

The Kyrgyz Republic

**Joint Economic Assessment:
Reconciliation, Recovery and Reconstruction**

July 21, 2010

**Asian Development Bank
International Monetary Fund
The World Bank**

With the participation of

**The Eurasian Development Bank
The European Bank for Reconstruction and Development
The European Commission
The International Finance Corporation
The United Nations**

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List of Acronyms

ACG	Arab Coordination Group
ACTED	Agency for Technical Cooperation and Development
ADB	Asian Development Bank
AFC	Agri-Food Corporation
ASW	State Agency for Social Welfare
AUB	Asia Universal Bank
BEEPS	Business Environment and Enterprise Performance survey
BPTC	Bishkek Passenger Transport Company
BTC	Bishkek Trolleybus Company
BTS	BishkekTeploSet
CADII	Central Agency for Development, Investments and Innovation
CAR	Capital Adequacy Ratio
CDS	Country Development Strategy
CHP	Central Heating Plant
CHPP	Combined Heating Power Plant
CIS	Commonwealth of Independent States
CoA	Chamber of Accounts
CT	Central Treasury
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
EC	European Commission
FAO	Food and Agriculture Organization
FCSDCU	Financial Company for Support and Development of the Credit Unions
GDP	Gross Domestic Product
GMCL	Guaranteed Minimum Consumption Level
GMI	Guaranteed Minimum Income
GPO	General Prosecutor's Office
HPP	Hydroelectric power plant
IDB	Islamic Development Bank
IDPs	Internally Displaced Persons
IFC	International Finance Corporation
IFI	International Financial Institutions
ILO	International Labor Organization
ISA	International Standards on Audit
JEA	Joint Economic Assessment
KDF	Kyrgyz Development Fund
KIHS	Kyrgyz Integrated Household Survey
LRF	Land Reallocation Fund
MB	Monthly Benefit
MDTF	Multi Donor Trust Fund
MER	Ministry of Economic Regulation
MFCs	Microfinancing Companies
MFOs	Microfinancing Organizations
MOA	Ministry of Agriculture
MOE	Ministry of Energy

MOF	Ministry of Finance
MoLEM	Ministry of Labor, Employment and Migration
MOTC	Ministry of Transport and Communications
MSB	Monthly Social Benefit
MTBF	Medium Term Budget Framework
NBKR	National Bank of the Kyrgyz Republic
NDB	Notionally-Defined Benefit
NDC	Notionally-Defined Contribution
NEP	National Energy Program
NGO	Non-Government Organizations
NPLs	Non-Performing Loans
OSCE	Organization for Security and Co-operation in Europe
PAR	Portfolio at risk
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PIP	Public Investment Project
PRC	People's Republic of China
RC	Reinforced Concrete
RSDS	Road Sector Development Strategy
SAI	Supreme Audit Institution
SCS	State Customs Service
SEA	State Energy Agency
SECO	State Secretariat for Economic Affairs
SIDA	Swedish International Development Agency
SMEs	Small and Medium Enterprises
SOEs	State Owned Enterprises
STS	State Tax Service
TA	Temporary Administration
UN	United Nations
UNHCR	United Nations High Commissioner for Refugees
UNICEF	United Nations Children's Fund
UNOSAT	United Nations Institute for Training and Research (UNITAR) Operational Satellite Applications Program
URM	Unreinforced Masonry
USAID	United States Agency for International Development
VAT	Value Added Tax
WB	World Bank
WFP	World Food program

SUMMARY OF THE MAIN FINDINGS OF THE JOINT ECONOMIC ASSESSMENT: RECONCILIATION, RECOVERY AND RECONSTRUCTION

Prior to the events of April and June 2010, the Kyrgyz economy was on a recovery path from the global economic crisis, with GDP projected to rise by 4½ per cent in 2010. Economic policies were guided by reliance on the private sector for growth in a liberal trade environment, supported by a sharp rise in public capital spending especially in energy. A continuation in a fall in poverty was confidently expected.

The events dealt a shock to prospects for economic growth. There occurred a weakening of private sector confidence, a contraction of liquidity in the banking system, massive stress on public finances, damage to physical infrastructure, critically the destruction by arson of housing in the south, and the displacement of around 375,000, of whom 75,000 are still displaced. The economy is projected to shrink by 3½ per cent in 2010; and output per head in 2010 will fall from the pre-crisis projection of \$943 to \$826.

The post-crisis social burden arises from the widespread displacement with an attendant need for shelter before the onset of winter as well as durable housing, food, security, livelihoods-restoration and social services programs. Support for the vulnerable groups affected by earlier natural disasters is also important for reasons of equity and social peace. A coherent, integrated approach to housing and livelihoods solutions based on freedom of choice by the affected populations and protection of their security and human rights needs must be placed at the centre of the reconciliation effort.

Physical damage to the infrastructure sectors is large. Public buildings and private commercial enterprises were damaged or destroyed, with consequences for provision of government services. Severe disruptions in agricultural and retail distribution and in the supply chain for production have occurred. Critical sectors such as energy remain vulnerable to breakdown as a result of destruction or (more importantly) disrepair, which could lead to severe winter energy shortages, threatening stability and peace. Thus, security in energy and essential public services remains a major public policy concern.

The government has launched a post-crisis recovery program. The authorities relaxed the fiscal stance as a counter-cyclical response to the investment and output shocks, are assessing systematically the damage, loss and the consequent recovery and reconstruction needs, and have applied for international support. The social burden is being met by an international humanitarian effort; and funding the Flash Appeal of the UN is important. Temporary, winterized shelter solutions adjacent to or within destroyed housing units must be implemented rapidly, accompanied and followed by a durable housing solution.

The JEA has identified the need for external support in three major areas:

- **Essential public expenditures and service.** With emergency expenditure needs rising, the budget would have to address these while maintaining other spending in line with authorities' regular spending plans.

- **Social needs.** The resettlement and integration of the internally displaced and the needs associated with other affected populations has put an unsustainable burden on fiscal resources. Through support for housing, livelihoods, social protection and other social programs identified in the JEA, donors can make an important contribution to economic and social recovery.
- **Critical investments.** The JEA has found that needs associated with destroyed private commercial and public buildings are closely tied with recovery prospects. Moreover, critical needs in energy and transport exist and if financed would make a large contribution to reconciliation and building peace. Financing need for such investments would be needed as a bridge to the period when the private sector resumes investing and enhance the economic security of the country by strengthening energy and transport.

The JEA finds that the total external financing need amounts to \$1 billion over a 30-month period (Annex I on Financing Requirements). Of this amount:

- A budget financing gap is estimated at \$335 million in 2010.¹
- Social sector needs are estimated at \$334 million, of which \$96 million corresponds to the UN Flash Appeal².
- Infrastructure support is estimated at \$350 million.

Support for agriculture and security-related needs as well as for private sector (tourism) makes up the balance (see Annex I).

In the next six months, donor support of \$671 million is required -- \$335 for the budget and \$336 million for other programs (including the Flash Appeal). The requirements for the years 2011 and 2012, *excluding the budget support amounts for those years that can be determined only once an elected government is able to formulate a budget*, are estimated at \$227 million and \$102 million, respectively.

The JEA notes that the capacity of the government to implement such a program, with external partner support, is adequate. But it is clear that sustained international technical support in design, implementation, monitoring and financial management will be vitally required. The authorities have progressed with improving management and fiduciary systems. The JEA notes that the recent legacy of lack of accountability and poor management of public assets is being firmly addressed, and impressive steps are already being implemented.

¹ The budget support need for 2011 will be identified early in the year based on the 2011 budget to be prepared by an elected government. Current estimates based on the plans of the present government show that the requirement could be of the order of \$225 million.

² The Flash Appeal is being finalized, so the amounts presented in this Report could slightly change.

CHAPTER I: BACKGROUND TO THE REPORT

In early April 2010, anti-government political demonstrations took place in various cities of the Kyrgyz Republic against the authoritarian tendencies of the president that had led to a centralization of power within the presidency. Protests were fuelled by economic and social policy decisions taken without adequate public consultation. Moreover, there was a widespread belief that corruption and misuse of public assets had risen markedly. These protests culminated in riots in Bishkek and several other cities in Kyrgyzstan on April 7-8 and violent crackdown by the government, the subsequent removal of the president from office, and the formation of an interim government³ headed by a coalition of opposition political and civic leaders. The events led to loss of life and injuries to persons, the destruction of private and public property, a weakening of confidence within the private sector, and to economic and fiscal pressures.

In a letter dated April 24, 2010 addressed to the President of the World Bank, the head of the interim government requested a mission to conduct an expert evaluation of the financial and budgetary needs arising from the events of April. Subsequently, the government welcomed a broad range of international financial institutions and other donors constituting a joint team to carry out an assessment.

In June, social tensions that had been on the rise in the south of the country with a population fractured by divided loyalties to the new government climaxed into violent inter-ethnic clashes over three days, particularly in the cities of Jalalabad and Osh. These two cities and some neighboring areas erupted in a spasm of ethnically-directed extreme, brutal violence and targeted arson. It is reported officially that over 300 persons have lost their lives, but the president stated that the toll exceeds 2000. Over 2500 have been injured. Large scale destruction of public and private property, especially housing, occurred.

In the wake of the violence, an estimated 75,000 refugees fled to neighboring Uzbekistan and a further 300,000 were estimated to be internally displaced within the southern oblasts of the Kyrgyz Republic. In an encouraging development, a return of refugees took place within about ten days and most of the internally displaced had also returned to their homes by mid-July. The number of remaining internally displaced persons is now estimated at 75,000. The associated need for housing and livelihood support as well as for social reconciliation and peace-building will have to be addressed urgently in the interests of the stability of the country. Conditions in the south of the country remain dismal and highly volatile with a continuation of low intensity ethnic conflict, sporadic security coverage and deep scars left by the violence.

The violent conflict in the south created new and deep social tensions that left many people bewildered, shocked and confused. Although the immediate causes of the conflict remain unclear, key messages are emerging. First, there is a need to promote social and political stability and security as a foundation for economic and social recovery. Second, a focus on equity is essential to avoid a perception of unequal attention being given to particular ethnic groups, regions or types of beneficiaries. Such perceptions could aggravate inter-group tensions and fuel future violence. Interventions need to be part of a broader nationwide reconciliation, recovery and

³ Throughout this document, the terms interim government and provisional government are used interchangeably. Following the referendum of June 27, the government refers to itself as a caretaker government. For simplicity, this document maintains the use of the terms “interim” and “provisional”.

development effort. Third, strengthening the legitimacy of the state and reestablishing an impartial security regime capable of protecting all citizens are critical.

This report – the *Joint Economic Assessment: Reconciliation, Recovery and Reconstruction* (JEA) -- responds to the request of the government and provides an assessment of the impact of tumultuous events of April and June. It discusses their economic and social effects, assesses the implications for the budget and the principal sectors of the economy, and presents an estimate of the support that could be obtained from external sources for social reconciliation, reconstruction and economic recovery. The *JEA* was prepared for and in close collaboration with the government of the Kyrgyz Republic. The assessment is based on information and data from the authorities, and in particular from the official *Commission for the Assessment of Damages in the South*, and the official *Directorate on Reconstruction and Development of Osh and Jalal-Abad*. The mission undertook field visits to the south and conducted surveys.

The economic assessment was carried out with the joint leadership of the Asian Development Bank, the International Monetary Fund, and the World Bank; with the participation of the Eurasian Development Bank, the European Bank for Reconstruction and Development, the European Commission, the International Finance Corporation, and the United Nations. The report draws also on the contributions of the Swiss and United States development agencies and those of several NGO partners, including ACTED.

The table in Annex I outlines the financing requirements for reconciliation, recovery and reconstruction based on the work of the joint mission.

Political Background

Since independence in 1991, the Kyrgyz Republic has made an enormous advance towards the creation of a liberal market economy with the aim of promoting sustained economic growth and fighting poverty, and has sought international integration through trade and investment, notably through membership of the World Trade Organization. It has met with some success in fostering open institutions, but has struggled to embed lasting democracy and civic freedom. OSCE missions have criticized the electoral process over the past decade as having fallen short of good practice. Elections for parliament in 2007 and for the president in 2009 were found to be deficient: regulations were changed arbitrarily and procedures ignored, sometimes at the last minute, leading to widespread public dissatisfaction with the process and its results. Over the recent past, the president concentrated power in his own administrative apparatus, reduced the national assembly to a cipher, and circumvented ministerial forms of government. Thus, checks and balances all but disappeared, consultation over policies and accountability was greatly reduced, and governance standards fell.

As noted, power was assumed by a provisional government following the resignation of the president in April 2010. The government quickly dissolved parliament and disbanded the constitutional court, which had been seen as too compliant to both the previous presidents of the Kyrgyz Republic. Provisional Government Decree No.1 concentrated the functions of the parliament, president and government with the provisional government.

The provisional government drafted a new constitution that shifts the balance of executive power from a presidential system to a parliamentary one. The drafting process involved public

consultations and a nation-wide debate. The constitution was approved in a nation-wide referendum on June 27, with an overall turnout of 72 per cent and an affirmative vote of 91 per cent. The turnout in the south of the country was 65 per cent. The referendum vested the powers of the presidency with the current interim president until the next presidential election in autumn 2011. International observers characterized the conduct of the referendum as substantially fair and proper, noting the conditions of large displacement of population in the south. Under the new constitution, parliamentary elections will be held in October 2010 and a fully empowered government would be formed thereafter, with the powers of the president being greatly reduced.

Organization of the Report

The *JEA* examines the overall impact of the political and social events of this year, assesses the measures necessary and the financing needs for early reconstruction and recovery, based on the losses and damages resulting from the events, as well as from the impact to confidence and private sector activity. It outlines a strategy for recovery as well as priority actions and investments based on the strategy. Sector specific assessments and needs are presented in annexes to the report. Annex I contains a comprehensive table of the financing needs for the recovery program that is being presented to donors for assistance.

Chapter II discusses the economic and social impact of the events and the resulting budget financing gap that must be funded in order to protect core economic and social needs, including essential public services and security. Chapter III presents the impact of the violent clashes in the south of the country in June, and assesses the humanitarian and the social needs that arise from the imperative to support the internally displaced persons and others affected by the conflict, develop and implement housing and livelihoods in a sustainable way and undertake measures towards social peace and reconciliation. It integrates the flash appeal of the UN system (in line with best practice for joint assessments). Chapter IV outlines reconciliation, recovery and reconstruction strategy that is being pursued by the authorities and which underlies the estimates for external financing need. The chapters that follow present the sector-specific impact and resulting needs. An assessment of the fiduciary safeguards and developments in public finance management is contained in Chapter IX as is a discussion of the financing options that are open to external partners and how coordination, implementation and reporting arrangements are being developed so as to ensure the integrity of the recovery program.

Acknowledgement

The *JEA* team wishes to express its warm gratitude to the Kyrgyz interim government for its partnership in this work. The head of the interim government, Ms. Otunbaeva, and the ministers of finance (till July 14), Mr. Sariev, and of economic regulation, Mr. Umetaliev, led the way and the cabinet of ministers, the National Bank, and government agencies engaged fully and keenly in the work of the mission. The mission benefitted greatly from discussions with Mr. Atambaev, a deputy head of the interim government and Mr. Satybaldiev, Vice Prime Minister and head of the State Directorate for the Reconstruction and Development of Osh and Jalalabad. A concluding discussion with the just-appointed First Vice Prime Minister, Mr. Muraliev, provided valuable insights. The close participation of the authorities has added greatly to the quality and the relevance of this report.

CHAPTER II: ECONOMIC AND SOCIAL IMPACT

Summary

The political disturbances in Bishkek in April 2010 and the outburst of ethnic conflict in southern Kyrgyzstan in June 2010 have been significant shocks to the economy. The economy is expected to contract sharply and face more uncertain prospects in the period ahead than envisaged prior to the crisis. There is a generalized weakening of confidence that may particularly affect investment, including foreign direct investment. Public finances have come under severe stress; there has been trouble at a major bank, and some social disruption, as well as physical damage, remains to be addressed.

Table 1. Impact of the Crisis in 2010

	Pre-crisis ^{†/}	Post-crisis
Growth in GDP (percent)	4.6	-3.5
Non-gold real GDP growth (percent)	4.3	-4.6
GDP per head (US dollar)	943	826
Inflation (percent; end of period)	13.0	6.6
Fiscal balance (percent of GDP)	-8.1	-14.9
FDI (\$ million)	248	144
External current account (percent of GDP) ^{††/}	-15.2	-6.6
Budget support needed (\$ million)	175	335

Source: JEA team calculations.

^{†/}Projections prepared in March 2010.

^{††/}Pre-crisis projection includes planned imports related to new energy sector projects which were to be financed by external borrowing.

In summary, the April and June shocks are expected to lead to a significant contraction in the economy compared to the pre-crisis growth estimate, and to a significant loss in income per head. Foreign investment could slow down substantially. Reconstruction and development needs are expected to extend into next year, when the economy is expected to begin recovering. The fiscal balance will expand significantly and would require external financing in the amount of \$335 million in 2010 and \$225 million in 2011. Additional non-governmental support would also be critical in the reconstruction, recovery and rehabilitation effort.

The Economic Impact

In the first quarter of 2010 the Kyrgyz economy had begun to recover from the global economic crisis and its regional spillovers. The economy grew by more than 16 percent in the January-March period (year-on-year basis), following a sharp slowdown in 2009 when growth fell to 2.3 percent from 8.4 percent a year earlier. This recovery was largely driven by strong gold ore yield and a pickup in industrial production and construction. With an economic turnaround in Russia and Kazakhstan, the country was beginning to see a recovery in external demand, through higher exports (50 percent growth in the first quarter, year-on-year), and a boost to consumption, as remittances began recovering (31 percent growth in the first quarter, year-on-year).

The events of April and June 2010 will result in a contraction in economic activity this year, by 3½ percent, (4½ percent in non-gold terms), compared to the pre-April projection of 4½ percent economic growth. The disruption to agriculture, trade and other services caused by the closure of international borders and internal unrest has been serious. Agricultural activity is expected to decline by 12 percent in 2010 as security problems and lack of inputs have led to a disruption in agricultural work and trading in the south—which accounts for one-quarter of national output. A majority of large corporates (with the exception of Kumtor) have postponed their original investment plans and the general uncertainty following the turmoil and the transitory nature of the current government is likely to affect investor confidence. On the positive side, higher-than-normal water reservoir levels should ease winter energy shortages and ease constraints on economic activity seen in the recent past.

Table 2. Kyrgyz Republic: Summary Economic Indicators, 2007–11

	2007	2008	2009	2010	2011
	Act.	Act.	Prel.	Proj.	
Nominal GDP (in billions of soms)	141.9	188.0	196.4	205.7	234.4
Real GDP (growth in percent)	8.5	8.4	2.3	-3.5	7.1
Non-gold real GDP (growth in percent)	9.0	6.5	2.9	-4.6	6.8
GDP per capita (in U.S. dollars)	726	968	853	826	883
Consumer prices (12-month percent change, eop)	20.1	20.1	0.0	6.6	8.0
Total revenue and grants	30.3	29.9	33.0	32.4	29.8
Total expenditure (including net lending)	31.0	29.3	37.0	47.3	38.8
Overall fiscal balance	-0.3	0.0	-3.7	-14.9	-9.0
Primary balance excluding grants	-1.9	-1.1	-8.2	-17.4	-9.9
Reserve money (percent change, eop)	38.5	11.3	18.3	21.3	16.7
Broad money (percent change, eop)	28.9	11.4	17.9	15.4	18.7
Credit to private sector (percent change, eop)	45.0	26.4	-2.8	-1.8	24.6
Current account balance (in percent of GDP)	-0.2	-8.1	4.0	-6.6	-9.0
Gross International reserves (million USD)	1,194	1,222	1,584	1,785	2,034
Gross reserves (months of next year imports, eop)	3.0	4.0	4.5	4.2	4.4
External public debt outstanding (in percent of GDP)	54.6	41.2	50.8	59.6	67.1

Source: Kyrgyz authorities; and Fund staff estimates and projections

Inflation is expected to reach 6.6 percent by end 2010. The significant downward revision to 2010 economic growth and the reversal in electricity tariffs in April should result in lowering inflation from the earlier end-2010 estimate of 13 percent.⁴ However, the imposition of oil export duty by Russia in April 2010—which would likely raise oil products prices in the country by about 30 percent—would add to headline inflation.⁵

The external current account is expected to swing to a deficit of 6.6 percent in 2010 from a 4 percent surplus in 2009, largely because of deterioration of trade and services balances. The heightened uncertainty from the turmoil in the south, and border closures are expected to offset trade and services. Despite an economic recovery in Russia and Kazakhstan, the Kyrgyz Republic would not be able to fully benefit from the positive external environment; exports could

⁴ Electricity tariffs were increased significantly by the previous government, effective January 2010. Following protests, the current government has reversed the increase.

⁵ Russia accounts for more than 90 percent of Kyrgyz petroleum imports.

be weak and summer tourism is expected to be badly affected. At the same time, the imposition of duty by Russia on oil exports to Kyrgyz Republic and Kumtor capital investment related imports are expected to result in a substantial increase in imports. The deterioration in the current account would be moderated by strong growth in worker remittances, which are showing signs of robust recovery (a near 30 percent increase in the January-May period, on a year-on-year basis). The import cover of international reserves would drop from 4.5 months in 2009 to 4.2 months in 2010, though if the anticipated external financing gap is not filled (see below) then this cover could drop to 3½ months, a low level given the high trade openness of the Kyrgyz economy and its vulnerability to external shocks.

Table 3. Kyrgyz Republic: Summary Balance of Payments, 2008–11

(In millions of U.S. dollars, unless otherwise indicated)

	2008	2009	2010	2011
	Actual	Prel.	Proj.	Proj.
Current account balance	-413	181	-298	-437
<i>Of which:</i> exports of goods and services	3,037	2,829	2,942	3,454
<i>Of which:</i> imports of goods and services	4,747	3,680	4,264	5,067
<i>Of which:</i> private transfers	1,431	1,013	1,200	1,314
Capital and financial account	513	110	188	484
<i>Of which:</i> net FDI and portfolio investment	240	55	255	183
<i>Of which:</i> medium- and long-term loans (net)	34	326	114	273
<i>Of which:</i> net short term flows including errors and omissions	242	-310	-148	0
Financing	-100	-291	110	-47
Gross international reserves (-increase)	-121	-293	-201	-250
Net use of Fund resources	18	2	-24	-22
Financing gap		0	335	225
Memorandum items:				
Current account balance (percent of GDP)	-8.1	4.0	-6.6	-9.0
Gross international reserves (end of period)	1,222	1,584	1,785	2,034
(in months of next year GNFS imports)	4.0	4.5	4.2	4.4

Source: Kyrgyz authorities; and Fund staff estimates and projections.

The recent crisis will have a muted impact on tax revenues which are expected to suffer moderately (in relation to GDP) as the economy slows. Tax revenues had been recovering well prior to the onset of the crisis, largely driven by the higher-than-expected output at Kumtor and a pickup in economic activity. Despite serious physical damage to tax offices in the April and June events, revenue capacity has been largely preserved and the authorities have generally resisted using tax incentives as a means to compensate those affected by the crisis (though there have been some incentives for tax payers in the south).⁶ Overall, institutional capacity in the State Tax and Customs Services has not been adversely affected by the turmoil. Given the less than proportionate share of the south in tax revenues—largely because of the preponderance of agriculture there—tax revenue decline from the events in Osh and Jalalabad is expected to be mild. Tax revenue performance in the April-June period has been volatile but broadly

⁶ The tax breaks for southern businesses are for income and sales taxes.

satisfactory. For the remainder of the year, however, the economic slowdown is expected have some effect on tax revenues, particularly on VAT. Moreover, the decision by the interim government to annul the imposition of VAT and retail tax on energy payments will also put downward pressure on revenues. Some exceptional non-tax revenues—cash confiscated from those linked to the previous regime—could provide relief, though its availability would depend on legal settlement.

