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The attached Joint Staff Advisory Note (JSAN) of the Poverty Reduction Strategy Paper for the Kyrgyz Republic, prepared jointly by the staffs of the World Bank and the IMF, was distributed with the member country's Poverty Reduction Strategy Paper to the Executive Boards of the two institutions. The objective of the JSAN is to provide focused, frank, and constructive feedback to the country on progress in implementing its Poverty Reduction Strategy (PRS).

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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KYRGYZ REPUBLIC

Joint Staff Advisory Note on the Poverty Reduction Strategy Paper

Prepared by Staffs of the International Monetary Fund (IMF) and the International Development Association (IDA)

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April 25, 2007

I. Overview

1. **The Kyrgyz authorities' Country Development Strategy (CDS) for 2007–10 builds on the policy experience from the National Poverty Reduction Strategy (NPRS), which was presented to the Executive Boards of the Fund and IDA in January 2003.** The CDS presents a change in emphasis following the March 2005 "Tulip Revolution," while preserving the main focus of the earlier strategy—job creation and poverty reduction. This Joint Staff Advisory Note (JSAN) summarizes staffs' views and provides advice on key priorities for strengthening the strategy and promoting its effective implementation. The next sections review poverty trends, macroeconomic and sectoral policies in support of the strategy, and the mechanisms for monitoring and evaluating progress. A summary of concluding remarks completes the assessment.

2. **The CDS is anchored on four strategic pillars—economic development, governance and transparency in public administration, human resource development, and environmental sustainability—and updates the strategy laid out in the NPRS.** It underscores the importance of a new development strategy focused on boosting economic efficiency, improving governance and service delivery, eradicating corruption, and better targeting social assistance, as key elements of its four strategic pillars. Further, the CDS attributes the slow pace of economic development to date, the skewed distribution of wealth, and the low impetus of reforms (including delays in privatizing strategic enterprises, fostering energy sector efficiency, and forging a business climate conducive to private sector growth) to weak governance under the previous administration.

3. **Staffs of the Fund and IDA agree with the prioritization of measures to support economic development.** They welcome the identification of sectoral initiatives—in particular, the authorities' commitment to pursue governance reform, anticorruption, and decentralization. However, it will be important that the authorities translate their broad policy intentions promptly into a set of time-bound actions with adequate allocation of resources. In this connection, one of the highest priorities will be to ensure that annual budgets and the medium-term budget framework (MTBF) are consistent with stated priorities and structural policies, as an essential step toward achieving the Millennium Development Goals (MDGs). It is encouraging that the authorities plan to use the Public Investment Program (PIP) as a key vehicle to channel resources to develop social sectors along with related infrastructure to support agriculture and industry. However, staffs urge caution in the use of resources to create and rehabilitate state enterprises (particularly in the agricultural sector), and the resort to an interventionist industrial policy, more generally.

4. **The CDS rightly underscores the need to diversify the economy.** Central to this will be improvements in the business environment—as identified in the strategy. Staffs advise the authorities to explicitly define the government's role in improving the business climate and to clarify related sector-specific policies. Measures of particular importance include implementation of the proposed reduction of administrative barriers and documentation for exports, along with the establishment of effective mechanisms for implementing the recently approved law on inspections, in order to foster private sector development. In addition, continued effective financial sector supervision to forestall risks and boost intermediation, and improvements in tax administration to minimize harassment of taxpayers and boost compliance, would be necessary to enhance the business climate.

5. **The CDS was prepared in a participatory manner, building on extensive consultations with a broad range of stakeholders, including representatives from parliament, development partners, and civil society organizations**.[1] However, it was delayed considerably, partly because of the political events in 2006 and early 2007, which have created a gap (of close to a year and a half) between the expiry of the previous NPRS and initiation of the CDS. In identifying strategies for mitigating poverty and social deprivation, the strategy sets up benchmarks consistent with the MDGs, particularly in health. Finally, in response to staffs' assessment of the authorities' annual progress reports on implementing the NPRS—see Country Report No. 04/201 and (Krygyz Republic—Poverty Reduction Strategy Paper—2004/05 Progress Report—Joint Staff Advisory Note, April 21, 2006 (www.imf.org)), the updated strategy has enhanced the mechanisms for

