceeds program targets. The foundation for a market based system of monetary control has already been put in place, including auctions for refinance credit, treasury bills, and foreign exchange; uniform reserve requirements; and a Lombard credit facility. A new payments clearing system in the banking sector is currently under consideration. Further steps are needed to refine and augment the indirect monetary instruments and improve the monitoring of financial developments. An improved system of banking supervision is currently being implemented. Each of these steps will help to ensure the orderly development of financial markets.

22. Existing bank overdrafts with the NBK were converted into notes on April 1, 1994 that are repayable in equal weekly amounts over three years. With the resumption of auctions for refinance credit in early April, 1994, the NBK will strictly limit the amount of any new overdrafts extended to commercial banks and will, if necessary, enforce these limits through appropriate disciplinary actions against banks, including the imposition of direct controls on the lending of banks that again incur persistent overdrafts.

23. The Government is committed to make monetary instruments more effective. In January 1994, the NBK took regulatory initiatives to encourage nonbank participation in the Treasury bill auctions and to foster secondary market trading. Future credit auctions will be closely coordinated with treasury bill and foreign exchange auctions to ensure an appropriate liquidity level of the banking system. In the second half of 1994, the Government intends to sell to the public small denomination in treasury bills (T-bills) with varying maturities. Other savings instruments, such as certificates of deposit, will also be developed. The involvement of nonbank investors in the primary market for T-bills and the introduction of government paper with different maturities will deepen the financial market and should, over time, help to limit the government's dependence on bank financing of fiscal deficits.

24. In early 1994, the NBK and the Government publicly announced that neither the NBK nor the Government will provide any funds to help clear existing domestic interenterprise arrears, except on a conditional basis to enterprises that are to be restructured by the ERRA (Section IV.b below).

25. To assure a better functioning of the domestic payments system, the NBK lifted all restrictions on vault cash holdings in April 1994. This step was a critical element in the effort to restore confidence in the banking system and the national currency. Furthermore, the NBK will establish by end-1994 a central clearing house, along with six regional clearing centers, to allow for same day settlement on the books of the NBK of multilateral net interbank positions.

d. Prices and wages

26. Very substantial progress has been made in implementing price reform. Following a generalized price liberalization in January 1992, a number of administered prices were further relaxed through the remainder of 1992 and the first half of 1993. Utility charges were separated from rents, which were raised 60 fold on state owned housing in August 1993, and increases in imported energy costs for petroleum products and coal were fully passed through to end users. Only prices for electricity, gas, and heat remain subsidized, particularly for residential consumers. Rents on privatized housing have been liberalized. The bread price was raised approximately eleven fold in 1993 and more than doubled on February 17, 1994. Retail margins that were imposed on all goods shortly after the introduction of the som remain in effect only on bread, and will be eliminated in mid-1995 at the time of the privatization of the bread complex.

27. Starting from July 1994, for budgetary and efficiency reasons, the Government will adjust, in stages, prices for electricity, heat, and gas with the objective of fully covering the costs of energy by the end of 1995. Furthermore the current system of cross subsidization effected through charging higher prices to industrial users will be eliminated by increasing faster the rates charged to households. Rents on publicly owned housing and the charges for associated maintenance will be raised in steps so as to

cover costs in the second half of 1996. This will reduce budgetary costs in these areas and encourage the purchase of apartments under the housing privatization program. These measures will need to be complemented by targeted transfers to the poorer segments of the population within the overall social safety framework.

28. To improve the efficiency of resource allocation and strengthen the financial position of enterprises, the Government eliminated on December 17, 1993 the maximum profit margins for "monopoly producers", defined as any firm with a domestic market share of at least 35 percent for the product or products it produces. Furthermore, the number of firms classified as monopolists was reduced to 50 in September 1993, to 15 in February 1994, and further to 9 on May 16, 1994 (five of which are classified as natural monopolies). The bread production complex has been removed from the list of natural monopolists and a program for its demonopolization and privatization has been drafted. The Government is committed to break up the bread complex and privatize 50 percent of the complex (excluding flour mills) by mid-1995. The process of determining which firms constitute monopolies will be further examined with a view toward limiting state regulation only to natural monopolies such as electricity, water, and railways.

29. Under the program, increases in the budgetary wage bill will effectively be limited to targeted future inflation rates through improved budgeting and expenditure management. However, average real wages in public administrative organizations could rise due to the planned reduction in government employment by 20 percent over the three-year program period. Greater flexibility in setting wages in budgetary institutions will be pursued by the Government in order to encourage skilled personnel to remain in the civil service.

30. The norm for total wage bills of state-owned enterprises currently stipulates that the total wage bill deductible for tax purposes in any enterprise cannot exceed 10 times the number of employees times the minimum wage. The Government intends to strictly enforce this provision. In addition, and more importantly, during the program period wages will be constrained through the imposition of hard budget constraints on state-controlled firms, including by eliminating directed credits. For enterprises under the ERRA, increases in the wage bill will be limited to less than the projected increase in the consumer price index.

e. External sector policies

31. At the time of the introduction of the Som, the Government introduced an exchange system virtually free of restrictions for current or capital transactions. Until such time as the interbank market is fully operational, it was decided to supply the interbank market through regular foreign exchange auctions at the NBK. There has been a significant improvement in the functioning of the foreign exchange market as the resolution of the overdraft problem has already allowed more banks to participate in the auction. Moreover, since early 1994 all foreign exchange bureaux have been

permitted to buy foreign currency without any restriction and without regard to their financial position vis à vis commercial banks. With the relaxation of the informal guidance provided by the NBK to banks and exchange bureaux, there was a sharp narrowing of the spread between the auction and retail exchange rates and a virtual disappearance of the spread between the commercial banks' exchange rates and the parallel market rates. The Government intends to ensure the continued smooth functioning of the foreign exchange markets, free from government intervention. The government also intends to maintain the full current and capital account convertibility of the Som within a freely floating exchange system, and to move to Article VIII status at the latest at the time of the 1995 Article IV consultations with the Fund. Throughout the program period, the volume of foreign exchange auctioned by the NBK will be consistent with the monetary program and the targeted foreign reserve buildup. The NBK intends to eventually replace foreign exchange auctions with direct sales and purchases in the interbank market.

32. In early 1994 the Kyrgyz trade system was substantially further liberalized. All remaining import and export licensing requirements have been lifted, with the exception of a list of 8 restricted goods 1/. The former schedule of export duties covered a wide range of goods with a considerable dispersion of rates and had a number of country specific exemptions. On May 16, 1994 the list of goods subject to export taxes was reduced to nine 2/ and the maximum export tax rate was brought back to 30 percent (except on rare animals where the rate is 80 percent). We recognize that export duties discourage exporters and intend to eliminate remaining export duties by the end of 1994, except those on rare animals, live animals, hides and leather, which will be eliminated by the end of 1996.