Table 4. Kyrgyz Republic: General Government Budget, 2008–11
(In percent of GDP)

	2008	2009	2010	2011
	Act.	Act.	Proj.	Proj.
Total revenue and grants	29.9	33.0	32.4	30.2
Total revenue	28.0	27.7	28.8	28.3
Tax revenue	23.0	22.7	22.5	22.7
Non-tax revenue	4.3	4.6	5.8	5.2
Capital revenue	0.7	0.3	0.4	0.4
Grants	1.9	5.3	3.6	1.9
Total expenditures and net lending	29.3	37.0	47.3	39.2
Current expenditures	24.8	29.1	35.0	30.6
Capital expenditures	4.2	7.5	10.3	8.7
Net lending	0.3	0.5	2.0	0.0
Discrepancy	-0.6	0.2	0.0	0.0
Balance	0.0	-3.7	-14.9	-9.0
Primary balance excluding grants	-1.1	-8.2	-17.4	-9.9
Financing	0.0	3.7	14.9	9.0
External	0.4	7.6	10.2	6.3
o/w unidentified	7.5	4.6
Domestic (incl. privatization)	-0.4	-1.5	2.1	2.7
o/w NBKR	0.1	-1.0	-0.1	1.9
Use of KRDF investments abroad		-2.4	2.5	0.0

Source: Kyrgyz authorities; and Fund staff estimates.

The crisis will add significantly to spending pressures. Costs associated with rehabilitation, reconstruction and resettlement as well as repair and rehabilitation of government buildings and offices, compensation for victims of the crisis, security related spending and elections are expected to be significant. The dissolution of parliament and special administrative structures under the previous government—the Central Agency for Development, Investments and Innovation (CADII)—has yielded wage savings. However, expenditure increases announced by the previous government to compensate for the large electricity tariff increase in January have not been reversed following the reversal of the tariff increase. Of these, pensions are expected to rise significantly (by about 30 percent) and are likely to have a significant medium term impact. Bank recapitalization costs could also be significant as well (see below).

Table 5. Kyrgyz Republic: Major Crisis Related Expenditure Measures in the 2010 Revised Budget

	KGS Million	% of GDP
Salary increases (law-enforcement agencies and other)	1,480.0	0.7
Increase in subsidies for utility companies due to tariff increase reversal	187.0	0.1
One-off payments for the victims of April events	220.0	0.1
Security related expenditures	284.0	0.1
Compensation payments for tariff increase in high mountainous regions	281.0	0.1
Rehabilitation of government offices damaged during April events	518.0	0.3
Increase in pensions including for electricity tariff compensation	1,724.0	0.8
Elections related expenditures	399.9	0.2
Rehabilitation costs in the south (private housing and public infrastructure)	4,600.0	2.2
Social infrastructure projects throughout the country	1,230.0	0.6
Commercial bank recapitalization/losses	3,500.0	1.7
TOTAL	14,423.9	7.0

Source: Kyrgyz authorities; and Fund staff estimates.

Capital spending is also expected to rise substantially to respond to the rehabilitation and reconstruction needs. About \$100 million (2.2 percent of GDP) is expected to be spent on domestically financed infrastructure, housing and other items in 2010. But these needs are expected to extend till 2012, with additional demand on budgetary resources amounting to another \$350 million in the 2011-12 period.

Infrastructure development is largely dependent on externally financed public investment projects (PIPs). The revised 2010 PIP has been adjusted downward by KGS 1.13 billion (compared to the authorities' earlier estimates) as donors re-estimated their projected disbursements for 2010 mainly due to revisions in administrative and procurement issues. Recent surges in construction input prices are also expected to severely affect the investment estimates in the medium term, and this is particularly important for the transport sector that comprises 60 per cent of the country's investment portfolio. On average, project costs are expected to increase by 40 per cent based on Ministry of Transport and Communication estimates. Supplementary financing may be required to ensure investment continuity and completion of critical road network for goods movement.

Half of the reduction in PIP is related to two transport projects, and the rest is largely in the energy and agriculture sectors, which have all been deferred to 2011. In addition, a major road rehabilitation project (Bishkek-Torugart) to be financed by the Arab coordination group worth \$65 million between 2011 and 2015 might be delayed due to difficulties in arranging an agreement between the investor and the interim government. The impact of the April 2010 events on PIP investments has also resulted in delays of approximately 1-2 months in implementation of some existing projects.

External support for the budget would be critical in allowing the authorities to overcome the consequences of the crisis and sustain essential public expenditures throughout 2010. The 2010 fiscal deficit (primary, excluding grants) is expected to worsen to 17½ percent from about 10 percent projected earlier, and 8.2 percent observed in 2009. The high one-off increase in gold related tax revenue and post crisis aid from Russia has provided a cushion for the budget in the first half of the year. While the government's own resources—largely comprising saved bilateral assistance received from Russia in 2009—are sizeable and could be utilized to bridge any delays in donor financing, they will be insufficient to cover the 2010 budget entirely. The external financing budget gap would be \$335 million with the greatest need in Q4, 2010. An amount of about \$105 million has so far been identified from various donors⁷ and is expected to be mobilized in the last quarter of the year. In case of a significant shortfall in financing, the authorities intend to adjust spending while preserving essential and priority expenditures. In light of debt sustainability implications of the large increase in deficit, external financing with high degree of concessionality would be essential.

JEA estimates suggest that if the remaining external financing need for budget in the order of \$230 million, were filled then recourse to domestic sources would be manageable. The authorities would utilize about \$187 million from own resources (about 4 percent of GDP).⁸ Two modalities for providing external support exist: (i) transfers to the budget following the practice of the IFIs or (ii) financing of specific budgetary expenditures, perhaps in the social sectors or in reconstruction, against evidence of the execution of these expenditures.

The authorities' monetary and exchange rate policies would support the post-crisis economic recovery while neutralizing the effects of large fiscal expansion. Notwithstanding the economic contraction, the unprecedented fiscal expansion expected in 2010 could result in large increase in monetary aggregates which in turn could be inflationary. The central bank plans to mop up any excess liquidity through domestic sterilization. While credit to the private sector contracted till Q3 2009, it rebounded briefly before declining again following the crisis. Credit demand is expected to remain sluggish largely because of the weak economy, while credit supply will be constrained if banking problems remain unresolved. With continued political and security uncertainty and a fiscal expansion, exchange market pressures are likely to mount.

The macroeconomic and fiscal outlook for 2010 is subject to a number of risks.

- Economic growth is subject to more than usual uncertainty. It depends in large part on political uncertainties during the transition to an elected government and the maintenance of security and law and order, particularly in the south.
- Agriculture which has been particularly affected by the events in the south remains vulnerable, and continued lack of access to local markets could affect the supply of produce in the country. This could also have implications for inflation.
- The confidence of investors has been badly shaken by the events in the south and could deteriorate further if the situation there worsens.
- Banking sector uncertainties also add to the risks to the economic outlook. Systemic problems could adversely affect intermediation and the payment system.

⁷ These include the Asian Development Bank, the World Bank, European Union and the UN and Russia.

⁸ The authorities intend to utilize any remaining amounts from their own resources over the medium term for development projects and any contingencies (see below).

- In a related manner, while the costs of capitalization of a major bank have been included in the fiscal accounts, any further need to recapitalize troubled banks could result in a substantially higher.

Macroeconomic outlook, risks and issues for 2011

The economy is expected to recover strongly, reaching 7 percent growth in 2011. The recovery would be made possible by a normalization of the security environment, continued reconstruction activity, an improvement in investor confidence and full resumption of trade and services flows. Resurgence in agricultural activity should also provide a major boost to economic activity. Continued growth pickup in large partner countries—Russia and Kazakhstan—should spur external demand for the Kyrgyz Republic, allowing an increase in exports and yielding a sustained recovery in consumption through higher remittance flows.

Considerable fiscal challenges would remain. The fiscal expansion initiated in 2009, and the further massive crisis related loosening in 2010, has been made possible, in part, by the space provided by improvement in debt ratios leading up to the crisis in 2009, and the timely availability of external financing. With growth expected to recover strongly in 2011, the authorities see the need to revert the fiscal deficit to a more sustainable level, and thus a substantial upfront adjustment in 2011. While some of the recent expenditure increases have been for wages and pensions, which would be difficult to moderate, the 2010 crisis has also resulted in an increase in one-off expenditures for rehabilitation, resettlement, reconstruction and social protection; these could be unwound quickly as the situation improves next year. However it is also clear that a significant amount of reconstruction would need to continue till 2012, resulting in high capital expenditures. The authorities also see a part of the fiscal consolidation coming from raising revenues through policy and administrative measures. In addition to the sizable fiscal consolidation in 2011, and the use of own saved resources, there would be significant external financing need.

Downside risks to the 2011 outlook remain.

- A continuation of an adverse security environment and any political uncertainty following the October elections could add to downside risks for 2011. Uncertainties in the banking system are also likely to raise questions about financial stability and credit growth. Depositor confidence, which has held up quite well to date, may be affected.
- The breakdown in intra-regional energy sharing agreements, which had come to the fore late in 2009, is expected to persist. The seasonality and regional dimension of the energy sharing crisis would mean that energy constraints could become binding, and pose a constraint on growth in 2011.
- The coming into effect of the Russia-Kazakhstan-Belarus customs union could create additional uncertainty as, in the likely event that the Kyrgyz Republic joins the union, it would lose the comparative advantage it currently enjoys in shuttle trade from its low tariffs.⁹ The imposition of export duty on oil products by Russia is also likely to adversely affect Kyrgyz re-exports of such products.

⁹ Shuttle traders from the Kyrgyz Republic typically import goods from China and re-export them to neighboring CIS countries.

Poverty and the Social Impact

The extent of the poverty and social impacts of the April and June events are still emerging. However, what is clear is that the impacts will be nationwide, and the effect on both the economy and the society will be profound and long term.

Multiple persistent societal stress points fed into the recent violence: poor governance (an ineffective administrative and security system), continuing poverty and widening socio-economic disparities. Factors in the south which further contributed to instability include competition over productive resources (agricultural land, irrigation water and pasture, commercial property and assets) harsh border regimes that stifle commerce and movement of people while feeding corruption, the role of the south as a transit area for the smuggling of drugs, widespread unemployment and under-employment particularly of youth. The problem of marginalized youth is further compounded by a neglect of children whose parents had migrated, and a deteriorating education system that does not equip a large part of youth for productive employment in the market economy.

The poverty and social impacts of the events will not be fully reversed by the reconstruction of infrastructure or the payment of compensation for lost livelihoods. Careful programming will be needed to address both underlying structural causes of poverty in these areas and the “new” poverty that has resulted from the recent events.

The strong rate of economic growth experienced over the 2003-08 period led to a sharp fall in poverty: during this period, overall poverty fell from 64 per cent to 32 per cent, and extreme poverty from 28 per cent to 6 per cent. A growth in worker remittances and a rise in real terms in pensions also played a significant role. Progress in fighting poverty is likely to have slowed in 2009 as growth decelerated in light of the international economic crisis, but a significant deterioration in poverty in 2010 is all but certain given the economic contraction projected for that year.

Quantitative estimates of the impact on poverty of the April events and the economic contraction in 2010 are not possible at this stage, but several qualitative statements can be made. First, the reversal in April 2010 of the energy tariff increases that came into effect at the beginning of the year will bolster household incomes, especially of the urban poor, with the effect being much more muted for the rural poor who though dependent on electricity are not beneficiaries of the district heating and hot water systems. The rise in tariffs was accompanied by increases in public sector wages, pensions, social allowances for privileged groups, and targeted cash transfers for the poor – as mentioned above, these have not been reversed.

Second, some rise in poverty, even if temporary, can be expected from the disruptions to economic activity from the April events. The closure of the border with Kazakhstan for six weeks and the persistent closure of the Uzbek border have affected border trade carried out by communities with a high incidence of poverty. Farming was disrupted by delays in supply of inputs, especially during the sowing season in the north of the country, as well as interruptions in the supply of credit.

Third, physical damage to businesses in certain cities and business closures will have an effect on employment. Moreover, the sectors that will bear the brunt of the disruptions and the growth

slowdown, construction and tourism, are labor-intensive sectors. The tourism sector has been badly hit by the April and June events and the perception of lack of security. In particular, tourism has all but dried up in the important region of Issykul, with consequent highly significant losses in income and employment. However, reconstruction activities if rapidly undertaken will generate jobs that will dampen the poverty-worsening effects of the recent events.

Impact of the June Events

A significant negative social impact of the May-June conflict is internal displacement (see the next section) leading to a disconnection of the needy from the formal government network of assistance. Many people are believed or reported to have lost their identity documents that would prove their eligibility for various benefits or services. Many previously registered beneficiaries are missing and it would take the local authorities perhaps several months to find out the status of their former clients. As of mid-July, the Government is issuing temporary identification documents to all in need (valid until the end of 2010), which are supposed to be accepted by local social offices, schools and healthcare institutions, but are not valid for banking transactions. But the displaced may not be aware of this activity and of their eligibility for benefits and services in the place they are currently residing. Other returned populations may feel too insecure or mistrustful of government to attempt to register for such benefits. It is expected that this disruption may bring a temporary poverty increase, which is not likely to be reflected by the official statistics.

On return, many people have been unable to settle back into their homes or resume work: their houses are damaged, looting has been widespread, and fear is pervasive. Cases of sexual and gender-based violence have been reported. The perceived and actual violence perpetrated during the crisis, as well as reprisals, recriminations and intimidations thereafter have eroded relationships and trust between different ethnic groups.

Livelihoods have been decimated for numerous households in the directly affected areas. These impacts were varied, including affected peoples fleeing their home areas and therefore being unable to work, businesses being destroyed, farmers unable to have access to fields and markets, and workers and traders unable to travel to their job sites. Weeks after the violence itself, safety and security concerns are such that many affected people are afraid or unable to leave their homes, let alone travel to work. Others are unable to access the inputs and supplies on which their livelihoods depend, including tradable goods, water for irrigation of fields, etc. Still others have no livelihood to speak of since their shops, market stalls or other businesses have been destroyed.

In addition to the need to support affected populations to restore or re-access their livelihoods, the crisis also drew attention to the economic vulnerabilities of other populations such as those families affected by recent natural disasters, as well as the economic disparities, such as pervasive youth unemployment, which contributed to the events themselves and would therefore also need to be addressed by any livelihood recovery support provided by the government and its development partners.

Box 1: Consultations with IDPs in Osh City

Consultations with returned refugees and IDPs in Osh highlighted the psychosocial impacts of the June conflict, including pervasive bewilderment regarding the reasons for the violence that had left whole families and communities destitute, feelings of abandonment due to lack of information from and presence of authorities, and intense fear and insecurity.¹⁰ The returnees also reported persistent and ongoing discrimination and harassment from authorities including the security forces since the end of outright conflict. This discrimination and harassment includes actions such as the continuing detainment of young Uzbek men, confiscation of identity documentation (e.g. passports) by the police, and refusal by banks to provide services such as withdrawals from personal bank accounts of remittances from relatives working abroad.¹¹

An Uzbek community in Osh reported feeling no resentment towards their Kyrgyz neighbors during the crisis itself, and being able to separate these neighbors from those taking part in the violence, only to feel growing resentment following the crisis as stories of Uzbek government workers being retrenched or intimidated into vacating their jobs in state hospitals and other government services have circulated.

Some of the most common sentiments heard during the consultations include:

- It is not our neighbors who did this
- I want to live here in my home or I will die
- We are afraid to leave our compounds
- How can the government truly not know what is happening to us here
- We no longer trust anyone in government to protect us

The Kyrgyz consulted felt that the young had been manipulated given the rumors and disinformation. There were fears of revenge attacks and concern at the fate of Kyrgyz policemen who had disappeared during the violence. Many Kyrgyz expressed a reluctance to travel to work or the markets through Uzbek neighborhoods. Others reiterated that the multi-ethnic apartment complexes had avoided the violence in June. Several were of the view that property damaged by recent mud slides, flash floods and earthquakes be repaired as well to ensure that all citizens benefit from the reconstruction process.

The impact of the most recent events on poverty in the southern oblasts—Osh, Jalalabad, and Batken—may be particularly severe such that both the depth and the extent of poverty increases. The loss of life and property is not only a human tragedy but will also have long term personal and economic consequences that will not be easily rectified through short-term assistance. For example, families may have lost a breadwinner or a childcare provider which could result in altering the economic opportunities for all members. In addition, households may have suffered the loss of livelihood if their business or place of employment was destroyed or if they were dependent upon the agriculture sector. Destruction of businesses by the outbreak of civil unrest in

¹⁰ A World Bank mission visited Uzbek neighborhoods (Kyzyl Kishlok and the Tashlak area in Shark village) in Osh on July 11, 2010, and met with groups of Uzbek men and women as well as with individual families, who had been made homeless by the June violence.

¹¹ Such refusal by banks to allow withdrawals was reported to happen even when the person holding the account had valid identity documentation. Moreover, the interim identity documentation issued to some IDP returnees explicitly states, that it is not valid for banking transactions. This poses a major challenge with regard to the design of implementation arrangements for any kind of cash transfers to Uzbek IDPs/returnees.

the South, subsequent outflow of refugees into Uzbekistan and waves of internal displacement of people have destroyed jobs in small service enterprises and in agriculture. Due to high informality in these sectors it is unlikely that the victims would be able to receive at least temporary unemployment benefits: most of them have never contributed to the Employment Fund, which makes them ineligible for assistance from this source.

Social safety net system

An important concern of the current government is that the existing social safety net system turned out to be too inflexible and not powerful enough to respond to the April and May-June crises. The risk of reversing the recent reforms of in-kind categorical benefits exists as there are no resources in place to build a responsive system that can address short- and longer-term poverty, including poverty upsurges, and link the needy to the labor markets including temporary work arrangements. Strengthening administration and inter-agency coordination of the safety nets is also seen as one of the important measures to ensure that the social safety nets are ready to respond promptly to a variety of needs and to follow their clientele in a way that addresses the entire complex of needs from temporary shelters to income support and non-disruptive service provision.

These impacts will require both immediate and longer term interventions. Short term support is essential to avoid household adoption of coping strategies that further undermine longer term welfare. These coping strategies, commonplace in situations where poorer households have experienced severe economic shocks, include the accumulation of unsustainable debt, the sale of productive assets, and foregone investment in human capital if education is interrupted or health treatment postponed because of non-affordability. Economic hardship will serve as a daily reminder to households of the violence that has taken place and, by intensifying resentments, is likely to make the reconciliation work that will be absolutely fundamental to longer term growth in these areas less successful. In this particular context, involvement in criminal activities may become an attractive option for groups that are unable to find other ways of providing for basic needs.

As noted, the overall lack of security has had a large impact on the tourism sector which is a major source of revenue for the government, profit for the enterprises, and income and employment for the population particularly in the north of the country. Accounting for 5 percent of GDP in 2009, tourism industry is one of the most affected sectors due to the recent crisis and the retail trade associated with tourism is expected to have declined sharply this year. There is anecdotal evidence that 80 percent of tourist bookings for the summer of 2010 have been cancelled. This will likely have significant impact on income and poverty particularly in the Issyk-Kul region.

CHAPTER III: THE HUMANITARIAN IMPACT AND THE FLASH APPEAL

The magnitude of the violence that affected southern Kyrgyzstan in June caused substantial physical damage and displacement of the population. The events highlighted the weakness of the interim government's grip on the situation in the south and to a certain extent even in other parts of the country, and pose a serious threat to the legitimacy of the political process envisaged to restore democratic governance in Kyrgyzstan. Because tensions have taken on a strong ethnic dimension, the impact is likely to be long-lasting. In addition to the significant short-term humanitarian response that is ongoing, there is also a need for longer term interventions to support physical reconstruction and economic recovery and to build reconciliation and trust between communities directly affected by the violence, between these and other communities throughout the country, and between the citizenry and the state.

Box 2: Description of the Events

On June 10, a wave of deadly violence began in the city of Osh (pre-crisis population: 258,000) in southern Kyrgyzstan, provoking a sharp rise in tension between the city's ethnic Uzbek and Kyrgyz communities. The violence then continued in the city, and spread to the surrounding district of Kara Suu in Osh province and the neighboring town of Jalalabad as well as several other districts of Jalalabad Province. The areas affected have also seen widespread arson, looting of state, commercial and private property; and schools, hospitals, and public utilities have suffered significant damage. The pattern of destruction, damage, and looting indicate a targeted act based on detailed information that enabled selective destruction of Uzbek homes and businesses often leaving neighboring properties belonging to Kyrgyz and other nationalities intact.

Kyrgyzstan's law enforcement and armed forces—still struggling to recover after April's events—have been caught unprepared despite warning signs, and were not able to prevent the violence. The death toll is likely 2000, with over 2,500 people injured. The humanitarian consequences of the conflict are acute and pressing for 1.1 million people (over a fifth of Kyrgyzstan's population). An estimated 375,000 people fled the conflict in Osh and Jalalabad, about 75,000 of whom sought refuge in neighboring Uzbekistan. Unexpectedly and apparently caused by a combination by both pull and push factors, the refugees began returning back to southern Kyrgyzstan in late June. Most refugees were back before the referendum on an interim constitution was held on June 27, 2010. Recent reports indicate that most of the displaced have returned to their homes, with many of the rest staying with host families. In addition to those displaced, the areas affected by the conflict are home to around 765,000 people, who were not displaced. Thus, 56percent of the population in the two Oblasts lives in conflict affected areas.

At this point, the security situation in southern Kyrgyzstan remains tense, and feelings of abandonment due to lack of information from and presence by the authorities persist, along with intense fear and insecurity. The returnees also report persistent discrimination and harassment from authorities including the security forces.

The events in the south have disrupted the post-April normalization process. They dealt a blow to the moral authority and legitimacy of the interim government, reducing the political space at its disposal for implementing much-needed market and governance reforms. While the politics and policies of crisis prevention, crisis management, and then post-crisis recovery will be pressing for some time they should not crowd out longer-term state-building, reform, and development initiatives. Even now that the majority of IDPs have returned to their homes, it will take many years of recovery and reconciliation efforts to heal the wounds.

The Flash Appeal

The UN Flash Appeal launched on June 18, which requested \$71.1 million for immediate emergency assistance, was revised on July 19 to \$96.4 million to meet the needs of around 1.2 million people living in the areas affected by violent conflict of June.¹² The goal of the revised Flash Appeal is to address immediate humanitarian needs, strengthening the preparedness to respond to potential needs, and assist maintaining and enhancing protection for affected communities and individuals. The revised Flash Appeal is based on the following strategic objectives:

- Provide humanitarian assistance to those in need taking into account the need for winter preparedness;
- Continue to advocate for the protection of civilians and the respect for human rights with special programmatic focus on vulnerable groups;
- Support essential health and social services, and help communities in rebuilding livelihoods, local economy, and trust among the affected communities;
- Capitalize on the strong international humanitarian presence to enhance response capacity and preparedness to respond to potential humanitarian needs.

The revised Flash Appeal identifies the lack of protection of internally displaced, returnees, and other vulnerable groups as the overarching humanitarian concern as the affected communities still live in fear because of continuing threats, intimidation, arbitrary arrests, and lack of legal protection. This protection challenge needs to be overcome in order to effectively meet the needs of the affected population regarding shelter, food, water and sanitation, health care and education. The appearance of a return to normalcy is fragile, and there is a significant risk of deterioration.

Costs/needs related to the refugees and IDPs

With the return of relative stability, rapid cluster assessments were completed and the results have constituted the basis for the programmatic revision of the original Flash Appeal:

- Early recovery/community restoration (\$10.7 million)
- Education (\$5.2 million)
- Food security and agriculture (\$31.7 million)
- Health (\$5.6 million)
- Protection (ranging from \$4.4 to \$11.1 million depending on priority levels)
- Shelter (\$29.8 million)
- Water and sanitation (\$3.5 million)
- Coordination Support services, telecommunications, and logistics (\$3.3 million).