[1] The government initiated preparation of the CDS in January 2006, and set up a working group comprising representatives from stakeholders, with an explicit mandate to update and extend the poverty strategy to 2010. This mandate involved designing a PRS that reflects the renewed aspirations of the public in the aftermath of the "Tulip Revolution." During the preparation process, the working group consulted development partners and representatives of the donor community and finalized the CDS in April 2007.

monitoring and evaluating progress, although these may need further refinements. In particular, the strategy has identified benchmarks for specific objectives and plans to involve civil society and development partners in evaluating progress.

II. Poverty and Social Deprivation

6. **The CDS presents a limited analysis of poverty, focusing on trends during 2000–05.** It notes that poverty has persistently declined during the period, from 63 percent to 43 percent of the population living below the poverty line.[2] Extreme poverty has also fallen to 11 percent in 2005. The document notes that urban and rural poverty fell significantly during this period, though it is clear that poverty declined faster in the urban areas. The incidence of urban poverty (30 percent) is far less than in the rural areas, where 51 percent of the population lives below the poverty line. Achieving the targeted reduction in poverty to 30.2 percent by 2010 would be feasible only if the ambitious growth targets could be met and the sizable inward flows of remittances are sustained.

7. **The CDS fails to treat robust labor-intensive economic growth as a cornerstone for poverty alleviation.** Although it discusses the impact of reforms on non-income dimensions of welfare, the analysis of the impact of proposed sectoral policies on employment, household incomes, and poverty reduction is limited. Staffs believe that some elaboration of the poverty profile, given the availability of an integrated household survey and labor force data, would enrich the poverty analysis and help identify directions for improving living standards through labor market interventions and social assistance.

8. **National and provincial inequality are not addressed explicitly.** There is evidence suggesting that inequality has declined, with the Gini coefficient reaching 0.28 in 2005. An analysis of the declining trend in income inequality and its characteristics would assist in ensuring consistency of future policy with further reductions in poverty.

III. Macroeconomic Framework and Policies

9. **The CDS indicates that prudent macroeconomic management during implementation of the NPRS (2003–05) has laid a strong foundation for macroeconomic stability.** During the period, growth averaged 4½ percent; GDP per capita increased by a fifth to US$ 475; inflation was contained in the low single digits and financial intermediation improved with the entry of foreign banks; and the general government budget deficit declined, as the authorities strengthened revenue mobilization

[2] A person is defined as poor if his/her annual per capita consumption falls below $239; the extreme poverty consumption threshold is $152 per year.

and expenditure management. In addition, the benign external environment that prompted large remittances from Kyrgyz workers in Kazakhstan and Russia helped the external position. The improved fiscal position, together with debt restructuring agreements with Paris Club creditors as well as enhanced external debt management, have helped reduce external public debt to just below 70 percent of GDP in 2006, and output growth has helped reduce poverty significantly. Staffs concur with the authorities' projected rapid decline in the external debt ratios, particularly if the policy environment is strengthened to support the projected medium-term growth profile. The declining path of the external current account deficit, albeit from a high base, is consistent with strong growth projected in merchandise exports and remittances. Staffs underscore that maintaining fiscal and external debt sustainability will hinge importantly on persevering with cautious external public borrowing and further enhancing the external debt management framework.

10. **The CDS focuses appropriately on consolidating macroeconomic stability and fostering further growth and poverty reduction.** Key instruments envisaged for achieving these objectives include enhancing the business environment by deepening reforms and encouraging productivity growth, and fostering economic diversification through the pursuit of liberal trade policies. The CDS identifies advancing public financial management and governance as crucial for establishing a stable and transparent environment conducive to private business. Staffs would have welcomed an analysis of the effect on growth and poverty reduction of the sizable workers' remittances (17 percent of GDP in 2006). They welcome the comprehensive macroeconomic framework underlying the CDS, but are concerned about the realism of some of the targets, particularly private investment, which is projected to rise to 36½ percent of GDP in 2010, from 17½ percent in 2006. Even assuming very large inflows of remittances, this target would appear too optimistic. The 8 percent growth target for 2007 (raised from 6.5 percent in earlier drafts of the CDS) is also optimistic, given that any reforms initiated are unlikely to have such a high immediate impact. Further, while it is understandable that the medium-term macroeconomic framework in the CDS is essentially a baseline scenario, staffs advise the authorities to align it with the annual budgets during implementation.