33. There are no quantitative restrictions or quotas on imports; import prohibitions solely reflect health and security considerations. No new licensing requirements, quotas or prohibitions will be imposed during the program period. A large number of import duties have also been eliminated recently. Except for the tax-free trade area with Kazakhstan and Uzbekistan and imports from Russia (and other tax-free bilateral agreements that the Government might enter into), a simple tariff schedule has been established with a flat rate of 10 percent. The effectiveness of tariffs will depend critically on the strengthening of the nascent customs administration, with technical assistance from the IMF and bilateral donors. The Kyrgyz Republic is not yet a member of the GATT, but intends to apply for observer status and eventual membership.

1/ Weapons, explosives, nuclear material, poisons, drugs, works of arts and antiques, precious rare earth metals, and rare animal and vegetable matter used in pharmaceutical production.

2/ Grains, sugar, vitamins, live animals, cattle skins, precious metals, ferrous and nonferrous scrap metal, rare and wild animals.

34. Kyrgyz foreign trade increasingly takes place through normal market mechanisms. For 1994 bilateral clearing arrangements for trade were agreed only with Russia and Uzbekistan, in order to ensure essential energy supplies and other inputs. The state order and state purchase systems have been abolished. Although a certain amount of state purchases will continue in agriculture, largely to fulfill commitments under the bilateral clearing arrangement with Russia, procurement contracts will be freely negotiated. There will no longer be a link between the provision of inputs and supply contracts. There will be no constraints on the sale of agricultural products, either domestically or abroad. The Government will widely publicize these changes through various media.

IV. Structural Policies

a. Enabling environment for market economy

35. The Government is committed to establishing a legal and regulatory framework that secures individual property rights, removes entry and exit barriers, and enables free business operations. To that end, the Government will prepare, by end-1994, an action plan for the enactment and implementation of the required legislative and regulatory measures, with emphasis on the following actions: (i) the submission to the legislature of a Company Law governing the activities of private businesses (a law on insolvency was passed by Parliament in January 1994); (ii) clarification of rights of lease-holders, and simplification of land-lease rules and regulation; (iii) adoption of legal and institutional arrangements for registration of physical and intellectual property, companies, share, and pledges/mortgages; and (iv) simplification of registration procedures for new businesses. Moreover, the Government is determined to provide a favorable environment for foreign investment by simplifying the licensing procedures for foreign investors, by ensuring the protection of foreign capital against expropriation and nationalization, and by providing equal incentives to domestic and foreign investors. Accordingly, the Government will improve the 1991 Foreign Investment Law and its implementation regulations in the course of 1994.

36. The Government has discontinued the system of centralized and obligatory state orders and supply contracts for domestic market. Moreover, the role of the Ministry of Trade, Industry, and Material Resources (MTIMR) is being transformed into one of support and service, and no longer of intervention and control. For this purpose, the Government will break up four large wholesale trade enterprises by December 1994 and privatize them in the course of 1995. In the transport sector, the Government will break up and demonopolize three holding companies and privatize 10 large trucking enterprises before the end of 1994. The Government will further privatize 28 transport enterprises in 1995.

b. Privatization and enterprise sector reform

37. The speed of privatization in the Kyrgyz Republic has been relatively rapid, but without a transparent competitive process or market-oriented share pricing. To date over 35 percent of the fixed assets of enterprises have been privatized, but the privatization process has taken mainly the form of transferring shares to labor collectives, with the exception of small enterprises. This process has not been conducive to the emergence of effective private ownership and profit-oriented management. Eighty percent of the special means of payment (vouchers) have been distributed, but not used. The Government recognizes that the methods of privatization should be substantially improved to make the privatization process competitive, transparent and equitable. To that end, a concept note and legislation on privatization was accepted by the Parliament in December 1993.

38. The Concept Note provides for privatization of all small-scale enterprises (with up to 100 employees) through auctions and/or competitive bidding with the use of cash and privatization coupons. Medium (100 to 1,000 employees) and large-scale enterprises (over 1000 employees) will be converted into joint-stock companies before their privatization. The main methods for future privatization of those enterprises will be competitive cash bidding by individual investors (up to 70 percent of the equity) and voucher auctions, open to individuals and investment funds (for 25 percent of the equity), while 5 percent of the equity would be reserved for the enterprise's workers. In February 1994, a governmental decree introduced other important measures to improve the privatization program. These include converting all state enterprises into open joint-stock companies within four months; retroactively converting closed joint-stock companies into open joint-stock companies within two months; allowing shareholders the right to sell their shares to citizens outside the company; auctioning enterprise shares that remain in state hands, starting March 1, 1994; submitting detailed procedures and criteria for use in selecting competing privatization proposals for government review; and developing privatization proposals for 70 enterprises by end-1994. Also, investment funds became operational on April 25, 1994.

39. Other legislative measures recently introduced include: (i) adoption of the State Property Fund's (SPF) resolution eliminating "profile" restrictions in previous privatization contracts as well as in future contracts; (ii) transfer of enterprise shares remaining with the State from line ministries to the SPF and the privatization of those shares; (iii) enactment of regulations on the operation of Investment Funds and registration of shares in those Funds; and (iv) definition of the criteria to be applied in the selection from competing privatization proposals, the most important of which should be price.

40. The enterprise sector is facing difficult challenges ahead. The most urgent policy issue is to address the soft budget constraint faced by enterprises, the negative consequences of which are spilling over to other enterprises, the budget and the banking sector. The Government will also

start addressing the problems of enterprises that are likely to remain temporarily, if not permanently, under state ownership. The Government recognizes that unless the governance, financial discipline and efficiency of state-owned enterprises (SOEs) are improved, its stabilization objectives will be in jeopardy. The Government is committed to convert all medium and large SOEs into joint-stock companies and introduce new corporate governance systems for a selected number of enterprises, by end-1994. The Government will also consider options such as downsizing non-profitable product lines and spinning off social services to local authorities; and, liquidating non-viable enterprises.

41. The Government has established by Presidential Decree the Enterprise Reform and Resolution Agency (ERRA) for a period of four years to address the problems of 29 large loss-making public sector enterprises. These enterprises have been identified and most are expected to cease operations immediately once ERRA becomes operational in June/July 1994. These enterprises will not have any access to bank credit and the Government will set aside in the budget funds equivalent to about 1 to 2 percent of GDP. These funds will be used mainly for transitional costs associated with the care and maintenance of enterprises that ceased operations, for the settlement of enterprise debts to the budget, other enterprises, and commercial banks, and for the cost of retrenchment. It is expected that a number of these enterprises will be liquidated after the completion of diagnostic studies.