¹² One month after the launch of the initial Flash Appeal, it is funded with \$12.9 million. Outside the Flash Appeal, almost \$32 million in funding has been recorded in the Financial Tracking System. (Flash Appeal, p. 5)

The Joint Economic Assessment and the Flash Appeal

To ensure consistency between the humanitarian and the transitional and development oriented actions, promoting the necessary continuum from humanitarian response to development, the JEA and the Flash Appeal have been coordinated to the extent possible.¹³ To this end, the revision of the Flash Appeal and the JEA exercise have been conducted in parallel.

However, these two instruments have different scopes and foci. Whereas the Flash Appeal focuses on the immediate humanitarian needs of those affected directly and indirectly by the conflict, the JEA examines the recovery needs of those directly and indirectly affected by the conflict, in addition to the macro-economic impact and infrastructure damages and losses. As such, the JEA sets the basis for the mainstreaming of early recovery activities in all sectors, builds on the foundations of the humanitarian response, and determines the sectoral requirements and priorities from early recovery to full recovery and provides links to the long term development objectives. Therefore, in terms of target populations, the JEA has a broader coverage, including other vulnerable groups¹⁴. Both instruments intersect thematically in the social sector.

¹³ This practice is consistent with the EC-UN-WB partnership that was formalized by the signature of the tripartite *Joint Declaration on Post-Crisis Assessments and Recovery Planning*, signed by the three institutions in New York on September 26, 2008.

¹⁴ For details on the strategy and approach for the social sector assessment, please see Chapter V.

CHAPTER IV: THE STRATEGY FOR RECONCILIATION, RECOVERY AND RECONSTRUCTION

Chapters II and III sketched the immediate impact of the political and social disturbances on the economy and on the social sectors. The government has responded to the new economic shocks by attempting to strengthen confidence in the private sector and by protecting essential public spending. Through some fiscal relaxation, the authorities intend to provide a stimulus to economic activity and employment. Similarly, outlays on essential repairs and rehabilitation to infrastructure and the capital stock are intended to strengthen the supply base of the economy and in particular improve the reliability in energy supplies that is vital to continued economic growth and maintenance of social peace.

The government responded to the June events by establishing a *Commission for the Assessment of Damages* to prepare for comprehensive reconciliation, recovery and reconstruction in the south. The program for recovery centers on the restoration of livelihoods and the reconstruction of housing and of commercial enterprises and markets will provide critical support to the economy and create jobs. The work of the *Commission* will be based on a detailed damage assessment being carried out by a *Directorate on Reconstruction and Development of Osh and Jalal-Abad*, (headed by a vice-prime minister) that reports to the *Commission*.

The over-arching need is to help the Kyrgyz Republic attain stability and social cohesion as a necessary foundation for its economic growth and social development trajectory. This would not only require addressing the immediate effects of the conflict on economy, society and infrastructure, but undertaking a range of activities including a reformed impartial security regime capable of protecting all citizens along with measures that build reconciliation among communities and between these and the state. It also requires strengthening the capital base through public and donor-funded investments to provide a bridge to the period when full confidence returns and private investment flows are resumed. It would also create room in the budget for higher social spending.

The risks of an inadequate response by government and external partners could be serious. An early re-assertion of macro-economic stability is a precondition for a return of confidence and for the avoidance of a further fall in the living standards of the general population. Social tensions need to be avoided by rapid and comprehensive reconstruction and reconciliation in the south, measures to protect essential public services, the conduct of a clean electoral process that is open to all shades of political opinion, inclusion of the newly vulnerable in the social safety nets and assistance for the productive reinsertion of these groups within the society, and ensuring conditions for employment growth. Inadequate attention to infrastructure and energy needs as well as agriculture would cripple the capital stock and delay the return to growth.

Supporting growth

The strategy for recovery and sustained growth is based on the recognition that the shocks to business confidence currently being experienced as a result of the conflict will lead to falling private sector investment and, thus, to a sharp decline in the rate of economic growth. Falling domestic demand will affect fiscal revenues, reducing the capacity of the state to undertake vital expenditures, including additional outlays on social spending. The authorities see the need to undertake public expenditures as a bridge to the period when private confidence is substantially restored through

- a combination of external financing for the budget and some counter-cyclical fiscal policy, implying a relaxation of the original fiscal deficit targets, so as to finance additional current expenditures, largely associated with the events;
- external support for essential reconstruction and rehabilitation needs to be undertaken largely by the public sector to substitute for the private demand shortfalls, and to safeguard production and employment; and
- external support for key priorities in the revival of private sector growth and financial support for the banking sector.

Protecting essential public spending

In view of the fiscal pressures, the authorities have taken prompt action to define a category of public expenditures – outlays on wages and salaries, social assistance, pensions, utilities, and procurement of medication and food – as protected expenditures. These were accorded priority and indeed have been paid in full. The government built on its experience from the Tulip Revolution in 2005 and managed to secure essential data required to continue the disbursements uninterrupted. Expenditures for non-protected items -- capital repairs, purchases of equipment and machinery – were temporarily discontinued, but will be made only as resources permit.

The authorities have, therefore, shown the capacity to manage expenditure priorities with flexibility and skill.

Addressing the needs of internally displaced persons and the vulnerable

The government is at the stage of settling its strategy towards the internally displaced and the vulnerable, based on the findings of its *Commission for Assessment of Damages* and advice being provided by international experts in the field. This section of the chapter describes the broad approaches and principles to be followed in this difficult area where an integrated approach to the needs of the affected population, sensitivity in allowing the population voice and choices, and equity of treatment across groups are of critical importance.

With the return of those who became refugees in Uzbekistan as well as most of those internally displaced to their former homes, the overall situation has within a short time-span evolved from one of exclusively humanitarian concern to one that requires interventions to support early and longer term recovery. Some activities need to be initiated immediately such as improvement of the overall security situation where the fears of both the Uzbek and Kyrgyz are addressed with sensitivity, provision of shelter by the end of October (i.e., before the onset of winter) along with restoration of water, electricity, and gas services, restoration of identity and property documentation, and support for the enhancement of the capacity of the Directorate for Rebuilding and Reconstruction of Osh and Jalalabad. Other short-term activities that need to be initiated as part of an early recovery effort during the remainder of 2010 will need to continue into the medium and even longer term to yield their intended outcomes. These include measures to support the recovery of businesses and agriculture, rehabilitate basic and vocational education, provide cash transfers for vulnerable groups, generate employment through labor-intensive public

works, initiate inter-community reconciliation, and establish psycho-social support for victims of violence.¹⁵

Box 3: Cross-Cutting Principles for Effective Recovery Activities

In light of the underlying social, political and governance issues which played a role in both the April and June events, it is clear that reconstruction and recovery processes must do more than address the immediate damages in affected areas. To avoid further social cleavages and triggers to violence, the reconstruction and recovery efforts of the interim government and its development partners must be framed within a series of cross-cutting principles designed to address the drivers of violence and instability and to promote sustainable peace and security. These principles are of equal relevance to multiple sectors (housing, infrastructure, agriculture, finance, livelihoods etc.), time horizons (immediate term, short-term, medium-term and longer-term) and stages (design, implementation, management, monitoring, exit etc.) which will be involved in the recovery process.

Equity. Recovery and reconciliation must focus on equity and avoid a perception of unequal attention being given to particular ethnic groups or regions or types of beneficiaries.

National Inclusion. Recovery and reconciliation must be national-level goals to which citizens throughout the country commit and in which they participate. The April and June events had direct and indirect impacts beyond those areas immediately affected by the conflict and weakened center-periphery relations throughout the country. State legitimacy cannot therefore be achieved without including the whole nation in building peace and stability.

Vulnerability Targeting. Reducing vulnerability, and not entitlement, should be the focus of the national response, in order to both help affected populations recover and mitigate against future violence. Patterns of marginalization and exclusion in different communities should be analyzed, and all vulnerable populations, whether IDPs, youth, households displaced by past natural disasters, female-headed households etc. should benefit from the recovery effort.

Transparency. Given the role that information and misinformation played in the events, and the ongoing propaganda campaigns, the recovery response should prioritize clear and regular communication with beneficiaries and the nation at large. Information sharing should include details of available support programs, eligibility and prioritization criteria, levels and duration of available support, etc. Scope for feedback from beneficiaries and non-beneficiaries (e.g. grievance mechanisms) should be built into all recovery activities.

Ownership. The active participation of affected communities and local leaders in the design and implementation of recovery efforts makes for more effective programming as well as strengthens the resilience of communities to future violence. Prioritizing beneficiary ownership can also help communities devastated by loss and displacement to regain a sense of identity and worth.

Peace Dividend. While different elements of the recovery effort will proceed along different timelines, identifying quick wins which can establish hope and trust and increase confidence in the state and the wider peace and recovery process will help to demonstrate a peace dividend to conflict-affected populations and promote stability.

Social Analysis. Recovery needs and expectations, even when linked to hardware (eg. buildings or finance), are inherently personal and linked to beneficiary's individual and community experiences of conflict and expectations for the future. A good understanding of community dynamics, built on solid

¹⁵ E.g. returnees while rebuilding their homes and/or businesses, people who lost employment, elderly / pensioners, female headed households, and people dependent on seasonal labor.

social analysis, is required to adequately develop, target, monitor and adapt programming.

Phasing. There is a tendency in recovery efforts to try to do too much at once, assuming that all required actions are priorities. Simplicity and realism are essential, to identify true priorities and avoid overwhelming the agencies implementing, coordinating and funding the recovery effort. Moreover, to avoid front-loading the immediate post-crisis period to the detriment of medium- and longer- term reconciliation and peace-building activities, it is essential to recognize that a comprehensive response requires immediate, short-term, medium-term and longer-term approaches.

Coordination. Close coordination amongst the stakeholders involved in the recovery process, whether beneficiary groups, implementing agencies, oversight bodies or the state is essential at all stages of the recovery process. Capacity building, if required, to ensure that the relevant state agency is able to effectively lead coordination efforts, including collecting data on the results of the recovery effort, will be an important immediate-term investment.

Exit Strategy. The exit strategy of the recovery effort should be clear from the beginning to avoid creating dependencies, distorting local markets etc. Doing this effectively requires a well-planned and ongoing communications strategy, including ensuring that beneficiaries are aware of the sources of support to which they can turn for assistance following the close of recovery programming. Sufficient capacity must also be built in the agencies to which ongoing activities, and the monitoring and evaluation of the impacts closed activities, will be transitioned

Core activities to support early recovery need to be coordinated between the government, the UN, NGOs, and other actors. Equally important is that there are robust monitoring arrangements to track reconstruction and recovery investments, which ensure transparency through involvement of local communities. Along with accelerated preparation, project design need to build in flexibility to enable responses to changing circumstances and opportunities. They must also build on best practice regarding procurement and financial management arrangements in post-conflict situations where timely delivery of projects benefits have urgency, and project management and implementing agencies may have limited experience on procurement and financial management procedures.

It is also critical that both the early recovery and medium to longer term assistance now being planned by the government will be governed by impartiality, needs based programming, and the humanitarian principles, and will not be perceived as favoring one ethnic group (the Uzbeks) over other groups, who may also be exposed to hardship and deprivation, and who may in the past have been subjected to disasters and displacement without receiving the assistance that is now being provided after the June events. For example, Kyrgyzstan has over the last several years been affected by a series of natural disasters including earthquakes and floods. Most recently, flash floods hit southern Kyrgyzstan in early June 2010 with over 70 villages affected and infrastructure seriously damaged. If the assistance to those affected by the current crisis is not part of a broader recovery and development effort also including those affected by these past events, it may contribute to aggravating inter-group tensions that could fuel future violence. The challenge of a broader recovery and development effort represents an opportunity for the state to demonstrate that it can deliver services equitably to its citizens irrespective of ethnic background, which in turn would contribute to fostering reconciliation, building the legitimacy of the state, and contributing to the stability necessary for sustained economic growth.

The violence and its aftermath revealed the weakness of the state and its lack of control over the security apparatus and the local administration. A precondition for stability and recovery is therefore the reestablishment of an impartial security regime capable of protecting all citizens.

Strengthening governance

The interim government has taken a number of steps to improve governance, create the conditions for higher standards in public accountability, and enforce assured control over budget expenditures and management of public assets.

First, the impact of the new constitution on the governance of the country would be revolutionary. A cabinet system of government headed by a prime minister answerable to parliament and with the powers of the president greatly attenuated would be an innovation for the Kyrgyz Republic. This constitutional change has been motivated by a widely-felt need to disperse executive power and bolster accountability to parliament. It is also driven by the need to widen consultation and debate within parliament, engage with the public at large, and allow a range of opinions within government to be expressed and evaluated before executive decisions are taken. If successful, such governance changes would prevent the concentration and centralization of power, lack of accountability, corruption and nepotism seen during the tenures of the last two presidents.

Clearly, institutions have to be built and governance practices re-engineered in order to make a parliamentary democracy work. Both parliament and the government would need strengthening, thereby increasing the burden on the civil service for analysis and policy advice. Parliament and its committees, the cabinet of ministers and cabinet committees, and civil servants would require technical assistance to develop modern practices. Donors, particularly those already engaged in government and civil service reforms, would be expected to play a major part in the reforms. It would be vital to strengthen local governance as well. The responsibilities of local self-governing bodies were rolled back in recent years and opportunities now exist to strengthen citizen's participation in local planning and decision making. Investment in local governance is particularly important given the local elections planned for 2011.

Second, the interim government has placed importance on reforms in public financial management. Specifically, improvements in the Treasury system within the ministry of finance are being implemented and the coverage of the budget has been extended to include all investment spending.

Third, the abolition of the Central Agency for Development, Investments and Innovations will greatly assist in raising governance standards. This body represented an effort by the former president to tightly centralize powers within his administration and to concentrate all policy and investment decisions in one body led by his son. Such powers will now revert to ministries and decisions will be taken with due debate and accountability. Indeed, the ministerial system of government and reinforced accountability mechanisms to be exercised by parliament are key reforms to be found in the new constitution.

Fourth, the management of public investments will be rules based, transparent and fully reflected in the budget. The interim government is taking steps to liquidate the main body that managed public investments, the Development Fund, which was earlier controlled by the president with little accountability, and to deposit its holdings in the central bank. The Development Fund held investments amounting to \$100 million (largely in a hydro power plant) and liquid assets of \$191

million, out of the proceeds of a \$300 million concessional credit from the Russian Federation to the state. A part of the liquid assets will be used to provide temporary bridging finance to the budget in the period prior to the flow of donor funds and will be safeguarded for high quality investment projects over the medium term.

Fifth, the authorities have reversed the privatizations of two electricity distribution companies and the telecommunications company that were carried out at end-2009 in violation of rules and procedures and which fell short of international good practices. Contrary to the law and regulations, these sales were not conducted with a pre-specified minimum reservation price and proper valuation of assets of the companies, and irregularities occurred in the acceptance of bid guarantees and documents. The reversal of privatizations in electricity distribution is proceeding with the agreement of the purchasing company and in telecommunications negotiations towards reaching an agreement are progressing.

Finally, the role of the State Property Commission in the management of public assets is being fortified so that proper standards can be applied in any transactions of state assets. The government is drafting revisions to the law of privatization and to supporting regulations to modernize practices. No transactions will take place before these are put into effect.

Risks to the strategy

The major source of internal risk arises from the continuation or even the intensification of social strife in the south of the country that led to violence and massive loss of life in mid-June. Social tensions are in part historic and ethnic-based with a mosaic of Kyrgyz, Tajik and Uzbek communities living both side by side and also within mono-ethnic enclaves in the Ferghana valley. Social tensions are partly political in nature: the ethnic Kyrgyz in the south have divided views about the change of government in April, whereas the ethnic Uzbek tend to support the interim government. Criminal activity, in part associated with the lucrative transport of illicit drugs through the south, and its links with governance structures together with the struggle over rent-seeking activities further complicate social relationships. A continuation of social tensions will damage economic activity and lead to higher reconstruction and recovery needs. It will also be a source of political instability and could poison the climate for the efficient absorption of donor financial support.

The external risks stem from the possibility of border closures with Kazakhstan and Uzbekistan; indeed, the border with Uzbekistan continues to be closed or open on occasion but with severe limitations. Such border closures have a severely disruptive effect on production and trade and lead to impoverishment of border communities. Keeping open the channels for trade flows as well as ensuring a smooth, uninterrupted operation of the common electricity grid that links these three countries are important contributors to stabilization.

Economic risks arise from weaker economic growth than projected, which would result in greater fiscal pressures and a possible threat to essential social expenditures. These risks would be compounded if the process of resolution of the large recently nationalized bank were to be protracted or if confidence in the sector itself were to weaken.

The governance environment remains weak; central government control over the south is sporadic, and even national-level institutions have been hollowed by years of centralized presidential rule by fiat. The run-up to the elections will distract political attention from governing with an attendant temptation to use public resources for electoral purposes.

Mitigating risks

These risks could be mitigated through a combination of decisive and sufficient external financing of the budget for 2010 and to the reconstruction and recovery program and by continued prudent fiscal management. The authorities have identified clear priorities in public spending and have successfully protected the essential. Budget support in the amounts assessed in this report, particularly if provided rapidly, would go a long way towards creating the conditions for social peace.

The authorities have shown flexibility in responding to the social tensions in the south by combining dialogue with law enforcement measures. But clearly they have been stretched to their capacity and beyond and international security intervention may be necessary. They have bolstered the pay of the security forces at fiscal cost. The neighbors can play a significant confidence-building role by announcing their determination to open borders or to keep them open and to ensure reliable transmission of electricity.

A comprehensive and well integrated approach to promoting social reconciliation and recovery based on the principles illustrated in the box above is important to mitigating the potentially dangerous social risks prevalent today. The implementation of measures over a period of years will have to be handled with sensitivity and skill.

A well formulated and determined post-events political process was launched by the interim government, with the rapid drafting of a constitution that entrenches democratic accountability and disperses political power and with the prompt scheduling of parliamentary elections in October 2010, to be followed by elections for a president (with greatly reduced powers) a year later. The country is well on the way to obtaining broad-based international political goodwill and support; this now has to be matched by significant international economic support. The impressive and rapid steps taken by authorities to improve governance and strengthen budget processes will help ensure that funds are spent for their intended purposes.

CHAPTER V: CRITICAL PRIORITIES IN SOCIAL RECONCILIATION AND RECOVERY

The need for social reconciliation and recovery in the Kyrgyz Republic is arguably the most pressing and significant in terms of establishing security and stability in the country in the short-to medium-term and thereby enabling ongoing recovery, development and growth. Chapter IV introduced the general principles and overall strategy for reconciliation, recovery and reconstruction; this chapter details the specific socioeconomic impacts of the crises, identifies targets populations and time horizons for action and assesses the instruments which will be most effective in meeting the country's specific reconciliation and recovery needs. It is organized around two main priorities for reconciliation and recovery, namely: support for the reintegration of IDPs and other vulnerable and conflict-affected populations and socioeconomic reintegration and peace-building.¹⁶¹⁷

Across both of these areas, it will be critical that assistance not favor any one ethnic group and address the needs of all vulnerable populations in affected areas, including those who may in the past have been subjected to disasters and displacement without receiving the assistance that is now being provided. The challenge of a broader recovery and development effort represents at the same time an opportunity for the state to demonstrate that it can deliver services equitably to its citizens irrespective of ethnic background, which in turn would contribute to foster reconciliation, build the legitimacy of the state, and contribute to the stability necessary for sustained economic growth.

Support for the reintegration of IDPs and other vulnerable and conflict-affected populations

Housing Needs¹⁸

The June violence is estimated to have displaced 375,000 people, more than 90 per cent of whom are now believed to have returned to their home areas. They have returned to widespread destruction and damage, with estimates of homes damaged or completely destroyed ranging from 1,813 to 3,450. Within Uzbek neighborhoods, the average household compound comprising two families (with an average of 7.5 persons per family) who generally inhabit separate small one-storey houses inside the joint compound, and an estimated 92 per cent of affected dwellings consist of this type of structure. An estimated 72 per cent of affected one-story houses are completely destroyed with another 19 per cent severely damaged. Close to a quarter of the completely destroyed houses do no longer have access to water, and around 72 per cent of the assessed houses no longer have access to electricity. At the moment most IDPs are living in tents erected inside their compounds, with friends, or in the streets and available public spaces. As housing is a primary human need and is cited by those affected by the recent violence as one of the most important elements of personal and community recovery, it is therefore a key priority for the recovery agenda.

¹⁶ See Annex on Recovery and Reconciliation for additional detail on the areas covered here.

¹⁷ Note that the financing needs presented in this chapter go beyond the immediate humanitarian needs that are contained in the Flash Appeal and are, thus, additional to the amounts in the Flash Appeal.

¹⁸ It is important to note that this section costs the financing *needs* for housing (based on the damage incurred); needs go beyond the estimated amount for the damage itself.

Full assessments of the impacts of the June events on housing are still ongoing. In Jalalabad, a completed assessment has found 450 destroyed or damaged homes. As of July 11, 2010, the number of destroyed and damaged houses in Osh was estimated around 2,500 based on a UNOSAT damage assessment and at 1,363 by a government assessment. An ongoing assessment by ACTED and Save the Children for UNHCR suggests the number of damaged homes could be about 20 per cent higher than the UNOSAT estimate in areas surveyed.¹⁹ Final figures from this assessment will be available by July 18, 2010.

Table 6: Infrastructure impacts at-a-glance

Infrastructure impacts at-a-glance	Osh & Jalalabad
Homes damaged or completely destroyed	1,813 - 3,450
Destroyed/damaged businesses ²⁰	248
Damaged public buildings	79

IDPs are anxious to begin repair and reconstruction of their homes before the onset of winter in late October. In terms of required assistance, IDPs are clear as to their preference to reconstruct their homes themselves and are confident that they could find the specialized skills needed (e.g. masons, carpenters, electricians, plumbers) in the community, including through contracts with Kyrgyz artisans. to ensure that all ethnic groups participate in the reconstruction process. It is thus building materials, and not cash allowances, which is the clear request of IDP communities – in part because of the likely inflationary effects of large-scale construction on the price of building materials, but also because of IDPs’ desire to be active participants in rebuilding their own identities and futures. This option of resident-managed repair and reconstruction of homes would involve the following approach:

- Supply of a package of construction materials that – depending on the level of destruction - would enable the IDP returnees to either construct a preliminary winterized (2-room) house or repair their original home.
- Cash-for-food or in-kind food allowance to feed affected families during the construction period since they would not be able to earn an income during while working on their home.
- Cash allowances to hire specialized artisans.
- Oversight and technical assistance to ensure adequate construction quality and use of appropriate technologies to e.g. secure the buildings against earthquakes.

Investments in reconstruction of homes for IDPs would be complemented by parallel investments in reconstruction for those population whose homes were affected by the recent series of natural disasters, including earthquakes and mudslides, to contribute to wider development and reconciliation.

¹⁹ The increase in the assessment of damages is a reflection of assessment methodology. The UNOSAT figure (2,500 affected homes) is based on satellite photography, and the government figure (1,363 affected homes) is not based on visits inside household compounds, whereas this is the case with assessment undertaken by ACTED and Save the Children for UNHCR resulting in an overall figure that could increase to 3,000 affected homes.

²⁰ Figures on damaged commercial and public buildings are from the preliminary assessment of July 3, 2010, prepared by the Commission for Assessment of Damages Caused by Events in June in the City of Osh, Osh and Jalalabad Regions.

→ Budget Requirement to meet housing needs: \$105 million

Social compensation needs

The costs of social compensation will depend on the number of casualties of the crisis and also on the method of compensation. One possible scenario, using compensation levels envisaged for victims of the April events and a preliminary estimate for the final number of casualties is given in the table below. It should be emphasized that the government has not decided on the approach to be followed for victims of the violence in the south – the numbers given below are illustrative and based on considerations of equity in compensating victims and families in the north and south of the country.