11. **Notwithstanding the achievements of the NPRS, critical challenges and risks remain.** These include the persistence of high unemployment, continuing dependence on gold as a main export commodity, delays in energy sector reform, a challenging monetary policy environment, and weak public financial management. Improving fiscal and monetary management would be crucial to underpin macroeconomic stability and enhance medium-term economic prospects. Staffs agree with measures identified in the strategy to enhance banking sector efficiency and boost confidence. In their view, it would also be essential to strengthen bank supervision, particularly in light of increased foreign interest in the banking sector and plans to introduce a mandatory deposit insurance scheme in 2008. It will also be essential to maintain a prudent fiscal stance to foster macroeconomic stability and debt sustainability. In this context, the fall-out from recent initiatives (the rapid increase in the public sector wage bill, a reduction in the retirement age, the proposed tax amnesty, and the uncertainties created by the bill before parliament envisaging nationalization of the mining industry) should be monitored closely in order to promptly

identify and limit any adverse impact on the economic outlook. Further, in implementing the planned fiscal decentralization strategy, care should be exercised (particularly through appropriate sequencing and measures to strengthen the central treasury) to forestall possible loss of fiscal control.

12. **Clarifying the link between the objectives of the CDS (especially its expenditure priorities) and annual budgets is crucial.** The CDS costs expenditure initiatives needed for attaining its ultimate objectives, but fails to reconcile the spending profile with the overall MTBF, annual budgets, and the resource envelope. The CDS states explicitly that identified resources are inadequate for fully financing the development plan—thus leaving a financing gap in the order of $500 million, even after accounting for likely donor contributions. The authorities expect to close the gap by further expenditure streamlining during the annual budgeting process and scaling up donor assistance. Staffs believe that a clearer specification of expenditure priorities and revenue sources, as well as further disaggregation of the possible sources of resources to address the financing gap (for example, debt reduction, borrowing and donor grants) would be useful in helping garner additional external assistance to support the poverty reduction strategy.

IV. Strategic Pillars

A. Economic Development

13. **The CDS rightly places a high priority on the energy sector as an engine of growth, and broadly identifies policies and investment needed for developing the sector.** Staffs urge the authorities to act promptly and decisively in areas such as raising electricity tariffs toward cost recovery levels by 2010, measures to enhance financial discipline and improve corporate governance and transparency, where clarity and action have been missing because of a turbulent political environment. The targeted investment level of $3.5 billion over a three-year period for the energy sector alone looks unrealistic. It is therefore important that investments are well prioritized and focused, particularly on thermal generation and export. Staffs believe that the CDS' emphasis on private participation is appropriate, but the legal and regulatory framework should be strengthened and political consensus sought to provide adequate conditions for private sector participation in the industry. Strategic actions under this CDS should focus, in the short term, on securing financial recovery of the sector (financial viability, improved efficiency corporate governance) and laying the foundation for its longer-term growth.

14. **Staffs welcome the analysis of mining sector problems and the recognition that the intrusive legal and tax frameworks impose an excessive regulatory burden on enterprises in the sector.** In particular, staffs welcome the commitment to develop a comprehensive market-oriented mining code, and the commitment to eliminate requirements for state evaluation of mineral deposits and licensing of exploration, among other measures. However, the authorities need to urgently clarify their intention regarding

the sector, given the recent legislation introduced in parliament calling for nationalization of the mining industry. Staffs welcome the explicit commitment to the Extractive Industries Transparency Initiative (EITI). They suggest that in addition to the commitment to eventually sell the public sector's holdings of Centerra shares, there should be a transparent plan for managing the corresponding proceeds.