42. In order to prevent the reemergence of large interenterprise arrears, and to harden the budget constraint, the Government will issue general instructions involving both enterprises and banks, including stopping deliveries to enterprises in arrears. The banks will be instructed to adhere to the regulation that stipulates not to accept any payment orders not backed by sufficient funds. The Government will not address the issue of existing interenterprise arrears through any generalized schemes, but only on a case by case basis within the enterprise restructuring process under ERRA and without jeopardizing the fiscal objectives.

c. Fiscal reform

43. The Government intends to undertake, with assistance from donors and the IMF, a fundamental restructuring of tax policy and administration, expenditure policy and management, and debt management. In order to reverse the rapid decline in tax revenues, the Government has already started implementing a comprehensive package of measures to broaden the tax base and increase certain tax rates. These include broadening the base of the VAT by including most exempt goods, credit and barter transactions and services; strictly limiting exemptions and deductions for the enterprise profits tax to valid business-related claims; strictly applying the limitation on deductibility of wages for the enterprise profit tax (EPT); equalizing the treatment of imports and domestic production subject to excise taxes so as not to disadvantage domestic producers; introducing a low uniform import duty on non-FSU imports; introducing a presumptive profit and income tax on

the private sector; imposing a higher excise tax on a few luxury goods with application to imports; charging royalties on domestic gold production; and, as a temporary emergency measure, introducing a 5 percent sales tax on retail transactions.

44. With the 1995 and 1996 budgets, the Government will continue to improve the structure and functioning of the tax system, with the goal of increasing the ratio of total revenue (excluding foreign grants) to GDP from about 11 percent in 1994 to 13 percent in 1997. In particular, it will reform the personal income tax to include capital income in the base. The rate of the enterprise profits tax for collectivized agriculture will be raised to 25 percent in the 1995 budget, and, together with that for private agriculture, to 35 percent in the 1996 budget. In the 1995 budget, the enterprise profits tax for all other enterprises will be restored to 35 percent. Also in the 1995 budget, the export duties will be further reduced to three products 1/ and the petroleum excise duty will be raised from 15 to 25 percent.

45. The Government recognizes that tax administration is still a weak point and it will redouble efforts at improving it so that tax collections better approximate estimated tax liabilities. It will strengthen further the authority of the Ministry of Finance over the State Tax Inspectorate (STI) and Customs. The Government has begun to pursue tax arrears more aggressively, eliminate extralegal exemptions granted at all levels of the Government, adjust collection targets for the State Tax Inspectorate to account for growth and inflation, and raise and rationalize the penalty structure. The Government intends to reform the State Tax Inspectorate by reorganizing it along functional lines, reassigning staff to more productive tasks, developing techniques to assess hard-to-tax taxpayers (through a presumptive tax), limiting the influence of the local tax inspectorate offices, making the STI's activities more accountable to the Government, and improving auditing efforts.

46. The Government has already started restructuring expenditures and is committed to accelerate its efforts. Outside the restructuring assistance agreed upon as part of ERRA, the budget will not at any time provide funds to enterprises that have accumulated arrears or that are otherwise in difficulties. Second, increases in the overall wage bill will be kept in line with projected inflation. To the extent that the Government is successful in reducing the size of the civil service consistent with the reduced role of government in the economy, there will be room for real wage increases for remaining civil servants. This will over time partially compensate for the deep erosion in real wages that has already taken place. The Government will restructure compensation to provide higher wages to more productive civil servants and to undercompensated professionals, particularly teachers and doctors. The Government will see to it that critical spending for education, health, maintenance expenditure and some

1/ Rare animals, live animals, and hides.

capital investments, will be protected from budgetary cuts. Beginning in 1995, the World Bank will support the Government in reviewing its expenditure management practices and in preparing a public investment program. The Government's objective is to limit the ratio of total expenditure to GDP to about 18 percent of GDP throughout the program period. Overall, current expenditure is projected to remain constant as a share of GDP, while capital expenditure would roughly double from very low levels.

47. The Government recognizes that it has so far made only limited progress in expenditure control and budgetary management. It will implement the recently adopted budgetary law which will provide a much enhanced framework for public expenditure management. It will finalize the implementation of a treasury system, improve all aspects of expenditure management and debt management, and establish an appropriate financial relationship between the Ministry of Finance and the National Bank.

d. Financial sector reform

48. Financial sector reforms will focus on steps to increase the effectiveness of monetary management by the NBK and the development of the commercial banking system. Reforms in this area to date have concentrated on the introduction of banking legislation (a comprehensive new central bank law and a commercial banking law were adopted in December 1992), the introduction of the national currency and the transition to a market based indirect monetary policy framework. At the time of the introduction of the national currency, the som, a fully liberal currency law went into effect. At the same time, changes were made in the payments system, and a full range of monetary policy instruments was introduced or enhanced. Weekly foreign exchange sales by the NBK to the interbank market, regular treasury bill auctions, and credit auctions were introduced. Reserve requirements were unified in July 1993, and a Lombard facility was introduced in August 1993.

49. Despite substantial progress in the modernization of the banking sector, further achievements are contingent upon reforms of the commercial banking sector. In turn, this must be linked with the elimination of the underlying structural problems facing the public enterprise sector; enterprises will need to observe a hard budget constraint and the Government will need to abstain from influencing credit allocation before the functioning of the financial system can become fully efficient. Other impediments to the development of efficient financial intermediation are the existing payments and clearing system, the remaining weaknesses in the legal and regulatory framework, the lack of familiarity with modern banking techniques in the banking system as a whole, and administrative weaknesses. The clearance of nonperforming loans from the books of the commercial banks as part of the enterprise restructuring efforts under ERRA will strengthen the banking system and set the stage for financial sector restructuring and rehabilitation. To this end, the Government will develop a financial sector reform strategy that will aim at: (i) a fundamental restructuring and rehabilitation of the commercial banking system; (ii) promote competition through a reduction of the concentration in the banking system; (iii)

increase the private sector's role through privatization of large state-owned banks, including through foreign participation; and (iv) improving the quality of financial services, including through technology transfers.

50. Until a comprehensive financial sector reform can be implemented, the Government will focus on enhancing the banking infrastructure and regulatory framework. Technical assistance will continue in order to strengthen the NBK's capacity to conduct adequate monetary policy and enforce the commercial banks' compliance with the new regulations. To that end, the NBK is putting in place a system of on-site supervision. Modern accounting and auditing standards that are necessary for the expansion of financial intermediation will be introduced at the NBK by December 1994 and at the commercial banks by end-1995, within the framework of a general national program. This will also include an adequate accounting for non-performing assets. The restriction of lending to a single borrower will be gradually lowered from 35 percent of a bank's capital today, to 30 percent on January 1, 1995 and further to 25 percent on January 1, 1996. Furthermore, the maximum limit for lending to related parties to the banks (shareholders, directors, and associates) will be reduced from the current level of 20 percent of own funds to 15 percent of own funds on January 1, 1995. Capital requirements of the commercial banks will be reviewed on a regular basis and increased to take account of inflation. To facilitate the opening of the economy to international markets, the banking sector will be encouraged to increase its foreign sector operations and to benefit from technology transfers.