Table 7: Possible Social Compensation needs related to events in South Kyrgyzstan²¹

<i>in USD at 2010 prices</i>			
	2010	2011	2012
One-off costs			
Killed	2000	0	0
Annual cost per person	21,820	0	0
Total, in million USD	43.6	0	0
Injured	2,000	0	0
Annual cost per injured	720	0	0
Total, in million USD	1.4	0	0
Ongoing costs			
Surviving family members of those killed	6000	6000	6000
Annual cost per person	1833	1833	1833
Total in million USD (half year 2010)	5.5	11	11
Injured	2000	2000	2000
Annual cost per injured	720	720	720
Total in million USD (half-year 2010)	0.7	1.4	1.4
Total Annual Cost (million USD)	51.2	12.4	12.4

Source: JEA estimates

Compensation for victims of the violence can be important both for humanitarian reasons and for reconciliation. However, given the ethnic rifts opened up and the magnitude of potential claims, it is critical to formulate an even-handed, ethnicity-blind approach that remains consistent with long-term sustainability of the social protection system.²² This is likely to call for a one-off donor-supported surge in compensation payouts followed by more targeted assistance based not on categories of recipients but actual need for income support. Adding an extensive categorical benefit even if well-deserved on moral grounds, but ill-targeted from a poverty reduction point of view, would not be fiscally sustainable.

²¹ UN Preliminary Estimate, June 2010.

²² The same criteria would apply to all rehabilitation activities.

Additional complications include: that the legal basis for refugees, the wounded, and heirs of the deceased from the June events to claim state support may differ from what the post-April legislation envisioned; that birth certificates, death certificates and other identity documentation lost or destroyed during the conflict may be difficult to replace, thereby constraining the ability of some families to make their claims or to have claims processed and; that any compensation system may need to address ongoing deaths, disappearances and injuries since the June crisis (e.g. injuries suffered by young men detained by security forces) which are perceived as equally meritorious of compensation by affected communities.

→ Possible 2010 Budget Requirement to meet social compensation needs: \$52 million

→ Possible annual recurring Budget Requirement to meet social compensation needs: \$12 million

Reconciliation through participatory community recovery and local area development

A coherent approach to promoting social reintegration will need to focus on building reconciliation and trust in communities directly affected by the April-June events in Osh and Jalalabad Oblasts and Bishkek, but also between and among communities throughout the country, as well as between the citizenry and the central state in which it has lost faith. A range of activities to facilitate reconciliation are recommended, including: community projects (reconstruction and rehabilitation of social infrastructure) and events (cultural, sporting, learning etc.) which promote social cohesion and help to rebuild social capital; ensuring access to medical and psychosocial support services for communities directly affected by violence, including victims of sexual and gender-based violence and torture; awareness-raising activities focused on civil rights and responsibilities; legal aid; strengthening community-level dispute resolution mechanisms; support to resolve title, property and access disputes; formal tracking of community dynamics and social acceptance to ensure a good understanding of reconciliation dynamics between displaced and communities of return or settlement.

In particular, community rehabilitation of social, economic and cultural infrastructure of collective benefit in communities in violence-affected regions as well as regions affected by recent natural disasters will be an important means of supporting social cohesion and may be mobilized relatively quickly through existing community development structures. Such projects will provide an opportunity for community members to unite round a collective goal with benefits for the whole population as well as to create short-term employment for vulnerable members of the population. The specific activities should be decided by communities in response to agreed local needs and could include: renovations of schools, health points and community centers, renovation or rehabilitation of potable water systems, renovation or upgrading of apartment buildings and associated facilities in urban settings, and rehabilitation of village or feeder roads and communal agriculture and erosion control activities in rural areas.

→ Total Budget Requirement to meet reconciliation need: \$25 million.

SocioEconomic Reintegration and Peace-Building

Livelihood Recovery

The June events decimated livelihoods for numerous households in the directly affected areas. The Commission for Assessment of Damages estimates a loss of employment for around 4,000 persons (mostly in service and trade). In addition, there is significant disruption of markets and economic activities since farmers and traders cannot move to sell their produce or buy inputs, and since people are afraid of venturing out of their homes and neighborhoods, they cannot access jobs, markets or necessary inputs to production. In addition to the need to support affected populations to restore or re-access their livelihoods, the crisis also drew attention to the economic vulnerabilities and disparities, such as pervasive youth unemployment, and the needs of people previously affected by natural disasters such as mudslides and earthquakes, which may have contributed to the events themselves and would therefore also need to be addressed.

In the immediate term, priorities include re-establishing safe access to employment sites and the means of production for those whose livelihoods have not been destroyed (e.g. farmers whose fields and agricultural inputs are unaffected, but who are unable to access them given ongoing insecurity) and developing temporary employment opportunities, such as cash for work initiatives and labor-intensive public works, for households whose livelihoods were lost or damaged during the recent events, as well as for other economically vulnerable populations.

In the short- to medium- term supporting employment creation/targeted livelihood support for IDPs and other vulnerable and lowest-income populations (including natural-disaster victims, female-headed households, families relying on others for accommodation, youth etc.) in areas directly affected by the April and June events, as well as other marginalized, at-risk regions will be a priority. Multi-dimensional support will be required, including local economic development grants, active labor market programs and self-employment assistance. In the longer-term, investments will also be required to improve the relevance of the educational system to the labor market, thereby reducing educational drop-out rates, youth joblessness and youth idleness, and contributing to enhanced security and local economic development.

→ Total requirement for re-integration and livelihoods: \$45 million.

Peace and Tolerance Building

Tensions and insecurity in the affected regions persist and the risk of future eruptions of violence remains high, particularly given the upcoming parliamentary elections. Supporting the establishment of a culture of peace and tolerance in at-risk environments throughout the country is both a short- and long-term priority. These activities will directly support security and stability and strengthen the resilience of communities to resist potential future drivers of conflict. Peace and tolerance activities recommended to address ongoing tensions in Kyrgyz include: immediate peace and tolerance training for local opinion-shapers (teachers, journalists, religious leaders, local officials, magistrates); human rights and protection training for security forces; public media campaigns on peace-building; community-level trainings on conflict management and

conflict resolution; development of peace and tolerance curricula for schools; grants for arts and cultural activities promoting peace messages; forums for inter-ethnic dialogue and cooperation.

→ Total requirement for peace and tolerance building: \$3 million.

Youth Inclusion

Youth are one of the most poor, vulnerable and marginalized groups in Kyrgyz and large numbers of young people were involved in April - June events. Whether politically or economically manipulated into taking part in recent violence, or motivated by resentments, radicalization or criminal motivations, it is clear that achieving a sustainable peace will require explicit targeting of youth needs. The creation of a new Ministry of Youth Issues in July 2010 is an important signal of the government's commitment to support young people to develop livelihoods and life skills as well as to contribute to decision-making and governance, and should be supported by international partners. Specific activities recommended in the short- and medium-term to promote youth inclusion include: life skills development; employment support; development of youth-friendly spaces and recreational opportunities in rural and marginalized communities; legal education and support services for youth and youth employers, including training on labor and migrant rights; and capacity-building support for youth organizations and youth-run services.

→ Total requirement for youth inclusion: \$5.1 million.

Building Confidence in Security, Stability and Justice.

This year's events clearly eroded citizen confidence in the state's ability to uphold security and stability in the country and to maintain its monopoly on violence – the very foundation of state legitimacy. While many communities in affected areas feel abandoned and/or persecuted by the full range of state institutions – from the executive itself to local authorities to state-owned media – it is state defense and security forces, both armed forces and the police – in which they are most disappointed. Unable to assure civilian protection, to control the spread and use of arms, to prevent military equipment and supplies from being co-opted by participants in the violence and to maintain command and control within their ranks, state security forces were seen - at best, as ineffective and strongly biased towards certain ethnicities - on the average, as complicit in the violence and - at worst, as the very instigators of the events.

In the immediate-term, experienced international security trainers and advisors working under the auspices of a respected agency, should be mobilized as a means of guiding this process and helping to ensure civilian protection and human security. The presence of neutral actors would reassure the citizenry of the commitment of government to fully respecting the human rights instruments to which the Kyrgyz Republic is a signatory and to preventing a culture of impunity within the defense and security sectors. Priority areas to be addressed in collaboration with international technical assistance include: prosecuting and punishing those guilty of human rights violations or torture, including sexual and gender-based violence; tasking the ombudsman or an independent agency with receiving citizen reports of crimes committed against them during the April - June events; and supporting an investigation of human rights abuses during the events.

In the medium-term, training of the security sector in civilian protection, professional ethics, human rights and due process should be prioritized, as should the overall professionalization of national security forces. Similarly, capacity-building for the ministries of defense, internal affairs and justice should all be envisioned. In all of these activities, the international community will be a key partner for the government and its expertise in similar exercises around the world should be fully utilized. Finally, the government of the Kyrgyz Republic is encouraged to commit to building a government and civil service representative of the nation's ethnic diversity. This may require the adoption of specific quotas, such as those previously enacted in Kyrgyz parliament to address the historic underrepresentation of women in the government. A wider security sector reform process could provide the necessary space for addressing this issue, alongside other weaknesses in the technical skills, institutional capacities, coordination and civilian oversight of the defense and security sectors. This would be a valuable investment in the long-term security of the country for both the government and its international partners. In the absence of a comprehensive strategy to address the lack of confidence in the security and justice sectors, stability may continue to elude the country and perpetuate an institutional vacuum in which organized crime, extremist movements and violent elements take further root.

→ The total requirement for security, stability and justice: \$ 8.0 million.

These aspects could also be funded directly by interested donors through financial and in-kind contributions to the government of the Kyrgyz Republic, and could be considered within a larger security sector reform project, if deemed appropriate.

CHAPTER VI: CRITICAL PRIORITIES IN INFRASTRUCTURE

The Kyrgyz Republic faces severe deficiencies in infrastructure: energy insecurity, poor road connectivity, lack of basic infrastructure services at the local level. The current crisis only serves to highlight the needs in this important area, which is a prerequisite for the economic development of the country as well as for promoting much-needed peace, security, and social cohesion.

The direct damage to infrastructure—energy, transport, and local government infrastructure—has been limited but indirect losses are substantial. In fact, the most visible damage has occurred to public, commercial, and private residential buildings. Infrastructure development or needs assessed in this chapter should not be viewed simply as a routine matter of economic development. The development of energy, transport, and local government infrastructure holds much promise as a means to bringing communities together, especially if such work is done in an inclusive manner.

Energy

In January 2010, electricity tariffs were raised by 56 per cent and 114 per cent for industrial and household consumers, respectively, and increases of 186 and 110 per cent were put into effect for hot water and district heating in urban areas. At the same time, pensions and public sector wages were raised, cash transfers increased and housing allowances in Bishkek were also raised so as to offset the impact on the vulnerable and the poor. Even with the sharp rise, energy tariffs would not have led to full cost recovery, as the country continues to enjoy the lowest energy tariffs in the CIS. With additional revenues from the tariff increase, the energy companies planned to step up vital rehabilitation and investments critical to ensuring security of supply, particularly in the demanding winter months, and to bolster programs for curbing technical and commercial losses, notably through metering. With the introduction of VAT and the retail tax on energy, budget revenues were projected to rise by \$15 million in 2010.

The interim government rolled back both the rise in household electricity tariffs (fully) and the rise in industrial tariffs (substantially) in light of heavy social pressure following the April events. The government has stated that future tariff policy will be determined by the elected government. The interim government recognizes the importance of raising tariffs towards full cost recovery levels, but has emphasized that future increases should take place in a gradual manner, with full consultation and communication with society, and with a targeted system of compensation for the poor. Without a carefully devised program of this kind, no sustained increases in tariffs would be achievable.

The impact of the reversal of the energy tariff increase will be felt on (i) the budget, in the form of losses in tax revenues and increases in subsidy expenditures for the communal energy services as well as for financing the tariff discount reinstated for inhabitants in the mountainous areas of the country; and (ii) diminished revenues for the electricity companies that will lead to cutbacks in essential repairs, maintenance and investments. Finally, the June events (iii) led to losses in the gas distribution system in Osh. Needs arising out of item (i) are reflected in the budget and have been discussed in Chapter II. This section discusses the needs arising from items (ii) and (iii).

Box 4: The energy crisis and government response

The country is heavily dependent on a Soviet-era regional power grid, developed as part of a regional water and power sharing arrangement, also involving Kazakhstan, Uzbekistan and Tajikistan. Because of geographical constraints, power was supplied to southern Kyrgyz Republic through the regional grid, but the recent construction of bypasses in neighboring countries means these countries may no longer participate in the regional grid, which in turn has raised the prospect of southern Kyrgyz Republic being cut off from the grid.

There is also a seasonal power production-consumption mismatch whereby hydroelectric production in Kyrgyz Republic is high in summer, but energy consumption peaks in winter. The sector is beset with heavy quasi-fiscal deficits, inadequate maintenance and investment, extremely low electricity tariffs (tariffs cover only a small fraction of costs) and high distribution losses (amounting to one-third of generation).

The authorities launched a comprehensive strategy in November 2009 to address these problems and have sought to build partnerships with bilateral and multilateral donors in support. The World Bank has been engaged in policy advice and investment financing over a number of years, including an emergency energy operation in 2009. USAID has been providing technical assistance. China and Kazakhstan have emerged as significant sources of financing for investment.

The **southern supply problem** is to be addressed by the immediate launching of construction of a new high voltage substation at *Datka*, and a north-south (*Datka-Kemin*) transmission line.

Energy production is to be boosted by revamping, the Bishkek thermal heating plant and completing the construction of Kambar Ata-II hydro power cascade (the latter mostly financed by donors and government resources).

Electricity distribution: To improve the sector's efficiency and lower the quasi-fiscal burden, the authorities are implementing a two-stage tariff increase amounting to a cumulative hike of more than 150 percent. Losses are also being cut through a nationwide installation of new meters.

Demand for electricity peaks in the winter, when thermal plants and the district heating systems of Bishkek, Osh and certain other cities are brought fully on stream. It is important to ensure security of supply not only for basic human needs but also to maintain social peace and to support economic activity and employment. There are several sources of risk to the supply of electricity over the winter of 2010/11:

- The budget for the fuel required to run the district heating systems described above are entirely unfunded. In the recent past, Kyrgyz exported electricity in the summer months (generated from water than was run off for irrigation purposes for neighboring states) and the proceeds were used to finance fuel stocks for the winter. In 2010, no summer export arrangements have been concluded, largely because of the April events, and it is unlikely that arrangements can be put in place on time. The requirement for purchasing stocks of mazut, coal and other fuels is estimated at about \$50 million.
- Essential repairs for the dilapidated equipment of the district heating plants for Bishkek and Osh amount to \$30 million – such repairs would bring reliability of heat supply to minimal levels.
- Essential repairs for the district heating systems for 23 other urban centres amount to \$25 million, again bringing the reliability of supply to minimal levels.
- Critical repairs to ensure security in electricity generation in Toktogul and the Bishkek thermal plants, purchases of cables, switches and other essential works in distributions, amount to \$69 million.

- The restoration of the gas distribution network in Osh and related expenditures amounts to \$6 million.

Thus, the total energy sector critical financing requirement amounts to \$180 million.

To put the energy sector on a path to sustainability, several priorities must be addressed. This will ensure that the activities financed in the energy sector are effective in meeting their objectives within a reasonable resource framework.

Starting a high-level dialogue with neighboring and downstream countries. It may be prudent to seek a high-level dialogue with neighboring countries to agree on summer exports linked with the irrigation water flows and on an arrangement to move power to areas in the north and south of the country in the summer and winter seasons.

Improving the financial viability of the power sector to avoid its collapse. In combination with efficiency improvements (decreased losses, better collection), a well-defined tariff trajectory to bring predictable cash flows to the sector would be essential to secure sustainable operations. Funds would be required for adequate maintenance to avoid further deterioration of sector assets and meet the significant investment needs to ensure reliable supply.

Enhancing sector transparency and strengthening governance. The Interim Government intends to immediately work on improving governance and transparency. This could be achieved by credible involvement of civil society and implementation of an Energy Transparency Initiative announced by the Interim Government. Such initiatives could underpin efforts to reduce corruption, increase transparency, improve targeting of social benefits, and accelerate the adoption of better practices in energy sector management and regulation.

Buildings and structures

Much of the damage in both the April and June 2010 events was borne by the building sector. In summary, damage to 2,314 residential buildings accounts for about 50 percent of the overall building damage estimate of approximately \$144 million,²³ followed by damage to several dozen public buildings accounting for 34 percent of the damage estimate, and damage to over 700 commercial establishments, accounting for 16 percent of the damage estimate.

The information provided above only accounts for direct damage to building structures, and does not account for damage to contents or ensuing economic losses. A detailed accounting of contents, or even economic activity for the various affected buildings, is unavailable at this time. In lieu of detailed data, the JEA team prepared an estimate based on simplifying assumptions drawn from experience to approximate damage to contents and ensuing economic losses to buildings. Economic loss in this case refers to losses other than direct property damage. Based on these simplifying assumptions, the estimate of total of building and contents damage is \$241 million, with public buildings and private commercial buildings accounting for about 55 percent of the total loss, and private residential buildings the remainder.

Thus, the total estimate of damage reconstruction under the public space is \$130 million including public buildings and private buildings-commercial.

²³ The needs associated with residential housing corresponding to this figure for damage is discussed in Chapter V.

Table 8: Buildings and Structures Damage and Loss Assessment
(\$ million)

Item	Building	Content	Economic	Total
Public buildings	49.73	37.30	3.36	90.38
Private buildings – Commercial	22.52	15.77	1.58	39.86
Private buildings – Residential	72.08	36.04	2.88	111.01
Total – Buildings and Structures	144.33	89.10	7.82	241.25

Source: JEA estimates.

Sector Priorities

All three aspects of the building and structures sector (public, private-commercial, and private - residential) are high priorities for recovery and reconstruction.

Of the three, private residential is the highest priority. Winters in the affected area are harsh, requiring any transitional shelters to be particularly robust thermally as well as with regard to wind and snow. Such transitional shelters will require substantial resources to construct; these resources could alternatively be devoted to permanent dwellings, thereby avoiding double-building. The construction season permits outdoor construction until about late November, thus allowing almost four months for construction, if it can begin by early August. Four months are sufficient to permit construction of a permanent ‘core’ house of perhaps 50 or more sqm, which in many cases will serve households through the winter. Therefore, a streamlined building materials provisioned, technically assisted owner-builder would appear appropriate, beginning as quickly as possible.

Constraints on such a program include:

- (i) **Material support:** As usual, lining up support (funds, building materials, technical assistance) for the program in a timely manner will be challenging, and should be tackled early.
- (ii) **Community support:** Consulting with communities and mobilizing their support for such a program, particularly in terms of buy-in by those affected, will be vital. Moving too quickly may feed suspicions, so building community support must move quicker.
- (iii) **Equity:** That is, tuning reconstruction in such a manner so as not to feed further animosities. This point has been emphasized by a number of parties - that victims should not be perceived by the larger community as gaining from the events, thereby feeding jealousy and touching off further rounds of violence. Building only a core house initially helps mitigate this issue.
- (iv) **Design:** One size doesn't fit all and neither does one housing design. Housing needs of ethnic Kyrgyz differ significantly from those of ethnic Uzbeks, so that design and reconstruction should anticipate and be flexible to accommodate these needs.
- (v) **Seismic:** Given the high seismic risk in the region, reconstructed buildings should not be collapse-prone - to achieve adequate seismic resistance is not very difficult, but does require some training of owners and builders. Experience in other regions (e.g., in Latin America and in reconstruction following the 2001 Gujarat, India, 2005

Pakistan and 2006 Yogyakarta, Indonesia, earthquakes) shows how to effectively provide this training and assure seismic adequacy.

These issues need to be addressed in an integrated social program that not only addresses the issues of physical reconstruction, but also at the same time addresses issues of physical, psychological and social trauma, livelihoods, gender and economic needs. Given the socio-economic roots of the April and June events, the need for such an integrated social program is even more pressing than in say a natural disaster.

Transport

The direct damage to the transport and communications infrastructure as a result of the April/June events has been limited. There was no direct damage to regional road infrastructure and the only reported damage to municipal roads was in Osh due to movement of defense equipment. The overall estimate for municipal road rehabilitation and for replacement of damaged or destroyed rolling stock is \$10 million.

Prices sharply increased for construction materials and petroleum products (bitumen, cement, steel, diesel fuel) because of the prolonged closure of the borders with Kazakhstan and Uzbekistan, and interrupted operations of domestic cement factories. Recent surges in construction input prices are also expected to severely affect the investment estimates in the medium term, and this is particularly important for the transport sector that comprises 60 percent of the country's investment portfolio. Moreover, parts of the road network are in need of urgent repair. Based on projected implementation of road projects, it is estimated that such significant price increases could lead to about US\$20 million increase over 2010-12 PIP.

The estimated financing need for the road sector is estimated at \$30 million.

Local government infrastructure

The April 2010 event caused no damage to water supply and sanitation infrastructure, roads, electricity, and heating infrastructure. The June 2010 events had a larger impact on civil structures. Osh City and Karasuysky District were affected in Osh Oblast, and Jalal-Abad Town, Bazar-Korgon, Suzaksky, Ala-Bukinsky districts were affected in Jalal-Abad Oblast. The immediate investments in the local government infrastructure are towards urban/public transport rolling stock replacement and expansion at approximately \$10 million in Bishkek and Osh.

The total estimated need for infrastructure development and service delivery arising from the April/June 2010 event is \$350 million.

CHAPTER VI: AGRICULTURE

Agriculture is the backbone of the rural economy and accounts for a quarter of total GDP. Agricultural gross value is expected to decline by approximately 19 percent in 2010 due to: a) late spring planting following the April events and delayed fuel provision; b) the suspension of fertilizer imports from Uzbekistan following the June events; c) reduced irrigation, pest and disease control, weeding and timely harvesting due to the insecurity of ethnic minorities in the South; d) a severe contraction in crop trading activity by farmers and traders in the South due to insecurity; e) higher fuel, machinery service and input prices; f) lower output prices; and g) to a lesser extent disruption to livestock grazing. The impact of the crisis has been exacerbated by a wet spring and early summer as well as mudslides in isolated areas. Clearly, with lower cash incomes, and reduced availability of food for home consumption, more households will become food insecure this year.

Ethnic Tensions and Interdependence in Rural Areas

Competition over access to land, irrigation, and pastures have been long-term contributory factors to ethnic tensions in the South. Restricted access to markets through Uzbek enclaves creates further tensions and is worsened by, poor farm to market roads and weak storage infrastructure. These tensions have been exacerbated by weak and inequitable management of natural resources by government, resulting in low rural incomes, food insecurity, environmental degradation and a general lack of trust in local government.

Despite these long standing tensions, there has also been a high degree of economic interdependence between the Uzbek and Kyrgyz communities. While reconciliation and peace building must be the initial focus, these can best be sustained in a vibrant rural economy in which the Uzbek and Kyrgyz communities re-establish their economic inter-dependent. This can be achieved through investments to improve equitable access to natural resources for both communities, to increase agricultural productivity and stimulate trade between the two communities.

Investment Requirements

In the short-term, the shock to farm incomes and food security resulting from the crisis may be mainly addressed through cash transfers. The private sector is sufficiently developed to be able to import and distribute the necessary input, materials and food products if demand exists. In the medium and long-term, the response to the crisis should be a renewed program of investment in rural communities, including investments to improve in rural infrastructure, access to markets and agricultural productivity.

- Improving Rural Infrastructure: Eighty percent of cultivated land in Kyrgyzstan is irrigated and generates an even higher proportion of crop output. Access to irrigation is a potential trigger for ethnic conflict. The State Committee for Water Resources estimates that a further 63 water user associations, serving 78,000 ha, require rehabilitation at an estimated cost of \$17 million over a five-year period. An initial investment to rehabilitate irrigation and drainage on about 30,000 ha would require a budget of \$12.5 million under the medium term program.

- Improving Access to Markets: There are strong agricultural trading links between Kyrgyz and Uzbek communities but the benefits of this trade are limited by poorly maintained farm to market roads, inadequate storage facilities and poor market facilities. An assessment of rehabilitation needs, ownership and management arrangements for this infrastructure could be in the order of US\$30 million over a five year period, including \$15 million under the medium term program.
- Improving Agricultural Productivity: The proposed investments in improved access to markets should be complemented by measures to improve farm productivity and to link farmers to markets. This requires measures to improve the provision of seed, improve crop and animal husbandry, implement land and pasture improvement measures, and rehabilitate orchards. It also requires advice to assist farmers to find and secure agreements with buyers. This support could be best implemented through a community-based micro-projects program, building on Kyrgyzstan's substantial experience in this field. This investment would require \$15 million over a five-year period, including US\$7.5 under the medium term program.