15. **The CDS recognizes the very poor condition of the transport network, particularly roads, and the impact on increased transportation costs.** It also highlights the serious risk of collapse of the road network. Staffs welcome the fact that the CDS now addresses the need for a phased transfer of the maintenance function to the private sector. Staffs also believe that it is necessary to develop a multi-year plan targeting the reduction of the backlog and prioritizing the preservation of the existing roads, and to strengthen the institutional capacity of the Ministry of Transport and Communications to ensure its focus on sector policy. Staffs note that the CDS proposes reintroduction of an extra-budgetary road fund, at a time that the authorities have committed under the PRGF arrangement to phase out the road tax and finance transport outlays from general tax resources. Staffs advise against the introduction of this extra-budgetary fund, as it could undermine the integrity of public finances without improving transport policies. They urge the authorities therefore to strengthen their commitment to the PRGF-supported program and adhere to the state budget as the primary instrument of fiscal policy.

16. **The CDS focuses appropriately on agriculture as a key sector for output growth and employment.** The focus of the strategy on completion of land reforms and new legislation in support of agro-processing industry development is sound. However, the strategy should focus more clearly on market-based production and support services. Some of the proposals are not consistent with the diagnosis and should be reconsidered. For example, given institutional weaknesses in the sector, and the recognition that low livestock productivity is due to lack of feed and inadequate animal health services, the emphasis on cattle breeding is misplaced and counterproductive. Irrigation is a critical input for profitable and market-oriented agricultural production. The CDS rightly sees a major role for Water User Associations (WUAs), and the advice to increase irrigation service fees and transfer on-farm irrigation infrastructure to WUAs is appropriate. Staffs advise that measures to improve availability of finance to farmers should be channeled through financial institutions and at reasonable market terms, and not through subsidized lending from the state budget. Finally, staffs believe that the specific targets for seeking financing and establishing plants and enterprises are misplaced and could inhibit the development of a profitable private sector.

17. **Staffs welcome and broadly agree with the comprehensive diagnosis of issues affecting financial sector development.** However, they are concerned about the proposal to establish a uniform mega regulator in the financial market. While the objective of strengthening the nonbank financial sector is laudable, the establishment of a mega regulator seems premature. As the recent FSAP Update highlighted, it is important that the newly established State Agency for Financial Supervision and Reporting (SAFSR) consolidate its institutional and technical expertise before enlarging its mandate. Staffs

recommend that the SAFSR should continue to focus on non-deposit-taking, non-bank financial institutions only and leave banking supervision in the near future to the NBKR. Staffs recommend the establishment of an appropriate regulatory framework before introducing mandatory deposit insurance. While financial sector issues are clearly identified in the analysis, staffs note that these issues are not reflected in the CDS Action Plan. Staffs believe that it is very important to develop a concrete action plan for implementing these measures.

18. **Staffs strongly endorse the analysis of shortcomings in the policy and institutional environment that have resulted in a poor business and investment climate.** They agree, particularly, on the importance of improving tax and customs administration, reducing excessive regulations, inspections, and licensing hurdles. Staffs also recognize the importance of judicial reform, as highlighted in the CDS. In that vein, they emphasize the importance of approving many of the legal acts referred to in the CDS, as well as effectively implementing them to secure a stable and transparent environment for private business.

B. Governance and Transparency in Public Administration

19. **The analysis of governance, corruption, judicial and political reform is candid and clear.** In particular, it recognizes the problem of state capture, the risk of vested interests prevailing over national development objectives, and the limited independence of the judiciary. It also notes the need for checks and balances, and clarity of responsibilities at the center of government. Many of the actions proposed will require full commitment of the whole apparatus of government and the Presidential Administration, and it is important to forge a clear consensus on actions. The CDS also indicates the importance of further reorganizing central government structures. To achieve this, the CDS proposes optimizing the structure of government through functional reviews, reducing staff numbers, and strengthening capacity of civil servants. Staffs strongly support these measures. They note, however, that the government has failed to implement the most critical recommendations of past functional reviews in most ministries and agencies. They therefore recommend a consistent and gradual approach, informed by pilot reorganization of a few key ministries, within the framework of a comprehensive civil service reform.