51. In the context of the development of a more effective monetary policy, credit auctions will be held on a regular and frequent basis with all refinance credit extended through the auctions. Technical assistance will be provided to refine proposed regulations to permit noncompetitive tenders at treasury bill auctions and to establish a structure for the development of secondary market trading. Government paper of different maturities will be introduced in the second half of 1994. The NBK will adopt further major reforms to reserve maintenance procedures and vault cash accounting that in effect would allow required reserve balances to include vault cash.

V. Social Safety Net and Human Resource Development

52. The development and implementation of an effective social assistance program is of the highest priority in order to ease the unavoidable hardship that the external shocks and the economic transition impose upon the population. The fundamental social protection issue facing the Government is how to ensure a minimum level of assistance to the most vulnerable groups and maintain fiscal restraint at the same time. The Government's policies for social protection are outlined in two key documents (Resolutions 539 and 608) which state that social support should only be provided to those in need, in a way consistent with fiscal realities. To effectively target social protection requires: (i) the establishment of separate social assistance and social insurance programs; (ii) the streamlining of the

current, complex administration of cash benefits and income support; and (iii) a reformed system for poverty and labor market monitoring.

a. Social assistance

53. The Government is committed to providing adequate funding for family allowances and well targeted social assistance. In early 1994, the Government eliminated bread subsidies to producers, while at the same time increasing cash compensation to the existing group of beneficiaries, with a view to achieving budgetary savings. In addition, family allowances and social pensions were removed from the Pension Fund and transferred to the budget. The ultimate goal of social safety net reform is to consolidate the existing family allowances, bread compensation, and other special social benefits (such as social pensions) into a single cash benefit, to be targeted to the poorest families with children, with special categories for low-income pensioners, disabled, unemployed, and childless persons. This will require a means-tested social assistance system based on self-selection and monitored by the Department of Social Protection. With the assistance of international organizations, the Government is determining the most cost effective way to carry out means testing in the Kyrgyz Republic. A poverty survey, which provided some preliminary results in February 1994, will provide new information on the extent of poverty. This new system for targeted assistance will be implemented fully in 1995. Domestic and foreign nongovernmental organizations (NGOs) may potentially have an important role to play in providing social assistance. To facilitate this, the legislation relating to the role and operations of NGOs will be revised.

b. Social security

54. The Government is in the process of reforming the system of pensions and social insurance, and has introduced a new Social Fund, which includes the Pension Fund, the Employment Fund, and the Social Insurance Fund as separate funds within the system. This consolidated fund will improve the efficiency of collection and contributions, as well as the efficiency of administration of various social programs. The Government is committed to ensuring the financial solvency of the Social Fund. The main priorities in this area are: (i) to broaden the payroll tax base by including all compensation with a view to reducing the tax rate, which is high by international standards, within the constraint of continued solvency of the Social Fund; (ii) to strengthen the system of revenue collection for the social funds; (iii) to simplify the system of pension calculation and compress the pension scale; (iv) to gradually raise the retirement age by five years; (v) to relate pensions to earnings; and (vi) to accumulate a modest reserve fund.

c. Labor market and employment

55. The Government is committed to addressing the policy and investment requirements of the labor market. The Kyrgyz Republic has already established an Employment Fund that is responsible for paying unemployment

benefits, providing retraining, and helping unemployed workers find new jobs. An immediate priority is to modify and streamline the payment of unemployment compensation in order to cope with rising unemployment. To that end, the Government already limited the Employment Fund's activities strictly to assistance to the unemployed and rationalized unemployment benefits by compressing the scale of benefits which will considerably reduce the administrative work and costs of providing benefits. The Government will base the eligibility for unemployment benefits upon at least 26 weeks of work in the preceding 12-months period; introduce an employee contribution of 0.5 percent of the payroll to the Employment Fund; and set aside a contingency fund in the budget to supplement the resources of the Employment Fund. In the long-term, the Government will adopt an earnings-related unemployment benefit and will set up a program of social assistance to protect those whose unemployment benefits have been exhausted.

56. The Government recognizes that the current direct link between housing and social services and place of employment prevents the evolution of a well-functioning labor market. Therefore, the Government will prepare for an orderly divestiture of social services from the enterprises to oblast authorities. Moreover, the development of private housing markets will be an important element for achieving labor mobility. At the same time, the employers' liability for funding severance payments was reduced to one month of employees' salaries and employers' contributions to the financing of retraining of laid-off workers were eliminated. The "propiska" system will be abolished by June 30, 1994, although the Government believes that it does not constitute a major constraint to labor mobility. The existing technical and vocational training system will be reoriented toward the commercial and services sector; and the objectives and content of the training will be made more relevant to the needs of a market economy.

d. Social sectors

57. The Government will pay continued attention to ensuring that priority and basic social services (such as primary and secondary education, and primary health care) are generally protected from expenditure cuts. Of particular importance, in the short-term, is the adequate provision of school supplies and teaching materials, as well as medical supplies for primary health care programs and basic institutional care. The Government will also start to address many structural issues both in the health and education sectors, including how these sectors should be financed, and how to improve the efficiency with which services are provided.

V. Sectoral Policies

a. Agriculture

58. The breakdown of interrepublican trade flows has caused large scale disruptions in agricultural production, distribution and processing. The initially only partial price decontrols have resulted in a deterioration of

sectoral terms of trade with a severe impact on the profitability of the sector. The policy challenge for the Government is to guide agricultural reforms during the transition in a way that is sensitive to short-term issues, while at the same time pursuing the medium-term objective of developing the sector in line with the country's comparative advantage under international prices. Within this framework, the Government's strategy is to improve the incentive framework for the sector, to encourage private sector development, and to adopt appropriate agricultural technology.

59. The Government intends to formulate a clearly articulated strategy for a market-based incentive structure for the sector. This strategy will clarify the role of the public, private and cooperative sectors in product and inputs marketing. Steps already taken include the adoption in early 1994 of a new system of limited state procurement for agricultural goods that is based on freely negotiated prices, provides for up front payments to producers so they may purchase inputs, guarantees a recalculation of the procurement price in order to compensate for inflation between the contract and delivery dates, and allows producers to freely sell their output to non-state buyers domestically and abroad. Private sector development in agriculture will be further encouraged under the provisions of a Presidential decree adopted on February 22, 1994. This decree establishes, among other things, that private citizens may "own" the right to use a plot of agricultural land for 49 years, a period that may be extended, may sell or exchange the use right, may use the land as collateral, and may unify plots on a voluntary basis. The Government also intends to increase the private sector's access to credit and support services.

60. Regarding agricultural technology, short-term problems will be addressed by encouraging agricultural enterprises to make full use of access to foreign exchange to import good quality seeds, fertilizers, pesticides, and spare parts for farm machinery and equipment. In the medium-term, adequately funded research and extension programs that are specifically focused on private farming constraints will be developed.