The total financing requirement (\$35 million) is calculated as the sum of the initial need for rehabilitation of irrigation and drainage, three year program for restoring and improving access to markets as well as raising agricultural productivity.

Principles for Investment

To re-establish trust in government and build peaceful communities, these investments should be based on principles of: a) equitable investment – this means ensuring a fair geographical distribution of investments, so that benefits are distributed fairly across ethnic groups; and b) community or private sector led investment – this means designing and implementing investments through community-based organizations (such as local investment committees, water user associations and pasture user unions) and managing public infrastructure and services through transparent public-private partnerships where possible.

CHAPTER VII: THE BUSINESS ENVIRONMENT

In addition to business damages and losses, the events of April have dampened confidence within the private sector by creating uncertainty about political and economic prospects. The June ethnic violence further fueled this uncertainty. Although the June 27 referendum helped bolster the interim government's credibility, the continuing ethnic tension and perception of lack of government control continues to hamper business confidence and weaken the investment climate. Private investment is now projected to amount to the equivalent of 14.8 per cent of GDP in 2010 or five percentage points below pre-April projections.

Thus, the loss in confidence has been translated into lower economic activity. In particular, tourism, which accounts for 5 per cent of GDP, has seen significant cancellations in bookings, and project reductions in foreign tourist arrivals well into the summer (tourism reservations are down 80 per cent from last year). Expectations have been conveyed that activity in this sector may not begin to recover before July-August, the usual peak of the season, and election –related activity may keep tourists away until the next year.

The closure of frontiers to trade and movement of persons by Kazakhstan and Uzbekistan - the latter closure persists - has created doubts about future access to trade and have broken or disrupted supply chains, especially in agriculture and road construction works. Neighboring countries' decisions to close borders for movements of goods and people have significantly impacted formal and informal trade, in both April and May. The readily observable substantial decline in exports of garments, fruits and vegetables, and dairy products is expected to show-up in trade figures once they become available. In addition to making the continuation of re-export activities difficult, the closure of the Kazakhstan and Uzbekistan borders also made it harder for bank borrowers from the trading sector to unload already imported stocks and repay working-capital loans (trading activities represented around 16 percent of GDP in 2009).

The business environment in Kyrgyz Republic has long been hampered by arbitrary behavior of the tax authorities, inspections and impositions of regulations not based on a predictable, transparent application of the rule of law, and poor progress with reforms relating to corporate governance, management of state owned enterprises and competition policy. Shortly after the April events, the business community proposed a series of actions to address some of these difficulties over the short term. The interim government has been sympathetic to these actions, and has moved them to an advanced stage of the approval process. Parallel initiatives are likely to come from other collective bodies (industry associations and professional bodies) as the opportunity to renew the impetus behind their reform agendas becomes clear to each stakeholder.

The reported increase in international and domestic perceptions of corruption and expropriation risks in the Kyrgyz Republic, which was covered in many international headlines throughout 2008-2009, has now been compounded by the uncertainty inherent in the current political and election processes. These will also need to be addressed by the future government alongside ongoing reform programs to improve the investment climate.

The damage to commercial establishments, business disruptions, and border closures arising from the April and June events resulted in losses to the private sector, particularly in tourism and retail

trade. Displacement of people, lack of security and restriction to movement (e.g., imposition of curfews) in the south have further reduced consumer demand for goods and services.

There arises an urgent need to provide resources for private activities such that the private sector economy can begin to take advantage of a revival of demand. This is particularly important in the vital tourism sector, where re-investment and working capital needs are evident and where cash balances have been depleted. Tourism export receipts in 2009 were about \$445 million, 20 per cent of which would be tourism-related retail sales. With the significant cancellations in tourist bookings, tourism export receipts for 2010 may fall as much as 60 percent. With this drastic drop in receipts, profits of tourist operators and retailers linked to tourism will be drastically cut. There will be limited reinvestment of profits. The foregone profits that would have been used for reinvestment would be around \$20 million. As such, the private sector, particularly, the tourism and related retail trade establishments would benefit from access to project financing and bridging facility from development partners, amounting to around \$20 million, to allow them to maintain and rehabilitate their establishments, and recoup foregone revenue in 2011, when more economic stability is achieved.²⁴

²⁴ Economic losses incurred by the tourism sector, such as losses arising from foregone wages to workers, foregone revenue by suppliers and servicing of existing financial liabilities in the sector, if included, is likely to be significantly higher than currently estimated.

CHAPTER VIII: FINANCIAL SECTOR

The Kyrgyz financial system remained sound through the 2009 economic crisis. Capital adequacy and liquidity of the system were adequate through the course of the economic crisis that the country faced in 2009. A large source of vulnerability of the system—exposure to banks in Kazakhstan—was reduced somewhat through the acquisition of two Kazakh banks by local banks, and the conversion of one subsidiary to its parent (Unicredit).

The April and June events have led to a worsening of loan quality. The non-performing loan ratio rose from 8 percent before April to 11 percent by end-May and is expected to deteriorate further following the events in the south of the country. The deterioration in loan quality is mainly concentrated in the trade and commerce sectors, suggesting a relatively strong impact of border closures. The business confidence effects of the continued political uncertainty suggest that credit growth this year will be weak.

Table 9: Kyrgyz Republic: Selected Financial Indicators

(In percent, unless otherwise indicated)

	31-Dec-08	30-Jun-09	30-Sep-09	31-Dec-09	31-Mar-10	30-Apr-10	31-May-10
Capital adequacy							
Net total capital/risk-weighted assets	32.6%	27.5%	29.4%	33.5%	31.7%	35.3%	27.3%
Liquidity							
Liquidity ratio	82.0%	82.8%	85.3%	86.8%	86.7%	90.8%	85.1%
Excess reserves/total reserves	30.4%	25.7%	25.3%	33.2%	15.8%	39.7%	45.2%
Asset quality							
Nonperforming loans/total loans	5.3%	8.7%	9.2%	8.2%	7.9%	9.4%	11.2%
Loan-loss provisioning/nonperforming loans	55.9%	52.8%	56.5%	58.4%	57.5%	53.0%	51.3%
Profitability							
Return on equity	20.7%	13.2%	13.2%	13.6%	12.5%	10.3%	-52.7%
Return on assets	3.8%	2.5%	2.4%	2.5%	2.4%	2.0%	-10.3%
Loans and deposits							
Loans/deposits	110.2%	97.2%	86.5%	75.7%	70.8%	108.5%	106.6%
Loans/total assets	46.6%	39.0%	36.2%	36.9%	36.4%	45.2%	46.7%
Foreign currency exposure							
Share of foreign currency deposits in total deposits	63.6%	67.6%	70.4%	68.3%	68.5%	54.0%	54.5%
Share of foreign currency loans in total loans	64.7%	64.0%	63.3%	62.3%	59.1%	59.1%	58.2%

Source: National Bank of the Kyrgyz Republic

Financial stability has been adversely affected by the crisis. Whilst most banks appear sufficiently liquid and capitalized, there have been problems at some banks, including Asia Universal Bank (AUB)—the largest, with over 20 percent of system deposits. The NBKR introduced temporary administration in AUB and 6 other banks (later reduced to four) after AUB saw a significant nonresident deposit outflow, allegedly linked to the previous regime. The five banks are also seeing deteriorating financial health and some are undergoing audits. The authorities are developing action plans accordingly—these could involve a change in management, and/or capital injections, if necessary.

AUB has been particularly affected by the crisis. The bank's loan portfolio has been affected by connected and insider lending, and loan quality has deteriorated, particularly following the events in the south where the bank had significant exposure. A sizable portion of its liquid assets placed with asset management companies prior to the crisis may not be recoverable. The government put the bank under conservatorship in June and subsequently nationalized it. Operations have been restricted, including (i) deposits from individuals will not be accepted, and (ii) transactions of legal entities will be restricted to a limited type of transactions, including salary-related payments, social fund payments and AUB loan repayments. The situation has been

further complicated by a recent court decision to hand over AUB assets that were acquired from Kyrgyz Promstroi Bank in 2007, back to the original owners. This decision is now under consideration in the courts.

AUB problems impose a cost on the budget. According to the latest estimates it requires regulatory capital in the order of KGS 3½ billion (\$76 million; 1.7 percent of GDP). Budgetary costs to resolve the bank will likely be inevitable.

The authorities are considering a number of options for resolving the bank. These could include (i) outright bankruptcy and liquidation; (ii) rehabilitation and sale and; (iii) restructuring through purchase and assumption—a good bank, bad bank solution or; (iv) sale to a foreign buyer. In considering these options, the authorities are cognizant of the systemic implications, fiscal costs and the need for the system to recover quickly and start providing an impetus to growth again. Given the technical deficiencies in the country, the authorities may need help to defray the cost of an external audit and hiring management and legal teams, in addition to covering the cost of recapitalizing the bank or covering the loss of government deposits.

CHAPTER IX: FIDUCIARY SAFEGUARDS, FINANCING MECHANISMS AND INSTITUTIONAL ARRANGEMENTS

The management of external aid for recovery should build on the progress achieved by the Kyrgyz Republic and donor organizations in aid harmonization. Kyrgyzstan is the first country in the Central Asia region that participates in international initiatives for aid harmonization and effectiveness in line with principles of the Rome and the Paris Declarations on Aid Effectiveness.

This section describes the overall fiduciary environment (public financial management, fiduciary and safeguards arrangements), potential financing options for the recovery efforts as well as the principles and mechanisms which will guide the implementation and monitoring of external aid provided for the recovery program.

Public financial management

A decade long reform effort on the PFM system²⁵ has resulted in a gradual formation of a professional technical team in the MOF and Central Treasury and establishment of a reasonably strong aggregate fiscal discipline in budget execution. This has entailed a process of fiscal consolidation and bringing extra-budgetary funds into the budget, introduction of cash flow forecasting and implementing a balanced budget, and elements of accountability in the use of public funds, considerable improvement in reporting, as a result of the introducing of new budget classification and a unified chart of accounts.

The remaining weaknesses of the PFM system are related to the shortcomings in strategic planning. They result in: (i) inconsistent outcomes of budget policy with a huge variation in the quality of public service provision across the country; (ii) frequent re-allocation of resources within the originally approved budget and hence low predictability of funds for spending units; (iii) weak links between the sector strategies, the Medium Term Budget Framework (MTBF), and the annual budget; (iv) a lack of transparency, with poor public access to key budget information and (v) poor system of internal checks and balances with the exception of selective spending entities. The internal audit system is at an early stage and cannot provide credible assurance of the legality, effectiveness, and efficiency of the use of public funds.

PFM reform efforts continue with heavy donor involvement and supervision. There is clear strong ownership by the current government. The Public Financial Management system proved to be sound against the disruptions caused by the April and June events and ensured functioning of essential budget organizations. The MOF and Central Treasury (CT) undertook the following actions and policy measures:

- (i) Treasury information was backed-up in a timely manner at the central data processing centre prior to violence against the treasury premises. Measures to protect budget execution records in locations near heightened ethnic and political tension were also taken. As a result information on the budget execution has been protected in spite of the physical damage incurred by local treasury divisions.

²⁵ Assessment of PFM reform progress is made possible by comparing two consecutive Public Expenditure and Financial Accountability assessments (PEFA) conducted in 2005 and 2009.

- (ii) The MOF and the Central Treasury continued to adhere to strict overall aggregate budget discipline in budget execution, with the exception of June when expenditure pressures became unmanageable and undermined the concept of balanced budget – main achievement of the PFM reform in Kyrgyz Republic.

In summary, progress in PFM has been tangible and the reform momentum is strong. Nonetheless, there are weaknesses as indicated above, but these are being addressed in an organized way with donor assistance. The new government will be asked to demonstrate clear commitment to reforms and to demonstrate results within the framework of receiving JEA-supported assistance for the economy. The JEA judges that conditions are appropriate for donor financing of the recovery and reconstruction program with the PFM tools and safeguards currently in place; a demonstrated continuation of reforms and strengthening of PFM systems will be required from the next elected government.

Financing Safeguards

Fiduciary aspects

Accounting, recording and reporting. Kyrgyzstan has reasonably strong systems of accounting, recording and reporting. Computerization of treasury functions enables regional treasuries to agree expenditure details with the local transit banks daily before submitting details to the central treasury which then agrees the total with the National Bank. The 2007 introduction of a GFS 2001 compliant chart of accounts has also improved the level of information available on a quarterly basis. However, national accounting and reporting standards for the public sector are not fully developed yet although recent resolutions if fully implemented, would go a long way in improving accounting and reporting in the public sector. Strengthened accounting and reporting systems in the public sector would result into development partners putting reliance on such systems for implementation of investment projects.

Internal audit. The internal audit system is at an early stage and cannot provide credible assurance of the legality, effectiveness, and efficiency of the use of public funds. While the normative and methodological basis for introduction of internal audit has been established, much needs to be done to develop reliable internal control systems. Today 12 units out of a planned 14 in ministries and central agencies have been established. But auditor capacity needs improvement and the importance attached to their work by managers is insufficient. The MOF, as a lead organization, is planning some activities aimed at improving capacity and further developing systems of internal control for the public administration in general.

External audit. Public sector auditing is performed by the Chamber of Accounts (CoA), the equivalent of supreme audit institution (SAI) in the country. However, due to capacity limitation audit of both ADB and World Bank-financed projects in Kyrgyzstan continue to be performed by private sector audit firms that periodically undergo assessments to determine their capacity to conduct audits in accordance with International Standards on Audit (ISA). Ongoing capacity

strengthening of the Chamber of Accounts that is supported by the Bank, in parallel with the efforts being made to develop financial reports in the public sector that can be subject to audit, should result in improving its performance in the medium to long term. The recently approved law on internal audit, together with the planned capacity development under the PFM Multi-Donor Trust Fund (MDTF), should help develop institutional and professional capacity for internal audit in the country. Other efforts to build internal audit capacity continue in parallel through investment projects implemented by line ministries.

Public procurement. Public procurement has gone through some reform through revisions introduced in the Public Procurement Law to bring it in line with international standards; introducing principles and stages of an efficient procurement process, and defining the mandate and authority of the State Procurement Agency. However, this agency which was established as an independent public procurement oversight body, was abolished in October 2009 as a part of the Government reorganization which took place under previous government. Instead, a new Department on Public Procurement Methodology has been established under MOF while the procurement supervision function was not assigned to any organization. In addition, the National Procurement Training Center has been taken over by a private ownership and the range of procurement training has been gradually decreasing.

As such, budget entities have become solely responsible for the procurement process, with no regular oversight from other government bodies. Random external audits are conducted by the Chamber of Accounts once every two years. This decision seriously undermines a system of checks and balances in public procurement and creates a responsibility gap for assuring the quality of public procurement, especially given that the public sector internal audit is weak. This heightens corruption risks in procurement.

MOF procurement unit intends to start publishing contract award information to bring more transparency to the procurement system. However, the process for redressing tender violations remains unclear. Given that public procurement carries a risk of high corruption, appropriate oversight and transparency will need to be established as a priority. The MOF recognizes this priority, but its capacity and current legal basis are the main constraints for immediate improvements. The MOF public procurement unit includes only five staff, whose major responsibility concerns methodology of public procurement. Recently, the unit began to request the minutes of tender commission meetings in an attempt to check accuracy of the tender process; however, the unit's capacity clearly is not sufficient to do this promptly and with acceptable quality. The unit also drafted a new public procurement law that is intended to re-establish appropriate procurement oversight. The process of approving the draft law will take quite some time. Even once approved, there will be a need for extensive capacity and institution building.

The treasury is developing a database of contracts, but there is an institutional gap in monitoring the adherence to the procurement rules. The Chamber of Accounts reviews procurement process only during the regular assessment of budget organizations once every two years. The Government had noted that the supervision function in procurement had been reportedly a source

of administrative corruption. The provisional government will need to establish the procurement oversight function to foster credible state institutions and to develop mechanism of dispute resolution and handling of complaints to reduce corruption in procurement.

Financing Options

A variety of instruments is at the disposal of donors for providing financing for reconciliation, recovery and reconstruction. Consistent with the *Paris Declaration on Aid Effectiveness*, aid should be predictable, harmonized, and aligned with national priorities and use the country's own institutions and systems. To the extent possible, donors should employ existing and already planned mechanisms for the provision of financing to the greatest degree, thereby strengthening the linkages to the national budget process. Such mechanisms are budget support, support to government agencies involved in reconstruction, support for the financial sector, financing of relief and reconstruction activities undertaken by international agencies, support through trust funds, and direct financing.

First, **budget support**, provided by donors directly into the government's treasury account, to fill the fiscal gap associated with the revenue shortfall and expenditure increase that are a direct result of the April and June events. Donors could use this mechanism to finance costs associated with the economic and social consequences of the events. As the government has programs under implementation in these areas, the use of this instrument would be a particularly effective mechanism and a speedy way of deploying resources.²⁶ Budget support could also be used to directly, or indirectly create fiscal space to finance rehabilitation and essential maintenance activities that the government intends to initiate. Moreover, fiduciary reviews of the country's budget systems covering all aspects of financial management, procurement, monitoring and auditing show that Kyrgyz has adequate standards. The country has undertaken to further improve these standards, including those in public finance management.

Second, donors may **reimburse the government** for specific relief and reconstruction expenditure incurred on goods and services under the government's procurement system, reimburse particular activities of government relief and reconstruction agencies and finance individual contracts for reconstruction based on national procurement rules,

Third, **support for the financial sector** in the form of technical assistance, capacity building, and participation through debt or equity instruments and guarantees to the AUB bank that would help bolster investor and consumer confidence.

Fourth, **project financing** will be required for the range of recovery activities identified in the JEA. Project financing could be used to meet the needs associated with infrastructure damage and loss, the energy sector needs, sustaining basic urban service delivery and ensuring adequate maintenance of core infrastructure including roadways, and agriculture. It could also be an instrument for the private sector growth needs.

²⁶ For the provision of humanitarian aid as well as immediate social sector support, however, the expertise and capacity of UN agencies and NGOs would be vital in areas where government capacities require further strengthening.

Coordination and Monitoring Arrangements

The involvement of the international community in Kyrgyz Republic's recovery calls for effective coordination across all actors and monitoring of aid flows across all sectors. Building on current government practice a comprehensive monitoring system should be built around three components, namely monitoring results, tracking aid, and assessing impact.

Monitoring Arrangements

Monitoring results. The monitoring of results under the recovery efforts will use systems already in place and align with the Country Development Strategy (CDS) results monitoring and evaluation process which involves civil society and development partners. The CDS established framework has enhanced the mechanisms for monitoring and assessing progress which include baseline data and expected outcomes focusing largely on macroeconomic performance, governance and business environment, monitoring targets in agriculture, infrastructure, and energy, which are coherent with efforts planned under the recovery. A nationwide monitoring system was established and operating from February 2008 with public access to the system from April 2008 at <http://www.mes.in.kg/>. The site provides the basis of a good system for monitoring and reporting of the recovery outcomes.

Tracking aid. Aid tracking is critical to ensure that the donor funds, especially when they do not go through the budget, are spent on the agreed activities in order to achieve the agreed objectives. Comprehensive and transparent reporting on aid, and how it is used, is also an important way of ensuring that donors align aid flows with national development priorities Donor assistance should be consistent with the government's program and the projects they finance should be included therein. It also facilitates funding allocation and identifies financing gaps.

Assessing impact. In addition to project related impact assessments, there could be periodic monitoring at the household level that uses a quantitative and/or qualitative method to measure the outcomes and impact of the overall post-crisis program. Such a tool would provide valuable information and help reinforce and/or redirect the recovery effort, as needed, in real time. Tools such as citizen score cards that have been used successfully elsewhere could be adapted for use in Kyrgyz Republic.

Coordination Arrangements

The government will hold quarterly coordination meetings with the donor community present in Bishkek. It could use these meetings to present progress achieved under its post-crisis program using data from the abovementioned aid tracking and results monitoring mechanisms.

Implementation Arrangements

In the case of non-budget support activities, existing implementation arrangements should be used to the extent possible and partners will work to build and strengthen country capacity through adopting a multi donor approach, or a "silent partners" approach when resources are provided by a donor while the implementation leadership is agreed with another donor within an agreed aid framework.

Capacity Development Needs

Capacities exist in most Kyrgyz Republic public sector entities. However, they are unevenly distributed with national structures stronger than those at the regional/sub-regional level, and stronger in some sectors than in others. Capacities also vary amongst regions/sub-regions. Weaknesses can be observed in terms of financial capacity, institutional capacity, skills capacity, and infrastructure capacity. Depending on the sector, one or more of these areas may require strengthening.

CHAPTER X: DONOR SUPPORT FOR RECONSTRUCTION AND RECOVERY

This chapter attempts to pull together the overall financing requirement for the reconciliation, recovery and reconstruction program that is based on the analysis of the JEA. The financing requirement consists of budget support for 2010²⁷ and of investment financing for social needs, infrastructure needs, agriculture, and private sector support needs that will be implemented over a 30 month period from July 2010 to end-2012. Donors are being asked to provide pledges and commitments for the overall financing support that has been assessed.

The overall financing requirement is \$1 billion (Annex I). It can be broken into three main elements: (i) support for budget, including the recapitalization needs of a major systemically-important bank -- \$335 million; (ii) support for social reconciliation and recovery, including the housing and restoration of livelihoods needs of the internally displaced persons -- \$334 million; (iii) infrastructure needs related to damages and losses of buildings and property and urgent rehabilitation or repair needs in energy and transport -- \$350 million. Other items consist of agriculture, security related spending, and support for private sector.

A tentative disbursement profile for the investment expenditures is also presented in Annex I. Clearly, much will depend on project management and implementation, but also on how quickly and firmly donor commitments are made and then translated into disbursements by them.

The profile shows that in the next six months, donor support of \$671 million is required -- \$335 for the budget and \$336 million for other programs (including the Flash Appeal). The requirements for the years 2011 and 2012, *excluding the budget support amounts for those years that can be determined only once an elected government is able to formulate a budget*, are estimated at \$227 million and \$102 million, respectively.

²⁷ The budget support requirement for the year 2011 has been tentatively estimated at \$225 million on the basis of preliminary plans of the government for the budget for that year. This requirement can be assessed only once an elected government formulates the 2011 budget and takes the decisions on the underlying revenue and expenditure measures. It will be put to donors for consideration for financing in early 2011.

ANNEX I: KYRGYZ REPUBLIC: FINANCING REQUIREMENTS FOR RECONCILIATION, RECOVERY AND RECONSTRUCTION

(millions of US dollars)

1	PUBLIC SECTOR RELATED NEEDS (6+15)	980
2	Budgetary financing gap²⁸	335
	banking sector capitalization	76
3	Cost of referendum and general elections	6
4	Additional Security-related expenditures	6
5	Targeted social assistance for newly poor	4
6	<i>Sub-total: general economy need (2+3+4+5)</i>	351
7	Social reconciliation and recovery	334
	humanitarian ²⁹	96
	support for IDPs and vulnerable groups	238
	housing needs	105
	livelihoods	45
	social compensation	52
	other	36
8	Security and peace-building	11
9	Infrastructure (10+11+12)	350
10	Buildings and structures	130
	public	90
	private Commercial ³⁰	40
11	Energy sector	180
	winter reserve for mazut/fuel/coal	50
	rehabilitation of gas distribution in Osh	6
	essential repairs for district heating in Bishkek and Osh	30
	essential repairs for district heating in 23 cities	25
	critical repairs for generation and distribution	69
12	Transport	40
	regional	20
	municipal	20
13	Agriculture	35
14	LESS: Amounts already identified as budget expenditures	101
15	<i>Sub-total: essential sector-related needs (7+8+9+13-14)</i>	629
16	PRIVATE SECTOR RELATED NEEDS	20
	GRAND TOTAL (1+15)	1000

²⁸ Of the estimated gap of \$335 million, \$105 million has been identified from the Asian Development Bank, the European Commission, the United Nations (election support) and the World Bank. The remaining financing requirement or donors is \$230 million.