20. **Staffs underscore the criticality of highlighting accountability and efficiency of the executive branch.** Accordingly, staffs encourage the authorities to take further steps to develop a merit-based public service, strengthen the rule of law, make the government apparatus more client-oriented, and increase transparency of public administration. In particular, staffs note the limited specific discussion of ongoing reforms in public financial management, and believe that continued progress in this area, particularly in ensuring a credible annual budget process and strengthening internal controls, will be fundamental to successful implementation of the CDS.

21. **The CDS' ambitious judicial reform agenda includes a reform of legal education, increased independence of the court system, simplification of regulations,**

and a streamlining of law enforcement bodies. Staffs agree with the criticality of these reforms, while underscoring that the aforementioned measures need to be accompanied by strong political will, respect by public officials of all laws, and independence of the judiciary.

C. Human Resource Development

22. **The CDS summarizes key constraints in the health sector and outlines measures to address them, particularly in the context of the comprehensive "Manas Taalimi" health strategy.**[3] Staffs further emphasize the need for continued good budget planning and execution in the health sector, building on the remarkable progress in 2006, which will require stepping up financing of the sector. Vigilance will be required to ensure fiduciary integrity, transparency, and accountability. The authorities should emphasize the importance of addressing human resource constraints in the sector, and ensuring effective management of the health sector at the highest political levels despite political changes. Continued attention will also be required to ensure fiscal balance in the government's commitments under the State Guaranteed Benefit Program and to avoid *ad hoc* and fiscally unsustainable decisions to expand unfunded entitlements.

23. **The CDS enumerates challenges facing the education sector.** For basic education (grades 1–9), the main issue is the poor quality of education. By contrast, although coverage of pre-school education has been increasing, it remains at less than half the pre-transition level. The needs of pre-school and higher education are, therefore, not sufficiently addressed in the document. The CDS identifies providing access and improving the quality of basic secondary education and of primary and secondary vocational training as key priorities, in view of the MDG on achieving universal primary education. However, the focus on vocational training does not seem warranted. In addition, while a demand survey of the labor market for qualified personnel is welcome, staffs recommend that the survey broadly seek to identify the educational needs of both the internal and external labor markets in which Kyrgyz citizens participate, and not simply concentrate on vocational training. Finally, while the CDS discussion of basic secondary and vocational education is extensive, it does not include sufficient information on priority interventions within these sub-sectors, nor does it consider trade-offs and sequencing of these interventions.

24. **The CDS correctly identifies the main problems in social assistance delivery as poor targeting and the large number of recipients.** Staffs welcome the commitment to revise the formula for determining eligibility for the Unified Monthly Benefit to improve targeting. It is essential to achieve the goal of raising the Guaranteed Minimum Level of

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[3] The "Manas Taalimi" Health Strategy is the overall framework for health reforms in the Kyrgyz Republic. It includes a shift of resources to primary care and financing arrangements to provide incentives for efficient use of resources, supported by the joint donor SWAp (Sector Wide Approach).

Consumption, while establishing a monitoring system to assess targeting performance. Staffs believe that annual increases of public sector salaries in the order of 20–30 percent are not appropriate or feasible social protection measures. Such high wage increases will depend on resource availability and can only be possible through restructuring of ministries and departments. Staffs also believe that the proposed pension system measures (for example, increasing the basic pension to 12 percent of average wages, indexation of the insurance component, extension of the personal accounts, and possible introduction of a funded pension pillar) need to be assessed as part of a comprehensive overhaul of the pension system, for which the World Bank is ready to assist the authorities. Meanwhile, the authorities should limit the impact on the fiscal stance of the recent retirement age reduction mandated by parliament.

D. Environmental sustainability

25. **The environmental pillar of the CDS is perhaps the least well articulated.** The analysis identifies many environmental issues, including the risks of natural disasters ranging from earthquakes, mudslides, and avalanches (the latter two linked to deforestation), to threats to health from uranium tailing and leakage of other hazardous wastes. Nevertheless, there is little prioritization among the issues and no clear links to economic development (particularly in agriculture and mining) are established. Programs and policies mentioned in the CDS appear to be a list of ongoing or proposed projects that do not identify measures to address related environmental problems. Staffs invite the authorities, when updating the CDS, to revise the environmental sustainability pillar, and identify key environmental issues along with modalities for their resolution.