61. Responsibility for the privatization and denationalization of agricultural sector enterprises has been reestablished under the Ministry of Agriculture and Foodstuffs, which will be assisted by local state administrations and rural committees. The Government intends to proceed rapidly with the privatization of these entities.

b. Mining

62. The Kyrgyz Republic currently has a small and highly specialized mining industry (including mercury, antimony, uranium oxide, coal, and gold). The Government believes that considerable potential exists to put into production gold deposits that have been evaluated previously, and is pursuing their development through joint ventures with several foreign firms. Moreover, recent exploration has indicated potential new resources of various other minerals. The Government intends to make readily available the original exploration information for these deposits to potential

investors who can evaluate it using international economic parameters to determine whether these minerals can be extracted and processed economically. To develop the full potential of the mining industry on a commercial basis--with technical assistance from the international community--the Government will: (i) assess the technical and economic viability of current state-owned mining operations, as well as their operational bottlenecks; (ii) evaluate the basic geology of the country; (iii) modify the role of the government from being that of direct participant in production activities to that of sector regulator; and (iv) establish laws and mechanisms to facilitate foreign investment.

c. Energy

63. Reflecting the underpricing of energy products during the Soviet era, the Kyrgyz Republic is a heavy consumer of energy relative to its level of industrialization and per capita income. The country is also a net importer of energy; its trade deficit in this category is estimated to have amounted to US\$140 million in 1993. At the same time, the country has abundant and relatively low cost hydro resources that could be efficiently exploited. There is also potential for oil and gas production, if exploration efforts could be resumed, preferably by private ventures. Against this background, the major objectives of the Government's ongoing energy strategy are to: (i) develop indigenous energy resources to reduce the country's dependence on imports; (ii) restructure the energy entities and prepare the legal framework to attract private sector participation; and (iii) promote energy conservation. A pricing policy with a view to ensuring efficient and economic use of energy products, and sustain the energy sector's development, has already been adopted. Moreover, prices of electricity, gas and heat, which are still highly subsidized for households, will be raised to achieve full cost recovery by end-1995. The Government is in favor of enhancing regional cooperation and developing export markets for electricity.

d. Infrastructure and transport

64. The demand for transport in the Kyrgyz economy has fallen in aggregate volume due to the collapse in output and trade and is expected to change drastically in qualitative terms as the economy adopts to new market conditions. The transport sector will, therefore, need fundamental restructuring, which the Government will promote by improving the sector's organization, the incentives of, and regulations facing, transport providers, and the allocation of public funds. More specifically, the Government intends to: (i) promote competition in road freight and passenger transport by eliminating unnecessary regulations, such as those restricting market entry; (ii) accelerate the privatization of domestic transport, especially trucking services, as described already in paragraph 36; (iii) establish an efficient road user taxation system, and liberalize prices immediately; (iv) separate the regulatory and operational functions of government agencies, and establish modern supervision systems, such as performance contracts for large public enterprises (railways, the airline,

and the public transport companies); and (v) ensure that public works are procured on a competitive basis, with the road construction companies being separated from the government.

65. The Kyrgyz Republic's telecommunication network is insufficient to meet demand from priority (business) and other subscribers. The Government recognizes that an efficient telecommunication system is needed for the country's full integration with the world economy. Therefore, the Government's strategy in the short-term is to: (i) stabilize the operations of the existing network and, where cost effective, improve service quality; (ii) build management and planning capabilities through the implementation of a comprehensive training program, and convert the telecommunications branch of the Ministry of Communication into a corporation with commercial orientation; and (iii) undertake a comprehensive change in the structure and level of tariffs as part of a broad financial restructuring program of the sector. Progress is being made in these areas with the assistance of the World Bank.

e. Environment

66. The Kyrgyz Republic's environmental problems are only moderate in severity and do not appear to pose immediate threats to human health or to sustainable development. Nevertheless, air quality in the major cities is unsatisfactory despite only moderate traffic. Intensive livestock complexes and some agroprocessing factories are among the major sources of water pollution. Tailings from mining operations, particularly for uranium, may pose significant health hazards. There is no disposal facility for industrial hazardous wastes and municipal waste disposal is inadequate. The Government is developing the necessary tools to deal with such issues: a new Environmental Law; draft laws for air, water, soils, nature etc; environmental assessment and auditing procedures; market based instruments such as pollution permits, fees and fines; and plans to extend the protected areas.

VI. External Financing Requirements

67. In view of the uncertainties in the economies of major trading partners, the medium term foreign trade projections are cautious. They are based on a gradual increase in export volume to traditional FSU trading partners (average annual volume increase of 4 percent between 1994 and 1997) as temporary interstate payments difficulties are resolved and economic activity increases in neighboring countries. Starting from a very small base, a higher volume growth of exports to non-FSU markets is expected (over 6 percent average annual volume increase between 1994 and 1997) as Kyrgyz producers penetrate new markets. This rate of growth could be substantially increased over the medium term, as a result of capacity enhancing investments in the energy and mining sectors.

68. A further jump of about 14 percent in average import prices is built in to the projections for 1994 (largely on account of gas price increases). We expect the overall import volume to grow by about 4 percent in 1994. While overall import volumes from the FSU are projected to grow only modestly over the medium term, imports from the non-FSU area will be largely driven by the availability of external financing. Over time the composition of these imports is expected to shift significantly from humanitarian assistance to investment goods.

69. Since 1991 there has been a severe deterioration in terms of trade as well as the loss of traditional export markets. This has implied significant reliance on short- and medium-term credits and exceptional balance of payments support, much of it initially at nonconcessional rates of interest. The Government's objective is to achieve financial viability in the external sector over the medium term. Given the severity of the terms of trade shock and the uncertainties in our traditional export markets, we believe that the Kyrgyz Republic will continue to rely on substantial external financing for a number of years. As a result of credits contracted at commercial terms, Kyrgyz debt service requirements are projected to increase relatively fast in the short term. Debt service on existing loans is projected to increase to about 25 percent of total exports in 1995 and then fall back to about 22 percent of GDP in 1996-97. In order to ensure the timely discharge of all debt servicing obligations, it will be important to target an adequate reserve buildup over the program period and it is projected that gross reserves (including gold) will grow from 1.1 months of total imports at end-1993 to 2.1 months of imports by the end of the program period. We expect debt service to stabilize over the medium term at a sustainable level of around 20 percent of exports.

70. The balance of payments projections (Table 2) suggest that, on average, additional external financing of around US\$280 million per year would be needed over the three-year program period, of which about US\$100 million per year is projected to be provided by the Bretton Woods institutions. In view of the relatively large disbursements in 1994-95 of funds committed in 1993, the financing gap projected for 1994-95 is somewhat lower at about US\$235 million (before use of World Bank and IMF resources) and is expected to be filled at the Consultative Group meeting on June 2 and 3, 1994 in Paris. The Government is confident that over time a pipeline of project loans and other regular aid assistance can be built up that would generate disbursements sufficient to reduce and then eliminate the need for recourse to exceptional balance of payments financing. Also, to speed up aid disbursements the Government has improved and centralized at Goskominvest the preparation of the documentation required by multilateral and bilateral donors. The Government will seek to meet external financing requirements almost exclusively on concessional terms and commercial borrowing will be generally avoided in order to keep debt service payments within the country's long run debt service capacity.