²⁹ Corresponds to the Flash Appeal of the UN

³⁰ Note that private housing is included under social recovery

ANNEX II: PROJECTED DISBURSEMENT PROFILE OF SUPPORT

(US dollars, millions)

	2010	2011	2012	Total
Budget support	335			335
Social reconciliation and recovery	214	95	25	334
Housing needs	45	40	20	105
Livelihoods	25	15	5	45
Social compensation	30	22	0	52
Other	18	18	0	36
Flash Appeal	96			96
Security and peace-building	6	3	2	11
Infrastructure	164	120	66	350
Buildings and structures	33	61	36	130
Energy sector	121	37	22	180
Transport	10	22	8	40
Agriculture	17	9	9	35
LESS: Amounts already identified as budget expenditures	-101			-101
Private sector related needs	20			20
Others³¹	16			16
Total	671	227	102	1000

³¹ Cost of referendum and general elections, additional security-related expenditures, and targeted social assistance.

ANNEX III: RECONCILIATION AND RECOVERY

Introduction

Southern Kyrgyzstan comprises the three Oblasts of Osh, Jalalabad and Batken which border Uzbekistan and Tajikistan and is part of the wider Fergana valley region. The population of southern Kyrgyzstan number 2.4 million with a complex ethnic make-up in which the Kyrgyz constitute the majority with 68% of the total population in the three Oblasts, and the Uzbeks are the largest minority with 26%. The remaining groups comprise Tajiks, Tatars, Uigurs, Turks, Russians, and other nationalities. Most of the population (78%) lives in the rural areas.

Key drivers of conflict include poor governance characterized by an ineffective administrative and security system, poverty and socio-economic disparities, competition over natural resources such as agricultural land, irrigation water and pasture, harsh border regimes that negatively affect the lives of ordinary people by stifling commerce and movement of people and by feeding corruption, the role of the south as a transit area for the smuggling of drugs, widespread unemployment and under-employment particularly of youth, and a deteriorating education system that does not equip youth to participate meaningfully in society. All of these factors contribute to create persistent societal stress points that can and have become articulated as inter-ethnic rivalry.

Both Southern Kyrgyzstan and the wider Fergana valley area have witnessed inter-ethnic conflict in the past.³² Yet, while the violence that began in southern Kyrgyzstan on June 10, 2010, was carried out by one ethnic group against another, and while rural youth are reported to have perpetrated much of the violence, the circumstances that triggered the violence and the actors that instigated and organized it are still unclear.

What is clear, however, is that the violence and its aftermath revealed the weakness of the state and its lack of control over the security apparatus and the local administration. A precondition for stability and recovery is therefore the reestablishment of an impartial security regime capable of protecting all citizens.

It is also critical that both the early recovery and medium to longer term assistance now being planned by the government and international actors will not be perceived as favoring one ethnic group (the Uzbeks) over other groups, who may also be exposed to hardship and deprivation, and who may in the past have been subjected to disasters and displacement without receiving the assistance that is now being provided after the June events. If the assistance is not part of a broader recovery and development effort, it may contribute to aggravate inter-group tensions that could fuel future violence. Thus, Kyrgyzstan has over the last few years been affected by a series of natural disasters including earthquakes and floods. Most recently, flash floods hit southern Kyrgyzstan in early June 2010 with over 70 villages affected and infrastructure seriously damaged. The challenge of a broader recovery and development effort represents at the same time an opportunity for the state to demonstrate, that it can deliver services equitably to its citizens irrespective of ethnic background, which in turn would contribute to foster reconciliation, build the legitimacy of the state, and contribute to the stability necessary for sustained economic growth.

³² In 1990, prior to independence there were clashes between Uzbeks and Meskhetian Turks in Fergana and Khokand in what is now Uzbekistan, and severe inter-ethnic violence between Uzbeks and Kyrgyz in Osh and Uzgen originating from perceptions of unfair distribution of land and housing.

Sector Impacts

Support for reintegration of IDPs: The June violence caused a massive displacement of Uzbeks. Most of those who were displaced are from the cities of Osh (population 258,100), Jalalabad (population 92,100) or the immediate surrounding areas. Some people, of both Kyrgyz and Uzbek ethnicity, have also been displaced within rural areas of southern Kyrgyzstan. Depending on estimates, between 179 to 2,000 persons were killed, and 375,000 people were displaced, with 75,000 people fleeing to neighboring Uzbekistan, while 300,000 became IDPs within Kyrgyzstan. Unexpectedly and apparently caused by a combination by both pull and push factors, the refugees began returning back to southern Kyrgyzstan in late June. Most refugees were back before the referendum on an interim constitution was held on June 27, 2010. Recent reports indicate that more than 90% of the displaced have returned to their homes, with the rest staying with host families. In addition to those displaced, the areas affected by the conflict are home to around 765,000 people, who were not displaced. Thus, 56% of the population in the two Oblasts lives in conflict affected areas.

The population profile of the two Oblasts of Osh and Jalalabad is as follows: ³³

Oblast	Population				Urban population		
	Total	Kyrgyz	Uzbek	Other ³⁴	Total	Kyrgyz	Uzbek
Osh	1,175,998	64%	31%	5%	272,490	34%	56%
Jalalabad	869,259	70%	24%	6%	200,752	64%	21%

UN together with international NGOs have very rapidly provided the affected families with immediate humanitarian relief comprising shelter, food, and critical non-food assistance. By early July, WFP had provided 300,000 displaced people with two-week rations. UNHCR has also established a 24-hour protection hotline for both Osh and Jalalabad that provides support for grievance redress regarding issues such as damage assessments and property documentation, law enforcement, and missing people.

The pattern of destruction, damage, and looting indicate a targeted act based on detailed information that enabled selective destruction of Uzbek homes and businesses leaving – with a few exceptions – neighboring properties belonging to Kyrgyz and other nationalities intact. Consultations with returned IDPs in Osh showed pervasive bewilderment regarding the reasons for the violence that had left them destitute, feelings of abandonment due to lack of information from and presence by the authorities, and intense fear and insecurity.³⁵ The returnees also reported persistent discrimination and harassment from authorities including the security forces. This discrimination and harassment comprise actions such as the continuing detainment of young Uzbek men during nightly operations by unknown actors, confiscation of identity documentation

³³ 1999 Population Census. Data from the 2009 census are not yet available.

³⁴ The balance is comprised by Russians, Uigurs, Tatars, Turks, Tajiks and other nationalities.

³⁵ A World Bank mission visited Uzbek neighborhoods (Kyzyl Kishlok and the Tashlak area in Shark village) in Osh on July 11, 2010, and met with groups of Uzbek men and women as well as with individual families, who had been made homeless by the June violence.

(e.g. passports) by the police, and refusal by banks to provide services such as withdrawals from personal bank accounts of remittances from relatives working abroad.³⁶

Assessments of the impacts on housing have been completed for Jalalabad but are still ongoing for Osh. For Jalalabad the number of destroyed or damaged homes is 450. Findings by July 11, 2010, indicate that final figures on destroyed, damaged and looted houses in Osh may be higher than initially estimated. The damage assessment undertaken by UNOSAT found that around 2,500 homes had been affected compared to the government assessment of 1,363 homes. However, the current ongoing assessment by ACTED and Save the Children for UNHCR has found around 20% more damaged homes compared to the UNOSAT figures in areas surveyed.³⁷ Final figures from this assessment will be available by July 18, 2010.

The average household compounds in the Uzbek neighborhoods comprise two families (with an average of 7.5 persons per family), who generally inhabit separate small one-story houses inside the joint compound. An estimated 92% of affected dwellings consist of this type of structures, and 72% of these houses are completely destroyed with another 19% severely damaged. Close to a quarter of the completely destroyed houses do no longer have access to water, and around 72% of the assessed houses no longer have access to electricity. Compared to water and electricity, fewer homes had access to piped gas before the June events, and of those who did, 94% are now without gas supply. Mostly outdoor toilet facilities were available in 94% of the affected homes, and the damage to 58% of these also includes the toilets.³⁸ At the moment most IDPs are living in tents erected inside their compounds, in the streets, or in available public spaces.

In addition to damage to private housing, businesses and public buildings have also been destroyed or damaged:³⁹

Category of impact	Osh & Jalalabad
Homes damaged or completely destroyed	1,813 - 3,450
Destroyed/damaged businesses ⁴⁰	248
Damaged public buildings	79

The Commission for Assessment of Damages estimates that the violence and displacement have caused loss of employment for around 4,000 persons (mostly in service and trade). In addition, there is significant disruption of markets since farmers cannot move to sell their produce or buy

³⁶ Such refusal by banks to allow withdrawals was reported to happen even when the person holding the account had valid identity documentation. Moreover, the interim identity documentation issued to some IDP returnees explicitly states, that it is not valid for banking transactions. This poses a major challenge with regard to the design of implementation arrangements for any kind of cash transfers to Uzbek IDPs/returnees.

³⁷ The increase in the assessment of damages is a reflection of assessment methodology. The UNOSAT figure (2,500 affected homes) is based on satellite photography, and the government figure (1,363 affected homes) is not based on visits inside household compounds, whereas this is the case with assessment undertaken by ACTED and Save the Children for UNHCR resulting in an overall figure that could increase to 3,000 affected homes.

³⁸ During its visit to Osh on July 11, 2010, the World Bank mission learned from UNHCR, that consultation with IDP households in Jalalabad indicate that they want to undertake reconstruction of homes themselves, and in its meetings with IDPs in Osh, the mission received the same message. IDPs also stated that they preferred to receive building materials rather than cash.

³⁹ In Osh, the mission observed several completely burnt out restaurants and large shops that belonged to Uzbeks. Neighboring buildings belonging to non-Uzbeks were everywhere intact.

⁴⁰ Figures on damaged commercial and public buildings are from the preliminary assessment of July 3, 2010, prepared by the Commission for Assessment of Damages Caused by Events in June in the City of Osh, Osh and Jalalabad Regions.

inputs, and since people are afraid of venturing out of their homes and neighborhoods, they cannot access markets. Lately though, there has been some resumption of commerce.

A Flash Appeal based on a UN inter-Agency needs assessment was issued on 18 June 2010, with a budget of USD 71 million. The goal of this Flash Appeal is to provide life-saving assistance to the IDPs in southern Kyrgyzstan, and to the around 765,000 people who are not displaced, but live in the areas affected by the conflict. With the return of the refugees from Uzbekistan and the gradual availability of more solid data on impacts and needs, the Flash Appeal is being revised based on the cluster approach headed by OCHA, which now will include Early Recovery with UNDP as the lead agency. The updated Flash Appeal is scheduled to be available by mid July 2010.

With the return of most displaced to their former homes, the overall situation has within a short time-span evolved from exclusively humanitarian concerns to a situation that requires interventions to support early and longer term recovery. Some activities need to be initiated immediately such as improvement of the security situation for the Uzbek communities, provision of shelter before the onset of winter by the end of October along with restoration of water, electricity, and gas services, restoration of identity and property documentation, and support for the enhancement of the capacity of the Directorate for Rebuilding and Reconstruction of Osh and Jalalabad. Other short-term activities that need to be initiated as part of an early recovery effort during the remainder of 2010 will need to continue into the medium and even longer term to yield their intended outcomes. These include measures to support the recovery of businesses and agriculture, rehabilitate basic and vocational education, provide cash transfers for vulnerable groups,⁴¹ generate employment through labor intensive public works, provide opportunities for youth, initiate reconciliation between communities and between these and the state, and establish psycho-social support and counseling services to victims of the June violence.

Core activities to support early recovery need to be coordinated between the government, the UN Cluster System, NGOs, and other actors. Equally important is that there are robust monitoring arrangements to track reconstruction and recovery investments which ensure transparency through involvement of local communities. Along with accelerated preparation, project design need to build in flexibility to enable responses to changing circumstances and opportunities, and also need to build on best practice regarding procurement and financial management arrangements in post-conflict situations where timely delivery of projects benefits have urgency, and project management and implementing agencies may have limited experience on procurement and financial management procedures.

Key activities and design elements outlined above can be brought together in the early recovery phase to support economic revival, reconciliation and peace-building over the medium and even longer term. Since information on needs is incomplete, the costs in the table below should be considered preliminary.

⁴¹ E.g. returnees while rebuilding their homes and/or businesses, people who lost employment, elderly / pensioners, female headed households, and people dependent on seasonal labor.

Time-line for start-up	Activity	Components	Component costs (USD million)
Short to Medium	Recovery and Reconciliation through Infrastructure Delivery	Housing for IDPs	45.0
		Other infrastructure	3.0
		Reconciliation through participatory community recovery and local area development	25.2
Short to Medium	Socio-Economic Reintegration and Peace-Building	Support for livelihood recovery	45.0
		Peace and tolerance building	3.1
		Youth inclusion	5.1
		Security, stability and justice	8.0

Recovery and Reconciliation through Infrastructure Delivery

Housing for IDPs: As described above, the June events resulted in extensive destruction of houses that is expected to amount to around 3,000 family homes. The majority of the IDPs (>90%) are now back in their homes and anxious to begin repair and reconstruction before the onset of winter in late October. All IDPs consulted expressed that they wanted to construct their homes themselves, since they or their parents or grandparents had originally built the houses. The IDPs would prefer to receive building materials rather than cash allowances, since they expected that prices for materials would increase sharply with the aggregate demand from all the returnees. They were confident that they could find in the wider neighborhood the specialized skills needed (e.g. masons, carpenters, electricians, plumbers), and would even contract Kyrgyz artisans if nobody within their immediate neighborhood were available. Thus, IDP management of the house reconstruction could contribute to reconciliation through the involvement of Kyrgyz members of the wider community.

If the option of repair and reconstruction of homes being managed by the owners themselves, this could involve the following approach:

Supply of a package of construction materials that – depending on the level of destruction - would enable the IDP returnees to either construct a preliminary winterized (2-room) house or repair their original home.

Cash-for-food or in-kind food allowance to feed the family during the construction period since they would not be able to earn an income during while working on their home.

Cash allowance to hire artisans.

Oversight and technical assistance to ensure adequate construction quality and use of appropriate technologies to e.g. secure the buildings against earthquakes.

→ Budget Requirement to meet IDP housing needs: 45,000,000 USD

B. Other infrastructure: The Commission for Assessment of Damages has estimated the damage caused to public infrastructure (e.g. gas and power supply, public buildings) in Osh and Jalalabad. This component would finance the costs of rehabilitation and repair of such infrastructure and equipment.

→ Budget Requirement to meet needs for repair of public infrastructure: 3,000,000 USD

Reconciliation through participatory community recovery and local area development: An effective response to the recent crises will not be achieved without a coherent and substantial approach to promoting social reintegration. Reconciliation and trust need to be built and rebuilt in communities directly affected by the June events in Osh and Jalalabad Oblasts and Bishkek, but also between and among communities throughout the country, as well as between the citizenry and the central state in which it has lost faith.

The June events are viewed through an ethnic lens, both by directly affected populations, as well as by the overall populace throughout the rest of the country. The perceived and actual violence perpetrated during the crisis, as well as reprisals, recriminations and intimidations thereafter have eroded relationships and trust between different ethnic groups. As but one example, an Uzbek community in Osh reported feeling no resentment towards their Kyrgyz neighbors during the crisis itself, and being able to separate these neighbors from those taking part in the violence, only to feel growing resentment following the crisis as stories of Uzbek government workers being retrenched or intimidated into vacating their jobs in state hospitals and other government services have circulated. Perceived regional and ethnic inequities in terms of allocations of government resources, and international responses, have also inflamed resentments towards the South in unaffected parts of the country.

Societal fractures take time to heal and reconciliation activities must therefore be strongly participative and supported over the short- and medium-term horizon. Their focus should be on re-establishing dialogue as a means of rebuilding relationships and trust. Both intra- and inter-community reconciliation will need to be supported. And while reconciliation activities will need to be highly tailored to specific localities and the events experienced there, they will also need to include national reconciliation dimensions. Psychosocial interventions to address the traumas and stresses experienced by violence-affected populations, including sexual, physical and psychological violence against women and children, will also be key.

To address these issues, a range of activities to facilitate reconciliation should be developed, including: community projects (reconstruction and rehabilitation of social infrastructure) and events (cultural, sporting, learning etc.) which promote social cohesion and help to rebuild social capital; ensuring access to medical and psychosocial support services for communities directly affected by violence, including victims of sexual and gender-based violence and torture; awareness-raising activities focused on civil rights and responsibilities; legal aid; strengthening community-level dispute resolution mechanisms; support to resolve title, property and access disputes; formal tracking of community dynamics and social acceptance to ensure a good understanding of reconciliation dynamics between displaced and communities of return or settlement.

In particular, community rehabilitation of social, economic and cultural infrastructure of collective benefit in communities in violence-affected regions as well as regions affected by recent natural disasters will be an important means of supporting social cohesion and may be mobilized relatively quickly through existing community development structures (eg. ARIS).

Such projects will provide an opportunity for community members to unite round a collective goal with benefits for the whole population as well as to create short-term employment for vulnerable members of the population. The projects should feature an inclusive participatory planning and management process and involve both community/neighborhood level activities, and activities that bring together communities and neighborhoods representing different ethnic groups in joint planning of activities that address shared needs. Such activities involving a larger area with multiple communities and neighborhoods would also provide a framework for engaging with local government, and contribute to restore trust by providing citizens a voice in local affairs. The specific activities should be decided by communities in response to agreed local needs and could include: renovations of schools, health points and community centers, renovation or rehabilitation of potable water systems, renovation or upgrading of apartment buildings and associated facilities in urban settings, and rehabilitation of village or feeder roads and communal agriculture and erosion control activities in rural areas.

→ Total Budget Requirement to meet reconciliation need: 25,200,000 USD

Socio-Economic Reintegration and Peace-Building

Support for Livelihood Recovery: The June events decimated livelihoods for numerous households in the directly affected areas. These impacts were varied, including affected peoples fleeing their home areas and therefore being unable to work, businesses destroyed farmers unable to go to their field or access irrigation water, and workers and traders unable to travel to their job sites. Weeks after the violence itself, safety and security concerns are such that many affected people are afraid or unable to leave their homes, let alone travel to work. Others are unable to access the inputs and supplies on which their livelihoods depend, including tradable goods, water for irrigation of fields, etc. Still others have no livelihood to speak of since their shops, market stalls or other businesses have been destroyed.

Box: Livelihoods in Osh

The main sources of employment in Osh oblast are agriculture and trade. These account for 39 and 19%, respectively, of total employment. Based on informal discussions with affected peoples and response organizations in Osh city, the indicative daily income (Kyrgyz Som) for various types of livelihoods is as follows:

- Day laborer (builder): 400
- Day laborer (high skill): 600
- Shopkeeper (large shop): 1400
- Shopkeeper (small shop): 950
- Market vendor (agricultural and food items): 200

In addition to the need to support affected populations to restore or re-access their livelihoods, the crisis also drew attention to the economic vulnerabilities and disparities, such as pervasive youth unemployment, and the needs of people previously affected by natural disasters such as mudslides and earthquakes, which may have contributed to the events themselves and would therefore also need to be addressed by any livelihood recovery support provided by the government and its development partners.

An effective response thus requires a multi-targeted and multi-phase approach which is targeted not only at the 375,000 people displaced by the conflict, but also the 765,000 living in the affected areas.

In the immediate term, priorities will be to:

Re-establish safe access to employment sites and the means of production for those whose livelihoods have not been destroyed (e.g. farmers whose fields and agricultural inputs are unaffected, but who are unable to access them given ongoing insecurity). This will involve re-establishing rule of law and central command and control over security forces, as well as facilitating opportunities for local populations to regain confidence in local security forces.

Develop temporary employment opportunities as a short-term coping mechanism for households whose livelihoods were lost or damaged during the recent events, as well as other economically vulnerable populations (e.g. unemployed youth). The authorities may wish to focus on cash for work initiatives and labor-intensive public works, which can absorb large numbers of people and contribute to projects of local significance (e.g. infrastructure rehabilitation, sanitation etc.) at relatively, low per person costs.

In the short- to medium- term, the priority will be to:

Support employment creation/targeted livelihood support for IDPs and other vulnerable and lowest-income populations (including female-headed households, families relying on others for accommodation, youth etc.) in areas directly affected by the April and June events, as well as other marginalized, at-risk regions. Multi-dimensional support will be required, including: local economic development grants; active labor market programs (e.g. provision of employment information, counseling and referral services, apprenticeship schemes, vocational training and second-chance learning opportunities, including literacy and numeracy skills); self-employment assistance (e.g. promoting access to credit, capacity-building for cooperatives and SMEs; agricultural extension support etc.). Activities must minimize market distortions and maximize beneficiary choice, involve strong involvement of local communities and build on existing capacities rather than create new structures.

In the medium- to longer-term, priorities will include:

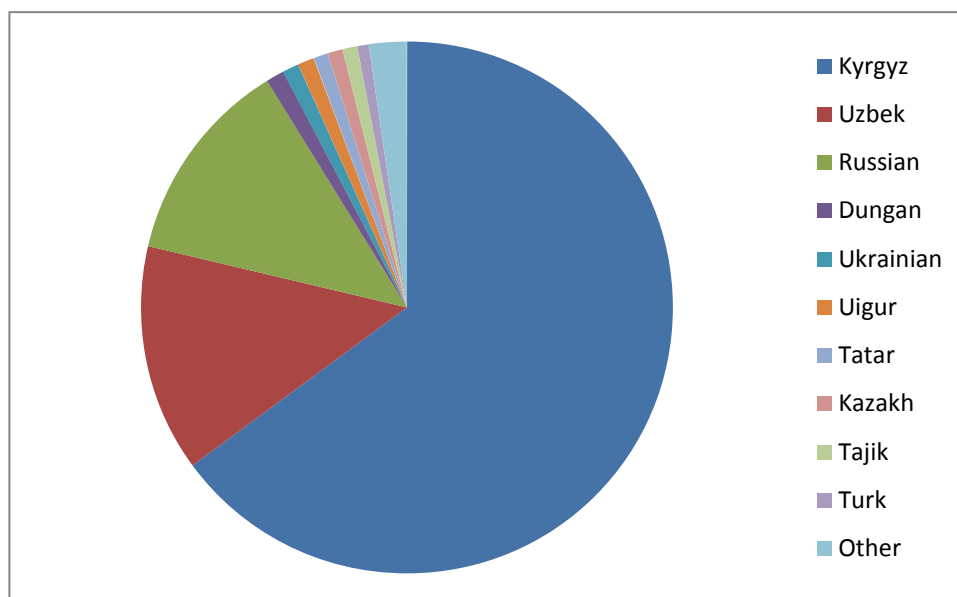
Improving the relevance of the educational system to the labor market through national education reform. An education system able to provide quality teachers and schools, relevant curriculum and employment-relevant skills will support reduced educational drop-out rates, youth joblessness and youth idleness, and thereby contribute to enhanced security as well as local economic development.

→ Total Budget Requirement to meet Economic Reintegration Support/ Livelihood Recovery Needs: 45,000,000 USD

Social Reintegration Support: The Kyrgyz Republic is a country of considerable social diversity – whether in terms of ethnicity, language, religion, urbanization or poverty. Many of these aspects played a direct role in both the April and June events. Diversity is not always a risk, however, and must be promoted as an opportunity for sustainable development moving forward. An effective response to the recent crises, whether in terms of rebuilding homes, restoring livelihoods or promoting stability and security, will therefore not be achieved without a coherent and significant approach to promoting social reintegration.

BOX: A Snapshot of Three Aspects of Social Diversity in Kyrgyz

(i) Ethnic Groups in Kyrgyzstan



(ii) Economic Poverty

Region	Percentage of the Population Living Below the Poverty Line⁴²
Kyrgyz Republic	31.7
Batken Province	31.5
Jalal-Abad Province	36.9
Issyk-Kul Province	46.1
Naryn Province	44.1
Osh Province	38.3
Talas Province	33.0
Chui Province	21.1
Bishkek City	13.2

⁴² National Statistics Committee. 2009. Poverty Levels in the Kyrgyz Republic in 2009.