V. Participation, Monitoring, and Evaluation

26. **Staffs are concerned about the absence of a formal set of monitoring indicators in the CDS, but note that these will be provided subsequently, once work on developing the monitoring and evaluation system is finalized.** They see this as a significant weakness that must be addressed as soon as possible. Staffs understand that the AsDB is helping develop these indicators, and that the World Bank, together with other development partners, is proposing to help enhance statistical systems. In addition, the Fund’s Statistics Department (STA) is willing to support the authorities’ statistical capacity building efforts. Staffs emphasize that the indicators to be developed should present clear and monitorable objectives, particularly as they relate to the MDGs in health, education, and poverty alleviation. In addition, introduction of monitorable targets for business climate and governance, as well as for sectors such as agriculture and energy, would facilitate implementation of the CDS. Staffs also believe that development of qualitative indicators to measure service delivery (particularly in areas where the population has most direct contact with government administration) will be very useful. It is also important to have external assessments as part of the monitoring process. In addition, effective monitoring will require a clearer analysis of the links between policies and outcomes.

27. **Staffs welcome the proposal for monitoring progress through official channels and civil society.** They note that it will be critical to develop mechanisms for effective monitoring along the lines suggested above. Staffs would welcome, for example, invitations by the authorities to civil society organizations and enterprises to report in an open forum on instances of corruption, poor service delivery, and difficulties in the business environments. This will also offer the authorities the chance to explain corrective policy actions.

28. **Finally, staffs emphasize that monitoring and evaluation should extend beyond collection of statistics and the development of information systems.** To be effective, there is also a need for clear mechanisms for ensuring accountability and responsiveness of public administration. The monitoring process should ensure that policy adjustments are carried out where necessary and in connection with annual progress reports to the IFIs.

VI. Conclusions

29. **The strategy enshrined in the CDS to consolidate macroeconomic stability and initiate a second wave of reforms has the potential to facilitate sustained private-sector-led growth and poverty reduction.** Attaining the ultimate objective of the CDS requires, nevertheless, a two-pronged strategy to underpin macroeconomic stability and support private sector growth. This will entail steadfast implementation of measures to improve the business environment, develop infrastructure, and foster efficiency and transparency in public administration. Further, it is imperative that the authorities display political will in implementing reforms to enhance governance and eradicate corruption. Staffs welcome the authorities' declared intention to revamp stalled reforms, particularly in the energy and mining sectors, and to improve the business environment. They emphasize, nevertheless, the importance of following through with concrete actions in these spheres. Meanwhile, the authorities should maintain fiscal discipline and ensure that further improvements in budget preparation and execution yield measurable public savings that help crowd-in the private sector and boost growth. Effective implementation of the CDS will also require prompt establishment of monitoring mechanisms described above to ensure transparency and responsiveness of public administration.

VII. Issues for Discussion

30. **Staffs agree that the main pillars of the CDS provide an appropriate roadmap for spurring economic and social development in the Kyrgyz Republic.** They underscore, nonetheless, the need to foster a transparent and rules-based business environment and refrain from an excessively interventionist industrial policy. On the macroeconomic side, staffs advise the government to persevere with fiscal consolidation and exercise caution in external borrowing, so as to safeguard fiscal and debt sustainability.

Furthermore, staffs emphasize the importance of developing appropriate monitoring indicators to help gauge the implementation of the CDS.

31. **Do Executive Directors concur with the thrust of this assessment?** In addition, do they:

- Agree with the areas identified by staffs as key to sustaining macroeconomic stability and achieving pro-poor, private sector-led growth?
- Share the staff's concerns about the unique challenges faced by the country in securing these goals, against the backdrop of a diminished resource envelope prompted by the authorities' decision early this year to forego HIPC and MDRI debt relief?
- Concur with the specific recommendations made by staff to strengthen the implementation and monitoring of the CDS?
- Wish to comment on how the authorities can minimize the potential risks from capacity constraints and lingering political tensions?