VII. Technical Assistance and Statistical Issues

71. The Kyrgyz Government has submitted a Technical Assistance Program to the Consultative Group. The Government has stated its intention that, except in very exceptional cases, it will not use borrowed resources for the financing of technical assistance but intends to continue its current practice of financing nearly all such assistance on grant terms. The Government has identified agriculture and energy as priority sectors. There is also an urgent need for technical assistance related to the restructuring and liquidation of enterprises under ERRA. As to the budget, we hope that technical assistance from the Fund in the area of expenditure policy and management, and in particular for the completion of the Treasury, will continue, and we expect the Fund, US-AID, Germany, and other donors to provide technical assistance for tax policy and administration. Japan is assisting us with the introduction of a new payments system and, together with the Fund and US-AID, on banking supervision. US-AID, France, and other donors are expected to provide further assistance on improving accounting procedures of the NBK and later of the commercial banks.

72. The Government of Kyrgyz Republic also recognizes the importance of a sound macroeconomic database compiled according to international standards for economic analysis and the formulation, implementation, and monitoring of economic programs. Although progress has been made with the help of IMF technical assistance in the areas of monetary, fiscal, and price statistics, the current database still has many shortcomings. Therefore, to address these shortcomings and to ensure the efficient utilization of technical assistance resources, the Government will establish a clear and specific timetable for the implementation of remaining technical assistance recommendations in the area of statistics and for the improvement of data compilation and reporting.

Table 1. Kyrgyz Republic: Selected Economic Indicators

(In percent change, unless otherwise indicated)

	1993 Est.	1994 Prog.	1995 Prog.	1996 Prog.	1997 Prog.
Real GDP growth	-16.0	-5.5	0.4	2.7	4.7
GDP deflator	1281.7	298.7	47.0	16.1	9.7
Consumer prices (period average)	1208.7	310.8	50.7	17.2	9.9
Consumer prices (end period)	1366.0	116.5	30.6	12.7	6.5
Gross capital formation/GDP	5.9	5.3	8.4	9.7	11.2
National savings/GDP	-10.1	-6.7	-2.5	-0.1	2.5
Total revenue (including foreign grants)/GDP	14.2	14.1	14.3	15.1	15.3
Total revenue (excluding foreign grants)/GDP	9.3	10.7	11.5	12.5	13.0
Total expenditure & net lending/GDP	22.4	17.9	17.8	18.1	18.3
Of which: Capital expenditure	0.8	0.7	1.2	1.5	2.0
Budget deficit/GDP	-8.2	-3.8	-3.5	-3.0	-3.0
Broad Money <u>1/</u>	...	64.9	37.4	29.6	29.1
Net domestic assets <u>1/</u>	...	70.8	39.5	18.9	16.4
Credit to Government <u>1/2/</u>	...	89.4	31.9	--	--
Credit to the economy <u>1/</u>	...	66.0	31.1	24.7	20.2
Velocity of broad money (ratio)	26.1	37.3	35.6	32.0	27.9
Export volume growth	...	1.1	3.9	5.6	8.0
FSU	...	0.1	3.4	4.6	6.9
Non-FSU	...	3.0	5.0	7.5	10.0
Import volume growth	...	3.6	0.5	2.0	3.8
FSU	...	-2.0	-0.5	0.9	0.9
Non-FSU	...	15.2	2.3	3.9	8.6
Exports/GDP	21.0	14.5	14.9	15.1	15.5
Imports/GDP	31.5	23.4	23.5	23.1	22.6
Change in export unit prices	...	8.5	1.8	1.6	1.9
Change in import unit prices	...	14.1	3.1	1.6	1.5
External current account (in millions of U.S. dollars) <u>3/</u>	-254.8	-303.5	-284.7	-271.1	-257.8
External current account/GDP <u>3/</u>	-16.0	-12.0	-10.9	-9.8	-8.7
Gross international reserves (incl. gold) (in months of imports, end of period)	1.1	1.2	1.6	1.9	2.1
External debt outstanding/GDP <u>4/</u>	17.9	19.3	26.5	32.2	36.3
FSU	10.5	6.9	5.4	3.9	2.8
Non-FSU	7.3	12.4	21.1	28.3	33.5
Debt service (in millions of U.S. dollars) <u>5/</u>	1.5	24.9	100.2	89.3	100.8
Of which: Interest	1.5	24.1	25.3	27.2	29.7
Debt service/GDP <u>5/</u>	0.1	1.0	3.8	3.2	3.4
Of which: Amortization	--	--	2.9	2.3	2.4
Total debt service/total exports	0.4	6.8	25.8	21.4	22.0
Of which: Amortization	--	0.2	19.3	14.9	15.5

Sources: Data provided by the authorities; and staff projections 25-May-94.

1/ Comparison with 1992 are not possible because of the transition from Russian rubles to Soms in May 1993.

2/ Includes a credit from Turkey channelled through the NBK to the budget.

3/ Excluding grants.

4/ Includes debt accumulated to fill projected financing gaps.

5/ Includes debt service on financing gap under the assumption of highly concessionary terms.

Table 2. Kyrgyz Republic: External Financing Requirements, 1993-97

(In millions of U.S. dollars)