(iii) *Human Poverty*

Region	Human Poverty Index⁴³
Kyrgyz Republic	6.9
Batken Province	7.9
Jalal-Abad Province	5.9
Issyk-Kul Province	7.8
Naryn Province	8.2
Osh Province	9.0
Talas Province	6.8
Chui Province	8.2
Bishkek City	5.2

The following three elements, peace and tolerance building, youth inclusion, and building confidence in security, and stability and justice are elements of the minimum package of social reintegration investments which are called for to enable the country's transition from crisis to sustainable development. A fourth element, namely reconciliation and rebuilding of social capital within and between communities, is addressed by the operation on Recovery and Reconciliation through Infrastructure Delivery described above.

Peace and Tolerance Building. While the April and June events were relatively short-lived, tensions and insecurity in the affected regions continue, exacerbated by highly polarizing information campaigns and rumors propagated through the media, mobile telephones and word-of-mouth. The high risk of future eruptions of violence, particularly given the uncertainties of upcoming parliamentary elections, is very high. Supporting the establishment of a culture of peace and tolerance in at-risk environments throughout the country is both a short- and long-term priority. These activities will directly support security and stability and strengthen the resilience of communities to resist potential future drivers of conflict. Peace and tolerance activities which would help to address ongoing tensions in Kyrgyz and which have proven effective in similar contexts include: immediate peace and tolerance training for local opinion-shapers (teachers, journalists, religious leaders, local officials, magistrates); human rights and protection training for security forces; public media campaigns on peace-building; community-level trainings on conflict management and conflict resolution; development of peace and tolerance curricula for schools; grants for arts and cultural activities promoting peace messages; forums for inter-ethnic dialogue and cooperation.

→ Total Budget Requirement to meet Peace and Tolerance Building Needs: 3,070,000 USD

43 UNDP Kyrgyzstan. 2009/2010 National Human Development Report. KYRGYZSTAN: successful youth – successful country. The UN Human Poverty Index focuses on the part of the population living in conditions of extreme deprivation. It includes the percentage of people who die before the age of 40, the literacy level of the adult population, and an overall indicator of deprivation (lack of access to safe drinking water and healthcare services, and percentage of 1- to 6-year-olds who are underweight). Lower index scores represent fewer people living in extreme poverty.

Youth Inclusion Activities. Large numbers of young people were involved in both the April and June events and youth are one of the most poor, vulnerable and marginalized groups in Kyrgyz. Whether politically or economically manipulated into taking part in recent violence, or motivated by resentments, radicalization or criminal motivations, it is clear that achieving a sustainable peace will require explicit targeting of youth needs. Yet, properly encouraged, young Kyrgyz could play an important role in driving growth, development and peace in their communities.

Box: Youth in Kyrgyz

Youth are one of the most populous sub-groups in the country. In 2008, young people aged 14 to 34 accounted for close to 40% of the overall population. Two-thirds of young people in the country reside in rural areas⁴⁴, where education, employment and leisure opportunities are often limited and/or of poor quality. Agriculture is the biggest employer of young people in the country (38% of all employed youth), yet jobs in this sector are often poorly paid and seasonal. Overall, young people are highly pessimistic about current trends in the country. A survey of youth attitudes conducted in 2009 found that only 21% of young people felt that positive changes were taking place in the country; meanwhile, 23% felt dissatisfaction with what was happening, 31% felt fear of the future and 14% felt apathy and acceptance of their fate.⁴⁵ Feelings of exclusion and powerlessness leave many young people open to negative forces in society, including criminal organizations, the drug trade and extremist groups, all of which are active throughout Kyrgyz.

It is recommended that the government and its partners develop youth inclusion activities to support young people to develop livelihoods and life skills as well as to contribute to decision-making and governance. Specific activities could include: life skills development (including information technology, foreign languages, leadership, healthy lifestyles and citizenship skills); employment support (including formal and non-formal skills training and vocational education, apprenticeships, business development skills, access to micro-credit, mentoring, employment creation and job counseling and referrals); development of youth-friendly spaces and recreational opportunities in rural and marginalized communities; legal education and support services for youth and youth employers, including training on labor and migrant rights; and capacity-building support for youth organizations and youth-run services.

→ Total Budget Requirement to meet Youth Inclusion Needs: 5,100,000 USD

Building Confidence in Security, Stability and Justice: The April and June events clearly eroded citizen confidence in the state's ability to uphold security and stability in the country and to maintain its monopoly on violence – the very foundation of state legitimacy. While many communities in affected areas feel abandoned and/or persecuted by the full range of state institutions – from the executive itself to local authorities to state-owned media – it is state defense and security forces, both armed forces and the police – in which they are most disappointed. Unable to assure civilian protection, to control the spread and use of arms, to prevent military equipment and supplies from being co-opted by participants in the violence and to maintain command and control within their ranks, state security forces were seen - at best, as ineffective and strongly biased towards certain ethnicities - on the average, as complicit in the violence and - at worst, as the very instigators of the events. Moreover, in many Uzbek communities, state agencies are claimed to have continued an anti-Uzbek campaign of

⁴⁴ UNDP Youth report

⁴⁵ UNDP Youth report

harassment and intimidation since the end of the widespread violent conflict. In this context, fear continues to paralyze communities of all ethnicities in the affected areas and citizens throughout the country lack confidence in the state security and justice apparatus.

In the immediate-term, experienced international security trainers and advisors working under the auspices of a respected agency such as the OSCE, should be mobilized as a means of guiding this process. The presence of neutral actors would reassure the citizenry of the commitment of government to fully respecting the human rights instruments to which the Kyrgyz Republic is a signatory. A strong signal needs to be given to end any perceptions of a culture of impunity within the defense and security sector and to ensure that all legal provisions of the Kyrgyz Republic are protected and upheld. The full legal and legislative arsenal of provisions to regulate the defense and security forces, and to prosecute and punish those guilty of human rights violations or torture, including sexual and gender-based violence, should be enacted. An ombudsman, independent state agency reporting directly to the President or parliamentary committee, supported by international observers, may also be beneficial in encouraging citizens to report crimes committed against them during the April and June events, to which many victims currently feel the state is turning a blind eye. Currently, many victims are reluctant to report crimes and violence to the Criminal Investigations division of the police, given that many allegations concern police officers. In other cases, victims report police inaction in the face of reported crimes. In parallel, the government is encouraged to support any international Human Rights investigations of the events which its international partners may propose. This type of commitment will further encourage confidence in the state's commitment to transparency and justice.

In the medium-term, training of the security sector in civilian protection, professional ethics, human rights and due process should be prioritized, as should the overall professionalization of national security forces. Similarly, capacity-building for the Ministries of Defense, Internal Affairs and Justice should all be envisioned. In all of these activities, the international community will be a key partner for the government and its expertise in similar exercises around the world should be fully utilized. Finally, the government of the Kyrgyz Republic is encouraged to commit to building a government and civil service representative of the nation's ethnic diversity. This may require the adoption of specific quotas, such as those enacted in Kyrgyz parliament to address the historic underrepresentation of women in the government. A wider security sector reform process could provide the necessary space for addressing this issue, alongside other weaknesses in the technical skills, institutional capacities, coordination and civilian oversight of the defense and security sectors. This would be a valuable investment in the long-term security of the country for both the government and its international partners. In the absence of a comprehensive strategy to address the lack of confidence in the security and justice sectors, stability may continue to elude the country and perpetuate an institutional vacuum in which organized crime, extremist movements and violent elements take further root.

→ The total Budget Requirement to build confidence in Security, Stability and Justice = 8.0 million USD. These aspects could also be funded directly by interested donors through financial and in-kind contributions to the government of the Kyrgyz Republic, and could be considered within a larger security sector reform project, if deemed appropriate.

ANNEX IV: SOCIAL PROTECTION

Introduction

The April-June events led to a considerable death toll and injuries that are unprecedented in Kyrgyzstan's history as an independent country. This, and the associated social upheaval, has had both direct impacts by causing major and lasting disruptions in society and economic activity and internal displacement, and the *indirect* effects—ranging from the closure of borders, which seriously disrupted trade, and labor migration through the effect on the financial sector, the business climate and on investor confidence. The inter-ethnic tensions in the south are most likely to depress the growth rate in 2010 and beyond, especially if political tensions do not abate and reconstruction and reconciliation processes take off slowly. The interim government's policy actions will play a critical role in containing the damage through direct assistance and indirect channels.

Background

Poverty. The Kyrgyz Republic is one of the poorest countries in the CIS, with a per capita income of US\$853. The country faced a difficult economic situation in 2009 and experienced only 2.3 percent growth, compared to an average of 5 percent over the preceding half decade. The global financial crisis adversely affected the economy through the transmission channels of exports and worker remittances, which declined, respectively, by 14 percent and 30 percent in 2009. Early information indicates that the recent political upheaval will dampen an economic recovery, keeping growth at about 2.2 percent per annum for 2010. Low economic growth makes significant poverty reduction more difficult to achieve, especially in the absence of a flexible and widely accessible safety net.

The population of the Kyrgyz Republic has experienced a significant decline in poverty over the last decade. According to national accounts data, private household consumption per capita increased by 16 percent in real terms during 2003-08. Over this same period, the average consumption per capita of the poorest 20 percent of the population grew by 11 percent a year. The factors driving the increase in household expenditures were the growth in worker remittances, public sector wages, pensions, and private sector wages.

Table 1. Kyrgyz Republic: Poverty Rates, 2008

(Poor as percentage of total population)

	Overall	Urban	Rural
Poverty	31.7	22.6	36.8
Extreme poverty	6.1	3.2	7.7

Source: Kyrgyzstan, Integrated Household Survey 2008

The National Statistical Committee estimates total and extreme poverty at 32 percent and 6 percent of the population, respectively, for 2008 based on the latest available data from the Kyrgyz Integrated Household Survey (KIHS). Rural poverty significantly exceeds urban poverty, as seen in the Table 1. Two-thirds of the poor and the extreme poor live in rural areas. The incidence of poverty is highest in the oblast of Issykul (52 percent) and lowest in Bishkek (15 percent). However, due to the concentration of the population in the southern region, one-quarter of the Kyrgyz Republic's poor live in Osh and another 19 percent live in Jalalabad.

Poverty in Kyrgyzstan differs considerably between urban and rural residents. This is due in part to the fewer income earning opportunities available in rural areas and high dependence on agriculture, whose productivity is circumscribed by such factors as the scarcity of dependable irrigation systems, availability of quality seeds and agriculture inputs, and less-than-optimal land use practices. Moreover, the lack of cash income leaves those rural households dependent on farming, which is especially vulnerable to weather -related shocks.

In addition, the non-income dimensions of poverty also appear more in rural areas. Electricity is available to all urban and rural residents, while district heating and hot water are available in Bishkek and partially in Osh as well as a few other towns. Additional community services, such as sewerage, gas supply, and water supply, are also available in most of the oblasts, but rural access rates to basic community services are significantly lower than in urban areas—as is common in many other CIS countries.

The profile of poor families is closely correlated to family composition. Families with three or more children have a much higher probability of living below the poverty line. An estimated 46 percent of children from families with three and more children fall below the poverty line against 36 percent of children from smaller families. An estimated 10 percent of children from families with three or more children are below the extreme poverty line against 4 percent of children from smaller families. The proportion of children living below the poverty line in the Kyrgyz Republic is 36 percent, with the highest incidence in Talas and Issykul oblasts at 55 percent and 53 percent respectively. Child extreme poverty rates are highest in Issykul and Naryn oblasts at 19 percent and 13 percent, respectively, and lowest in Bishkek and Chui (between 2 and 3 percent).⁴⁶

In the first quarter of 2010, significant policy changes were introduced that would impact household incomes. On January 1, 2010, the government raised electricity and district heating and hot water tariffs by 114 percent, 110 percent, and 320 percent, respectively. Simultaneously, the government also increased the level of pensions (24 percent), public sector wages (by KGS 200 per month), and cash transfer programs of the MB and the MSB (by about 18 percent and 81 percent, respectively). In addition, the government monetized the categorical benefits based on entitlements and abolished some recipient categories (e.g., persons living in high altitude areas). Moreover, during the first quarter of 2010, remittances rebounded by 18 percent compared to the first three months of 2009.

Poverty is estimated to have remained constant in 2009 at 31.7 percent. However, in 2010 it is likely to fall by a total of 2.3 percentage points to about 29 percent. The increase in social benefits through the MB, MSB, and monetization of categorical benefits led to a decrease in poverty of 1.7 percentage points. The decrease due to the pensions and public sector wages led to an additional decline in poverty in 2010 of about 0.5 percent⁴⁷. There are potentially two avenues that would result in significant revision of poverty trends: (1) a remittance rebound—which could lead to a decrease in poverty, and (2) a supply shock resulting an export fuel tariff imposed by Russia, which provides the vast majority of Kyrgyz Republic's total fuel imports.

In April, the economic situation changed significantly. The political instability, closure of the border with Kazakhstan for six weeks, and the continued closure of the border with Uzbekistan led to a disruption in economic activity. The farming sector was particularly affected due to the

⁴⁶ Child Poverty in Kyrgyzstan, UNICEF (2010).

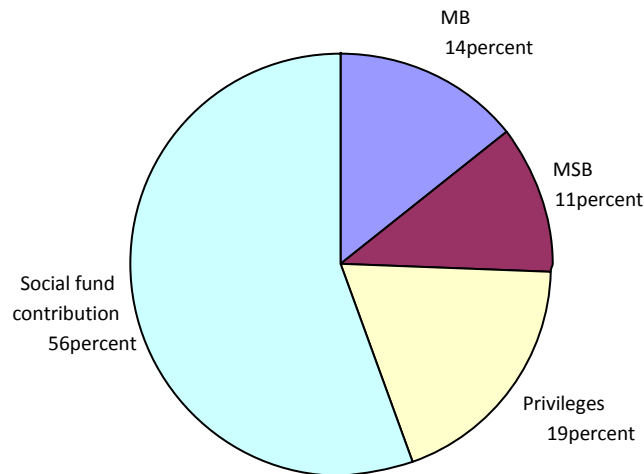
⁴⁷ World Bank staff preliminary estimations

resulting difficulty for farmers to obtain affordable fertilizer and credit (due to the disruption in the financial sector). They were also hit hard by the sharp increase in fuel prices. Moreover, as a result of the June civil unrest many businesses—especially those in southern cities—were adversely affected by total destruction, closures and/or decrease in sales. The events in April resulted in an immediate human impact, as 96⁴⁸ persons were killed and 1,622 persons injured, of which 822 were registered as receiving medical treatment⁴⁹. Furthermore, the official death toll in Osh and Jalalabad oblasts has reached 322 after the June clash, and more than 2,200 people were injured.

The disruptions have not impacted all social groups equally. The population groups most likely to bear the brunt of the slowdown are SMEs, construction, agriculture and tourism sector employees and small farmers. The disruption in the supply of credit, especially to farmers, during the sowing season in April/May, exacerbated the difficulty farmers had in purchasing fertilizer and fuel resulting from the border closure. The political instability and civil unrest forced thousands to flee the South of Kyrgyzstan leaving their land and property unattended, wiping out even small opportunities for many who would otherwise be employed at least in the informal agriculture and trade. Issykul, already the oblast with the highest poverty rate, is likely to be severely affected, given the importance of income from Kazakhstan tourists to the local economy. The other most affected areas are Osh and Jalalabad oblasts where the number of the poor has been the highest.

Spending for social assistance. Currently, the main types of policies to protect the poor and vulnerable include: (i) social assistance, (ii) social services for vulnerable groups of the population, (iii) social insurance, and (iv) unemployment allowances⁵⁰.

2010 Republican Budget Expenses in Social Protection



Source: 2010 Approved Republican Budget, Ministry of Finance, Kyrgyz Republic

⁴⁸ Including 3 killed in Mayovka on 12 April and 5 killed in Jalal-Abad on 13-14 May.

⁴⁹ Numbers are not final and are being updated twice a week by the Ministry of Health.

⁵⁰ Unemployment benefits are not traced in the budget appropriation. The actual payments made annually by the MoLEM are not significant in relative terms and are not included in the graph.

The spending for social assistance (cumulative MB and MSB) in 2010 increased by 73 percent compared to 2009. Spending has increased relative to GDP as well, and for the first time reached 1 percent of GDP, which is still lower than in most peer countries.

The main reason for the higher MB budget was an increase of GMI⁵¹ envisaged in the CDS. The main reason for the increase in the MSB amount was the January 1, 2010 increase of energy tariffs (subsequently reversed). New regulations detach the calculation of MSB from the GMI, and flat rates of MSB are set for 15 categories of beneficiaries⁵². The increase of the “privileges” budget because (i) on January 1 all privileges were monetized, and (ii) there was an increase in energy tariffs.

Table 2: Republican budget spending on social assistance

(KGS million)

	2009 approved budget	2009 actual budget	2010 approved budget
Social benefits (MB+MSB)	1,250.0	1,365.0	2,363.0 (73percent increase)
percent of total expenditure	2,5	2,6	4,0
percent of GDP	0,5	0,6	1,0
Privileges	639.9	829.0	1,713.0 (107percent increase)
percent of total expenditure	1,2	1,6	2,9
percent of GDP	0,3	0,4	0,7

Source: 2009 & 2010 approved Republican Budgets; 2009 annual budget execution report of the Central Treasury, Kyrgyz Republic

During the last three years, the increase of the privileges budget has been at much higher rates than the increase in the MB and MSB budgets.

The social fund expenses, excluding government contribution, are projected to decrease by 7 percent in 2010. However, the budgetary contribution to the social fund has been increased substantially in 2010. The approved 2010 budget envisages a transfer of KGS 5 billion (8 percent of total budget expenditure) to the pension fund against KGS 2 billion in 2009. As result the total expenditures of the social fund are projected to increase by 43 percent in 2010. In 2010 the total budget is KGS 19.1 billion. of which KGS 17.6 billion is projected to be spent on pensions, compared to 12.1 billion in 2009.

Unemployment and unemployment benefits. The rate of unemployment in Kyrgyzstan is estimated at 8.2 percent in 2008 based on the ILO definition. Neither national statistics nor ILO provides more recent data. However, according to other surveys the share of the labor force without jobs is much higher, at 18 percent. Both figures are strongly affected by measurement issues related to the high share of the informal economy in Kyrgyzstan.

⁵¹ Guaranteed Minimum Income – the means test benchmark to assess the eligibility for Monthly Benefits.

⁵² President Decree N 511, of 15 November 2009.

Unemployment benefits are aimed at providing a safety net in case of job loss. But their level (the amount of the individual benefit ranges from KGS 250 to 1.000 per month, with an average of KGS 450 per month as of 2009) is too low to provide effective consumption smoothing, or to have a significant poverty reduction effect. While this low level discourages “dependency mentality” and encourages job search, it may deter job seekers to register as unemployed, given the paperwork involved. Eligibility depends on 3-years’ participation in the formal labor market with at least 12 months of social contributions payment. This disqualifies youth—comprising 60 percent of all registered unemployed—from obtaining unemployment benefits. The economic and poverty reduction significance of the unemployment benefits scheme is limited, with high under-registration and hidden unemployment. Only 3.000 unemployed in the Republic receive the benefit, most of which are residents of Bishkek. With very limited coverage, insufficient labor demand in the formal sector, and the pressure of high poverty levels, job-seekers are forced to the informal sector for some kind of paid work. That work, however, is badly paid, irregular, and does not confer the labor rights and safety standards associated with formal employment.

It is expected that internal displacement resulting from the June events brings an unemployment upsurge, which is not likely to be reflected by the official administrative statistics. People who have lost semi-formal or informal jobs in small business, petty trade and farming have mostly been non-contributors to the Employment fund and therefore (i) are unlikely to turn up for registering as unemployed, (ii) would not receive the status of an unemployed according to the Employment Law in effect. To respond to the expected unemployment crisis caused by June unrest, the Government is considering a few options including public works, establishment of a ‘restoration and development’ fund and setting up a system of micro credits for revitalization of SMEs. However, administrative barriers are worrisome as (i) there is no single agency in charge and coordination between migration, employment, fiscal, social authorities and local governments remains to be improved, (ii) at the local level administrative barriers – different operational procedures and eligibility requirements of various possible programs – are likely to discourage many of those in need to apply.

Social Assistance. The social assistance system in the Kyrgyz Republic is in the process of transition, and is currently a mix of new programs and programs inherited from the previous system. Over the last 10 years the government made serious efforts to reform the social assistance system in order to improve its targeting and turn it into a more consistent and efficient scheme.

Currently the social assistance system includes a number of cash benefits and category-based compensations (formerly called “privileges”). There are two targeted cash benefit programs: the Monthly Benefit⁵³ (MB) for the children of poorest families and the Monthly Social Benefit (MSB), mainly for the disabled and elderly not eligible for a pension⁵⁴. People capable to work are not entitled to social assistance benefits.

In the Kyrgyz Republic, granting of state benefits to eligible beneficiaries is strictly centralized and regulated by the Law of the Kyrgyz Republic on State Benefits. State benefits are funded from the central government budget and administered by the State Agency for Social Welfare (ASW), with the exception of unemployment benefits, which remain administered by the Ministry of Labor, Employment and Migration (MoLEM).

⁵³ Former Unified Monthly Benefits.

⁵⁴ Without any working record.

Monthly Benefits. The MB is a means-tested cash benefit for children from the poorest families. Since 1998, after the adoption of the Law on State Benefits, the government started applying means-testing to social benefits through the introduction of the MB targeted to children of low-income families and other poor individuals.

Recipient families have to meet certain criteria to qualify for assistance. The average monthly per capita family income has to drop below a means-tested threshold, called the Guaranteed Minimum Income (GMI),⁵⁵ which is calculated as a relative share of the extreme poverty line. When per capita income of a family is below GMI, the Government pays this difference to the children. The children are the only beneficiaries of MB within the family. The MB scheme covers 17 percent of children in the country.

The persistent problems in the social assistance system of Kyrgyzstan, irrespective of the recent political upheaval, are the large exclusion of extreme poor from the mainstream social assistance schemes, and the weak purchasing power resulting from the low level of the benefits paid to the extreme poor children (average MB is 25 percent of the extreme poverty line, at around US\$5.6 per month for a child). The low level of benefits during the last several years has been the result of the lack of regular updates of GMI levels.

In November 2009, the Law was amended (and entered into legal force from January 1, 2010), and currently the MB is targeted to children from extreme poor families only. The analysis done before the adoption of the new law showed that the coverage of the extreme poor children by the MB is too low, approximately 35 percent. Hence, the previous government decided to improve the MB eligibility criteria to reduce the inclusion and exclusion errors and to expand the coverage of the extreme poor through the MB system. Further work was planned to be done during 2010.