	Prel. 1993	Proj. 1994	Proj. July/June 1994/95	Proj. 1995	Proj. 1996	Proj. 1997
Current account balance, excluding official transfers	-254.7	-303.5	-336.4	-284.7	-271.1	-257.8
Trade balance	-166.4	-224.6	-269.5	-225.5	-219.5	-211.6
Exports	334.9	367.9	381.0	388.6	416.8	458.7
FSU	222.7	243.7	259.7	257.4	273.5	297.9
Non-FSU	112.2	123.6	121.3	131.2	143.3	160.9
Imports	-501.3	-592.8	-650.5	-614.1	-636.3	-670.3
FSU	-316.7	-375.7	-391.1	-388.5	-398.2	-407.9
Non-FSU	-184.6	-217.1	-259.4	-225.6	-238.1	-262.4
Net noninterest services	3.7	-25.5	-18.6	-15.9	-15.3	-12.1
Net interest	-1.5	-24.1	-23.9	-25.3	-27.2	-29.7
Net private transfers ^{1/}	-90.5	-28.5	-24.3	-18.1	-9.0	-4.5
Amortization	--	-0.8	-37.8	-74.9	-58.4	-61.1
Repurchases	--	--	--	--	-3.7	-10.0
Change in gross reserves ^{2/}	-27.0	-12.8	-16.6	-23.8	-21.0	-14.0
Errors, omissions, and short-term capital	-55.1	--	--	--	--	--
<u>Total financing requirements</u>	<u>336.8</u>	<u>317.1</u>	<u>390.8</u>	<u>383.4</u>	<u>354.2</u>	<u>342.9</u>
<u>Disbursements from existing commitments</u>	<u>336.8</u>	<u>200.9</u>	<u>155.2</u>	<u>91.6</u>	<u>32.4</u>	<u>29.9</u>
Grants	116.0	42.5	31.4	16.3	7.4	4.9
Loans	210.8	143.4	100.4	50.3	--	--
FSU	93.8	8.2	--	--	--	--
Non-FSU	117.0	135.2	100.4	50.3	--	--
Bilateral creditors	9.6	106.3	80.7	37.1	--	--
Multilateral creditors	107.4	29.0	19.7	13.1	--	--
Of which: IMF (SBA and STF)	61.8	--	--	--	--	--
World Bank	17.9	29.0	19.7	13.1	--	--
Other	27.8	--	--	--	--	--
Foreign direct investment	10.0	15.0	23.4	25.0	25.0	25.0
<u>Disbursements from expected new commitments ^{3/}</u>	<u>--</u>	<u>116.1</u>	<u>235.6</u>	<u>292.0</u>	<u>321.7</u>	<u>313.0</u>
Grants	--	54.1	57.1	58.0	63.0	57.9
Loans	--	62.0	178.5	234.0	258.7	255.1
FSU	--	--	--	--	--	10.0
Non-FSU	--	62.0	178.5	234.0	258.7	245.1
Bilateral creditors	--	17.8	62.5	74.7	103.1	95.8
Multilateral creditors	--	44.2	116.0	159.3	155.6	149.3
Of which: IMF (ESAF)	--	13.2	33.0	36.3	33.0	16.5
World Bank	--	29.7	64.0	77.1	82.3	86.2
Other	--	1.3	19.0	45.9	40.3	46.6

^{1/} Includes migrants' transfers.

^{2/} Excluding monetization of gold; including commercial banks.

^{3/} To be mobilized through the Consultative Group process.

TABLE 3. KYRGYZ REPUBLIC: SUMMARY AND TIMETABLE OF PRINCIPAL POLICY MEASURES, 1994-96

Policy Area and Objectives	Strategy	Measures	Timing
1. <u>Fiscal Policy</u>			
Adapt public finances to market economy and progressively lower the budget deficit.	Broaden the tax base, streamline expenditures and strengthen budget planning and control.	<p><u>Tax Reform:</u></p> <p>(a) broaden the VAT base by including exempt and zero-rated goods, credit and barter transactions and services;</p> <p>(b) strictly limit exemptions and deductions for the enterprise profits tax (EPT) to valid business-related claims;</p> <p>(c) strictly apply the limitation on deductibility of wages for the EPT;</p> <p>(d) impose a higher excise tax on a few luxury goods with application to imports;</p> <p>(e) start charging royalties on domestic gold production;</p> <p>(f) increase rate of EPT for collectivized agriculture to 25 percent (1995 budget) and 35 percent (budget 96);</p> <p>(g) increase rate of EPT for private agriculture to 35 percent;</p> <p>(h) increase rate of EPT for enterprises to 35 percent;</p> <p>(i) increase the petroleum excise duty to 35 percent (budget 95) and further to 35 percent (budget 96);</p> <p>(j) include capital income in the personal income tax base;</p> <p>(k) apply uniform profit tax rates across industries and services;</p> <p>(l) bread complex to honor its obligation to transfer the counterparts to food aid to the budget.</p> <p><u>Tax Administration:</u></p> <p>(a) eliminate tax exemptions granted at all levels of government;</p> <p>(b) adjust tax collection targets in line with growth and inflation;</p>	<p>Implemented</p> <p>Implemented</p> <p>Implemented</p> <p>Implemented</p> <p>Implemented</p> <p>1995 and 1996 budgets</p> <p>1996 budget</p> <p>1996 budget</p> <p>1995 and 1996 budgets</p> <p>1995 budget</p> <p>1996 budget</p> <p>Throughout the program period</p> <p>Throughout the program period.</p> <p>Throughout the program period.</p>

TABLE 3. KYRGYZ REPUBLIC: SUMMARY AND TIMETABLE OF PRINCIPAL POLICY MEASURES, 1994-96

Policy Area and Objectives	Strategy	Measures	Timing
		(c) reorganize the State Tax Inspectorate (STI) along functional lines and limit the influence of local tax inspectorate offices;	Throughout the program period.
		(d) improve STI's taxpayer services by computerization, staff training, auditing and strengthening the payment system;	Throughout the program period.
		<u>Expenditure Restructuring:</u>	
		(a) budget not to provide resources to support the troubled enterprises other than those agreed under the PESAC;	Throughout the program period.
		(b) overall wage bill to be contained in line with projected inflation;	From 1995 onward
		(c) improved targeting of social subsidies and transfers as outlined in Section 8;	Throughout the program period.
		<u>Expenditure Control and Budget Management:</u>	
		(a) establish proper budget coverage and classification in accordance with international norms;	1995 budget
		(b) all spending ministries to report to treasury cash accounts, unpaid bills, and commitments on a monthly basis.	From 1995 onward
		(c) finalize the establishment of the Treasury	End 1995

TABLE 3. KYRGYZ REPUBLIC: SUMMARY AND TIMETABLE OF PRINCIPAL POLICY MEASURES, 1994-96

Policy Area and Objectives	Strategy	Measures	Timing
2. <u>Monetary Policy</u>			
Progressively reduce inflation	Pursue appropriately tight monetary and credit policies.	(a) strictly limit bank credit to Government and public enterprises	Throughout the program period.
		(b) allocate all refinancing credit through credit auctions;	Throughout the program period.
		(c) introduce government paper with different maturities.	Second half 1994
3. <u>Prices and Wages</u>			
Ensure market determination of prices.	Progressively eliminate remaining price controls and direct and indirect subsidies.	(a) further reduce the number of enterprises on the monopoly list to nine enterprises;	Implemented
		(b) limit price controls to natural monopolies, such as electricity, water supply, railroads, and bread pending demonopolization and privatization of bread complex;	Throughout the program period.
		(c) increase electricity, heating, and gas prices to households to achieve full cost recovery;	End-1995
		(d) increase public housing rents to fully recover operating and maintenance costs by mid-1996;	Throughout the program period.
		(e) for state enterprises, total wage bill deductible for tax purposes not to exceed 10 times the number of employees times the minimum wage.	Throughout the program period.

TABLE 3. KYRGYZ REPUBLIC: SUMMARY AND TIMETABLE OF PRINCIPAL POLICY MEASURES, 1994-96

Policy Area and Objectives	Strategy	Measures	Timing
4. <u>Enabling Environment for Market Economy</u>			
Create an environment conducive to the development of a market economy and private sector.	Establish an appropriate legal and regulatory framework for private sector development.	(a) government to prepare an action plan, which will set out the steps to be taken, including timetable, to amend/enact the required legislative and regulatory measures to liberalize private sector activities, and foster its development, with priority given to the following actions:	June 1994
		(i) to clarify the rights of leaseholders; to simplify land-lease rules; and to facilitate transfer of lease and similar user rights;	December 1994
		(ii) to impose stricter duties on companies in the registration of shares; to clarify the concept of legal personality and the difference between limited and unlimited liability;	December 1994
		(iii) to allow for the registration in a Central Registrar with district offices of security rights by lease or pledge;	December 1994
		(iv) to prepare legislation/decrees on Competitive State Procurement Procedures for publicly financed purchases and contracts;	December 1994
		(b) Government to prepare a comprehensive Company Law for review with IDA;	December 1994
		(c) government to establish a central legal reform unit to coordinate activities required under the action plan; improve the legal enforcement process, strengthen civil dispute resolution institutes, etc;	June 1994
		(d) government to submit a progress report on the implementation of the action plan and a timetable for further legal reform activities.	Throughout 1994

TABLE 3. KYRGYZ REPUBLIC: SUMMARY AND TIMETABLE OF PRINCIPAL POLICY MEASURES, 1994-96

Policy Area and Objectives	Strategy	Measures	Timing
Create an environment conducive to the development of the market economy and private sector.	Improve competition and efficiency by maintaining a liberal foreign exchange regime, and by liberalizing domestic and external trade.	<p>(a) maintain current and capital convertibility and promote an active interbank foreign exchange market to improve access to foreign exchange;</p> <p>(b) reduce the list of goods subject to export taxes to 9;</p> <p>(c) reduce the list of goods subject to export taxes to three products;</p> <p>(d) abolish all export taxes;</p> <p>(e) imports to remain free of quotas and prohibitions, except for health and security reasons;</p> <p>(f) government will break up four large wholesale trade enterprises by December 1994 and privatize them by end-1995;</p> <p>(g) government will demonopolize three transport holding companies and privatize 10 large trucking companies;</p> <p>(h) government will privatize a further 28 transport enterprises in 1995;</p> <p>(i) adopt Article VIII status.</p>	<p>Throughout the program period.</p> <p>Implemented</p> <p>December 1994</p> <p>December 1996</p> <p>Throughout the program period.</p> <p>December 1994 and December 1995</p> <p>Before end-1994</p> <p>December 1995</p> <p>Before completion of 1995 Article IV consultations</p>
5. <u>Privatization</u>			
Reduce the role of the State in economic activity - Enable the creation of a significant number of private enterprises.	Improve privatization through transparent and competitive process, conducive to the emergence of effective private ownership.	<p>(a) government to amend legislative and/or regulatory provisions to allow free exercise of individual share-holding property rights by members of labor collectives. Such new laws and/or regulations to be applied to already privatized enterprises.</p> <p>(b) Government to issue a decree to eliminate from privatization contracts already concluded, any restriction on the range of business activities that can be undertaken by enterprises, and direct SPF and local governments not to place such restrictions in future privatization contracts.</p>	<p>Implemented</p> <p>Implemented</p>

TABLE 3. KYRGYZ REPUBLIC: SUMMARY AND TIMETABLE OF PRINCIPAL POLICY MEASURES, 1994-96

Policy Area and Objectives	Strategy	Measures	Timing
		(c) government to issue a directive that SPF will use auctions and bidding procedures for future privatization of all enterprises (except those under the purview of ERRA). In the case of medium and large enterprises, privatization coupons and Investment Funds will also be used.	Implemented
		(d) demonopolization and privatization of the bread complex	To begin in the second half 1994 and to be finalized before the end of 1995
6. <u>Enterprise Reform</u>			
Improve the performance of state-owned enterprises (SOE's)	Create joint stock companies.	(a) government to issue an administrative order to convert all medium and large SOEs into joint stock companies.	Implemented
	Improve the governance of SOEs.	(a) government to develop a plan for implementation of the above decision in respect of an agreed number of medium and large public enterprises, and introduce for these enterprises new corporate governance systems (by-laws, boards of directors, management, and independent accounting and auditing).	September 1994
	Rationalize financial transfers to enterprises.	(a) government to set aside public funds equivalent to 1-2% of GDP to finance restructuring/liquidation of 29 large loss-making enterprises;	After PESAC disbursements begin
		(b) 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;	Implemented
7. <u>Financial Sector</u>			
Develop efficient financial intermediation.	Increase the effectiveness of monetary management by NBK, and develop modern commercial banking system.	(a) strengthen the NBK's capacity to conduct monetary policy;	Throughout the program period.
		(b) reinforce within NBK a system of on-site supervision;	1994/95

TABLE 3. KYRGYZ REPUBLIC: SUMMARY AND TIMETABLE OF PRINCIPAL POLICY MEASURES, 1994-96

Policy Area and Objectives	Strategy	Measures	Timing
		(c) introduce modern accounting and auditing standards for the NBK;	End 1994
		(d) introduce modern accounting and auditing standards for commercial banks, including an assessment of non-performing assets;	End 1995
		(e) banks to comply with the restriction of lending to a single borrower at no more than 30% of capital by end-1994 and 25% of capital by end-1995;	End 1994 and 1995
		(f) reduce the limit for lending of banks to related parties from 20 to 15 percent of capital;	End 1994
		(g) increase capital requirements of the commercial banks in line with inflation;	Throughout the program period.
		(h) develop a system of settling net interbank clearings in the books of the NBK.	1994
<u>Social Safety Net</u>		<u>Social Assistance:</u>	
Establish an effective social safety net.	Minimize negative social effects of economic restructuring within fiscal constraints.	(a) transfer the responsibility for financing family allowances from the Pension Fund to the Budget;	Implemented
		(b) consolidate existing family allowances, bread compensation and some other special benefits into a single cash benefit to be targeted to poorest segment of the population;	Action plan - 1994. Implementation - 1995
		<u>Social Insurance:</u>	
		(a) broaden the payroll tax base by including all compensation;	1995 budget
		(b) consolidation of various pensions, schemes and benefits;	Action plan - 1994
		(c) simplification of pension recalculation and indexation system;	Implementation - 1995

TABLE 3. KYRGYZ REPUBLIC: SUMMARY AND TIMETABLE OF PRINCIPAL POLICY MEASURES, 1994-96

Policy Area and Objectives	Strategy	Measures	Timing
		<u>Labor Market and Unemployment:</u>	
		(a) introduce employee contribution to the Employment Fund of 0.5% of payroll;	Before end-1994
		(b) transfer the administrative costs of the Employment Fund to the Budget;	1995 budget
		(c) transfer most social services provided by enterprises to local governments;	Implementation to start in 1994