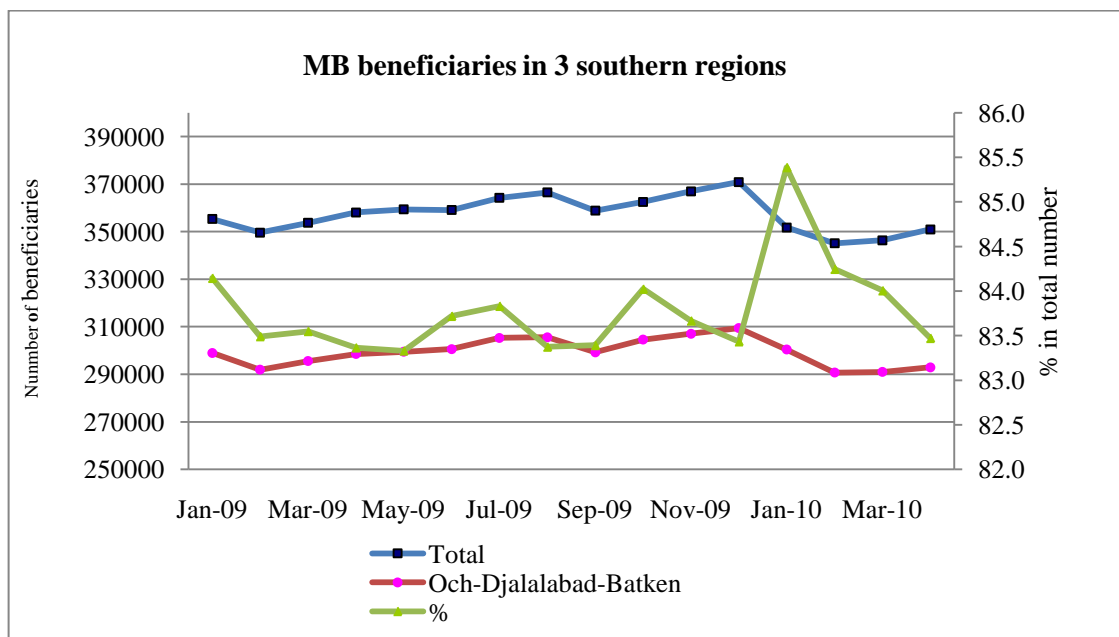
The level of GMI stood at KGS 200 until recently. It should be noted that the extreme poverty level is currently set at KGS 960. October 1, 2009, the level of GMI was increased to KGS 240, and again to KGS 282 beginning January 1, 2010. Currently the average MB paid to beneficiaries is KGS 212 plus a KGS 40 flat rate topping-up to compensate for food price increases (the latter is financed by the European Union funds). The government is planning to increase GMI to KGS 310 retroactively from July 1, 2010, and the funds to cover this increase are foreseen in the approved 2010 budget.

Targeting in Kyrgyzstan is complicated by the large number of households living below or near the poverty line, and by the high share of household income coming from informal earnings that is difficult to verify. In addition, the “propiska” system, which restricts lawful residence to where one is registered, leads to the exclusion of the majority of internal migrants from applying for social benefits (as well as for maternity and unemployment benefits, healthcare, and education for their children). Other groups often excluded from these services and benefits are stateless individuals (some of them ethnic Kyrgyz without proper papers); rural women in Muslim religious marriages without a state marriage certificate, and persons with disabilities (who are required to obtain 10 different documents in different places in the span of 7 days to prove their status—a physical impossibility for someone with a serious disability, unless a bribe is paid).

The MB also envisages a one-off benefit at child birth for poor families and flat-rate allowances for children under 3 years old.

⁵⁵Formerly known as the Guaranteed Minimum Consumption Level (GMCL).

In April 2010 the number of MB beneficiaries stood at 351.000. It should be noted that 84 percent of the MB beneficiaries are concentrated in the three southern regions (Jalalabad, Osh, and Batken), which were the scene of renewed unrest (June 2010). Currently, the social protection authorities cannot confirm the changed needs or the situation of their clientele: the work to track registered clients has just started in late June, when social offices resumed their operations. In Osh, one of the most affected cities, only 21 new applicants turned up for the MB in June, hence it is difficult to estimate the need and possible inflow of applicants. The MB administration and outreach mechanisms are weak and additional barriers are likely to be (i) migration and internal displacement – mostly migrants cannot apply for the MB and other benefits in their current place of temporary residence since local welfare offices are unable to communicate and cross-check their information timely, (ii) lack of verification documents of families, whose property had been damaged or destroyed, (iii) low awareness of the population of whether they could be eligible for the MB as a result of worsened conditions such as loss of income source.



Source: Agency for Social Welfare (Kyrgyz Republic) operational data

Monthly Social Benefits. The Monthly Social Benefit (MSB) is a cash payment paid to defined categories of individuals unable to work and not entitled to pensions. Currently, the following categories of citizens are MSB recipients:

- Children with disabilities;
- Disabled from childhood;
- Disabled ineligible for pensions;
- Elderly above retirement age ineligible for pensions;
- Mother-heroes;
- Children who lost the breadwinner

Most citizens in the above categories are entitled to additional allowances for health services at state health care institutions, free medicine, housing subsidies for payment of public utility bills and a number of other state social support measures.

In recent years, the number of MSB recipients significantly increased (more than 66 percent between 2000 and 2008). As of May 1, 2010, the number of MSB recipients was 63,818 persons⁵⁶. Due to economic and social disruptions in June the Government is concerned that the number of MSB recipients can decrease, at least temporarily, until de facto location and status of every client is reconfirmed.

According to legislation, the MSB was linked to the GMCL, and until October 1, 2007 its size grew uniformly for all categories of beneficiaries in tandem with the increase of the GMCL.

In response to the 2008 increase in food prices, in September 27, 2008, a Presidential Decree was issued on “On Payment of Supplements to Monthly Social Benefits.” For different categories of beneficiaries the supplements varied from minimum of 100 KGS to maximum of 300 KGS. This was followed by another Presidential Decree, October 13, 2009, “On the Size of State Benefits,” which further increased the MSB amount for all categories. It also detached the calculation of MSB from the GMI, and set flat rates of MSB for 15 categories of beneficiaries.

In 2009, MSB program expenditures amounted to KGS 535 million, which is 1.2 percent of the state budget. From January 1, 2010, in light of the increase of the MSB for all categories of beneficiaries, the total MSB expenditure envisaged in the budget was increased by 77 percent (to just below KGS 1 billion in 2010). Currently the average monthly amount of MSB is around KGS 1,300 and the temporary Government has drafted a decree increasing it up to KGS 1,500 .

Privileges (now called compensations). The social assistance system also used to support 38 types of “privileges” for 33 types of beneficiaries. The privileges were enacted under 10 laws and a number of regulations. Privileges were extended for transport, communications, energy, medicines, health services, housing, sanatorium and resort services, utilities, and other municipal services. Depending on the category, privileged persons were eligible for 100 percent, 50 percent, or 25 percent price discounts up to a quota (social norms of consumption). The difference between market prices (posted tariffs in the case of energy and utilities) and amounts actually paid by privileged categories within social norms previously were paid directly to the energy/utility providers by the government.

In 2010 the number of privileged groups was decreased to 25 and in-kind privileges were monetized. After monetization, the privileges became a monthly lump sum compensation for all types of what were previously in-kind privileges. Currently the list of recipients of privileges pertains mostly to those living in mountainous areas (accounting for almost two-thirds of all privilege recipients), people with disabilities (about 20 percent), war veterans (10 percent), law enforcement officials, the military, Chernobyl victims, and some other categories. Currently there are 52,009 beneficiaries of this compensation system.⁵⁷ The 2010 total budget of compensations is KGS 1.7 billion, which is more than double the 2009 budget and 42 percent of the total budget for social assistance. The monthly amount of monetized privileges varies from 1,000 to 7,000, depending on the category of the beneficiary.

⁵⁶ ASW data

⁵⁷ ASW report as of 01 May 2010

There has been a concern about reversal of the reforms and achievements reached earlier in 2010, especially since the electricity, district, and hot water tariff increases were reversed by varying degrees after April 2010. Formally, there have not been any changes in the social safety net and monetized privileges remain intact. The Government is aware of the positive impact of monetization on the rural beneficiaries, especially those living in the South where the economy is more cash-scarce. At the same time, the recent initiatives of the temporary Government – focused on developing a set of compensatory measures to the April and June victims – are flowing in the ‘old’ direction, by suggesting to establish new categorical in-kind benefits such as free housing, free kindergarten access, free vocational schooling and so on. This is a result of the current social safety net’s inflexibility, low coverage, small benefits and administrative weaknesses, making it a poor tool to address the shocks and to ensure inclusivity of those in need. Until these hurdles are overcome, the reversal trends are likely to be unavoidable.

Social services. Social services include those for vulnerable population groups. In practice, these services are almost exclusively limited to residential institutions for children, people with disabilities, and the elderly. There is also a poorly funded system of home-based social services for orphans, elderly, and people with disabilities. The government has a plan to develop a system of rehabilitation centers for the disabled. In 2009 the government established a Child Protection Department at the national level, as well as a network of regional Family and Children Support Departments, staffed by 178 specialists of child protection. While this is a positive development, they still lack capacity and training to be fully operational. However, services for families and children at the community level are still lacking, apart from a few pilot projects supported by donor resources.

Social insurance. The social insurance system consists mainly of pensions for former employees or farmers (for old age and disability) and their dependents (survivorship). Other social insurance benefits include illness or maternity benefits for contributors and funeral benefits for pensioners.

Pensions are one of the main social protection instruments in the country from the point of view of both coverage and the impact on welfare. Kyrgyzstan inherited from the Soviet Union a notionally-defined benefit (NDB) pension system operated on a pay-as-you-go basis, with a low pensionable age (55 for women and 60 for men), and practically universal coverage. Pension entitlements in this system were generous in comparison to the fiscal potential of the state, with the result that after the collapse of the Soviet Union, the pension system in the 1990s was characterized by substantial arrears. Delays in the payment of pensions and payment in kind were the frequent result.

A new pension law for the Kyrgyz Republic was adopted in 1997. Important features of the new pension system were: (i) the gradual increase in pension age to 63 for men and 58 for women by 2007; (ii) the abolition of some pension privileges; and (iii) the introduction of a three-component pension system. The first component is the so-called base pension, which is equal for everyone who has the necessary number of work years (25 years for men and 20 years for women). The second component is the continuation of a notionally-defined contribution (NDC) based pension supplement to smooth the transition from the previous to the new system. The third component is a new NDB-based supplement, which will eventually replace the NDB component.

The NDC system introduces a direct link between workers’ pension contributions and their pension entitlements after retirement, but keeps in place the pay-as-you-go principle. The reforms allowed for the transfer of pension liabilities from the government to an increasingly balanced Social Fund. The pension system has also become an effective instrument for reducing poverty

among the elderly: World Bank data show that households with pensioners have 20 percent less risk of becoming poor compared to households without pensioners.

The longer-term sustainability of pension system was weakened by amendments introduced into the Pension Law in 2007, which effectively returned the pension age to 55/60, substantially increasing the number of pensioners, while also reducing the number of contributors. As a result, further adjustments to the system were made to rebalance Social Fund financing to meet growing pension liabilities. To help rectify this situation, the Government plans to transfer base pension payments from the Social Fund to the Republican Budget in stages over five years, commencing with a transfer of 20 percent of the base pension in 2010. This should release Social Fund resources for payment of insurance components of pension, but puts an additional burden on the government budget. Meanwhile, legislation was passed that introduces a fully funded pillar into the pension system, requiring resolution of issues related to the replacement of the pay-as-you-go system of resources allocated to the funded pillar, and the funding of reliable investment options in the small and volatile financial market of Kyrgyzstan.

A key problem with social insurance benefits is that they assume employment in the formal sector. Nearly half of the work force, is found in the informal sector, which by definition is excluded from the formal pension scheme. This also precipitously shrinks the base for social contributions, placing serious pressure on the finances of the Social Fund, and hence on the consolidated budget.

Although in theory the main function of pensions is to smooth income over the life-cycle, in practice they function as a key form of social assistance in Kyrgyzstan, since most pensioners live in large extended families. Households with children therefore benefit from the presence of a pensioner in the household. Owing to this poverty alleviation effect, raising pensions may be a socially desirable policy in the short term. This effect is incidental, however, since pensions are by definition not specifically targeted on the poor/vulnerable.

Sector Impact

Impact on social assistance system (social and budgetary). The April protests in Bishkek officially resulted in 1,688 casualties, of which 86 were reported dead. The interim government decided to pay one-off lump sum compensation to all the victims: 1 million KGS to the families of the dead, and from 10,000 to 100,000 wounded depending on the severity of the injuries. As of May 26, the total amount paid one-off was KGS 100 million out of the total of KGS 200 million envisaged. This amount was added to the ASW budget for “Compensations.”

Out of 1,622 wounded victims as of May 24, only 822⁵⁸ were formally recorded in the hospitals⁵⁹. The Ministry of Health currently is examining the recorded casualties to assign categories of disability. Depending on the category, these victims may become MSB beneficiaries. If all 1,622 wounded victims are categorized as disabled, this will increase the number of MSB beneficiaries by 2.6 percent, and hence require additional budget resources amounting to around KGS 15 million during 2010 (from June 2010 to December 2010). In 2011, the required increase in the MSB budget to include 1,622 victims would be KGS 25 million if the current average level of MSB is maintained⁶⁰.

⁵⁸ These are the people who submitted IDs when registered in the hospitals.

⁵⁹ As reported by the deputy head of the interim government, Elmira Ibraimova.

⁶⁰ Calculations of possible budgetary impact in this section are indicative and based on our own assumptions only.

Currently there is also a pressure on the interim government to compensate the victims permanently, by assigning them to a privilege/compensation category similar to World War II Veterans. The monthly payment of compensation to this category is KGS 7,000. If this measure is confirmed, the required additional amount to be paid to the victims in 2010 would be KGS 82.7 million, or a 4.7 percent increase of the compensation budget (June-December 2010). The required estimated additional amount for 2011 would be KGS 141.8 million, or an 8 percent increase of the compensation budget.

As said earlier, currently it is not possible to quantify the impact on poverty. However, authorities stated that they expect some increase in extreme poverty, and therefore up to a 20% increase in the number of MB applicants in autumn. Given the 7.4 percent of extreme child poverty, every percentage increase in extreme poverty may bring approximately 19,000 new MB beneficiaries into the system. The planned increase of GMI to 310, and therefore an increase of average level of MB to 240 (212 now), plus the KGS 40 flat-rate food price increase compensation paid to all the beneficiaries would result in additional monthly spending of KGS 5.3 million on MB. Therefore, the required additional spending for MB would be KGS 31 million for July-December 2010.

If the underlying assumptions of this estimation materializes, then the overall additional spending required in 2010 would be about KGS 130 million, in addition to the KGS 200 million already foreseen in the amended budget for one-off compensation measures.

The authorities are fully aware of the need to maintain social peace if the current fragile stability in the Republic is to be preserved. As often happens in post-crisis situations, social pressure is high to increase social benefits in terms of eligibility as well as amounts of transfers. Authorities reported that payment of the pre-existing social benefits has been fully executed for the months of April and May and the commitment by MOF and line agencies assessed to continue protecting social expenditure in the critical months ahead.

The authorities are preparing an adjusted budget, which will be adopted by decree, as parliament was dissolved after the April events. In the frame of the preparation of this adjusted budget, ASW has already submitted to MOF a request for the financing of various social benefits for which it holds responsibility. The request is broadly based on the appropriations contained in the initial 2010 budget law, apart from the ad hoc one-off compensations for the victims of the April events. While the ASW expressed concern over whether it will be able to fully execute its payment obligations over the next few months, the MOF seems confident it will find the necessary fiscal space to finance in full all protected social expenditure.

January-May 2010 Treasury reports confirmed full and timely payments of all state benefits. ASW reports confirmed the Treasury reports. Payments of privileges in May 2010 from the Central Treasury were KGS 114.5 million. KGS 100 million as lump-sum compensation to the victims of the April events was also paid. Payments of MSB in April⁶¹ 2010 from the Central Treasury were KGS 85.4 million. This is in line with the required amount requested by the ASW from the Central Treasury.

The Treasury reports provide evidence of payments of MB as well as payment of the KGS 40 topping-up for the month of May.

⁶¹ As of 26 of May reports for May were not yet ready in ASW.

Table 3: January-May 2010 budget execution of MB

(KGS thousands)

Name	Number of MB beneficiaries	Financed from Central Treasury	
		MB	KGS 40 topping up
Bishkek city	1983	2325,1	359,5
Chui oblast	3 190	2 822,5	601,8
Talas oblast	14 324	15 771,4	3 594,8
Issyk-Kul oblast	12 880	13 816,6	2 463,7
Naryn oblast	25 626	36 357,9	5 015,3
Batken oblast	47 837	59 394,0	10 834,3
Osh oblast	134 097	149 101,0	25 679,8
Jalalabad oblast	110 994	104 549,0	22 920,9
Total:	350 931	384 137,7	71 470,1

Source: ASW operational data

In two regions close to Bishkek, Sukuluk and Belovodsk,⁶² it was verified on the ground that the amounts were credited with the local treasuries and transferred to the respective post offices and banks for payment to final beneficiaries.

Authorities stated that the delivery systems of benefits were not damaged during April events. No regional social protection center has been affected. However, in several locations in Jalalabad oblast, the local branches of banks and post offices have been closed for several days following the unrest there at the end of April and beginning of May. This caused some temporary delay in payments of benefits in these regions.

Impact on Social Services. Social services are not likely to be substantially affected directly by the April or June events, largely due to their non-existence in many (rural areas) and generally minor role even in the country's weak social safety nets. Rather, they face a number of pre-existing challenges, notably the fragmentation of relevant ministries and agencies. The former problem is compounded by the lack of a social policymaking body in the Cabinet. The latter occurs despite the potential for NGOs to provide efficient, community-based services for families, young people, and children and adults with disabilities, given the existence of a law on social contracting, and that Kyrgyzstan has more NGOs operating than other Central Asian countries.

⁶² A one-day mission was made to these two regions to verify the actual payments of the benefits.

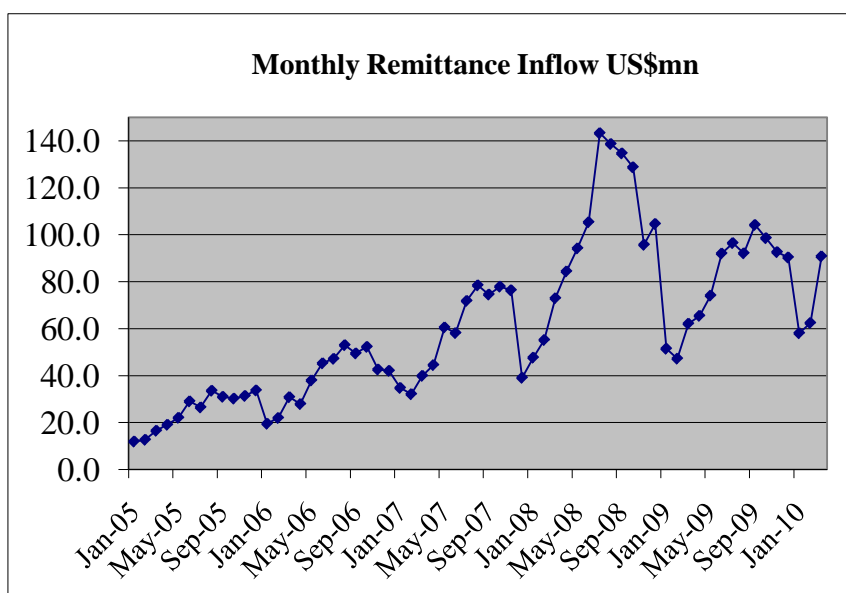
Key challenges

The direct impact of April – June events on the social safety net seems limited, but highlights the weakness of the pre-existing system in terms of targeting, overall support levels (i.e., inadequate amounts for significant poverty reduction), and high exclusion error. On the other hand, there is a risk that, under social pressure, important earlier systemic reforms to address those shortcomings would be reversed. If such backsliding were to materialize, those results could be sacrificed for the sake of social pacification.

Impact on Employment, Unemployment, and Migration. Employment and unemployment levels are expected to have changed little in the immediate aftermath of the April events. This is in line with world experience that these are slow-moving variables, which react to shocks with a considerable lag.

It is more likely to expect high impact of the June events on unemployment. While no pick-up in applications for registered unemployment status was observed so far, it can be attributed to large internal displacement, loss of documents and disruption of work of the employment services during the civil unrest. Additionally, as mentioned earlier the people who have lost jobs in the semi-formal or informal sector would not be eligible for the employment benefit anyway and thus have no motivation to go through the bureaucracy of application procedures. Also, such applications are strongly seasonal, and early summer is the seasonal low point. The impact would mostly be noticeable from the fall, after seasonal jobs in agriculture fade out. The Ministry of Labor registered no marked impact on unemployment of the April events. The number of job-seekers without work was 104,000; 66,000 of whom were registered as unemployed, of which 3,000 were receiving unemployment benefits (two-thirds of them in the Bishkek area). About a third of the registered unemployed were women. At the same time, the data on the post-June situation is currently being collected with the assistance of local authorities and the expectations are that while the April events had not had a substantial impact on migration, the opposite has to be said about the unrest in June. According to the Russian migration authorities, they are facing a peak of applications from Kyrgyz migrants, who are explaining that they are not only seeking migration permits for the purposes of getting employment, but also for personal security reasons. NGOs and media in several Russian regions report an increased inflow of migrants from the country as well. Bishkek authorities are increasingly concerned about a visible increase in internal migration to the country's capital, leading to increased risks of repeated authorized acquisition of land and further pressure on the capital's labor market and social infrastructure. It is important that the authorities respond to this challenge not by introducing more prohibitive policies, but by focusing on enforcement of law and human rights of the migrants as well as the residents.

Following the June events, it is expected that growth performance of the major host countries continues to be markedly better and migration will pick up. In this regard the MOL said there were 350,000 Kyrgyz labor migrants in Russia, and about 60,000 in Kazakhstan. Kyrgyz diasporas in Russia estimate the number of migrants as over 500,000 and likely to increase to 700,000 and further. Roughly 80 percent of all labor migrants were from southern Kyrgyzstan and this share is not likely to drop. Remittances that recently picked-up largely due to improving activity in the Russian and Kazakh economies, are currently being supplemented by humanitarian assistance collected through Kyrgyz diasporas in Russia and Kazakhstan and transferred to the South.



Priorities

From a short-term perspective, the key challenge for the authorities will be to keep operational the social assistance delivery mechanisms and ensure that the payments of social assistance transfers made from the Central Treasury reach the intended beneficiaries.

In the medium- and long-term perspective, it should be noted that with the exclusion of 67 percent of extreme poor from the MB system, and 60 percent of disabled from MSB system, the social assistance scheme of the Kyrgyz Republic could be considered badly targeted. In addition, the amounts provided to the beneficiaries were not sufficient to have a significant impact on living conditions. The allocation of the overall budget on social assistance would also need to improve to enhance its pro-poor orientation. An obvious way to attain this would be to reverse the rising trend in the share of privileges/categorical compensation in the total budget.

Before the April events, the Government took sound measures to improve the social safety net, i.e., to increase the coverage of the extreme poor and raise the benefit level to help the beneficiaries escape extreme poverty, as well as to decrease the outflow of funds to the non-poor. By introducing new selection criteria and increasing the GMI level from January 2010, leakage to the non-poor was lowered, and inclusion of extreme poor was improved during the first three months of 2010.

The new authorities are building on existing policies and recent policy reforms with the aim of fighting poverty and social exclusion and promoting greater social inclusion. They are currently assessing the key immediate and longer-term challenges to social inclusion, the most crucial of which is the increased social and ethnic tension, especially in the southern regions. The increase of GMI from KGS 282 to 310 is already envisaged in the approved 2010 budget of MB, and MOF officials provided assurances that the budget amendments initiated after the April events

would not affect this expenditure item. A formal decision of the interim government (a draft decree) needs to be adopted to apply this increase⁶³.

In the near future, given the current methodology applied for the MB, and in order to deal effectively with poverty and social exclusion, the only swift reaction from the government could be a further increase of GMI above planned KGS 310 and waiving – at least temporarily - the eligibility barriers related to land possession. When the authorities include the 40 KGS flat-rate payments to the MB beneficiaries (currently paid as compensation for food price increases) into the GMI, the GMI will increase to KGS 350. Analysis shows that an increase of GMI to KGS 350 will increase the number of beneficiaries by 10 percent⁶⁴.

In the medium- and long-term perspective, to address poverty and social exclusion, the authorities will have to improve the measurement of both, as well as identify the major problems affecting the social assistance system. On this basis, the authorities will have to take complex and multi-dimensional measures, which will require an integrated approach combining existing policies in social assistance domains. The issue of a disproportionate increase of compensation/privileges budget, compared to other social assistance transfers, needs to be addressed, and resource reallocations should be made toward transfers that have a better targeting performance on the poor⁶⁵.

One of the challenges faced by the authorities is to resist social pressure that could reverse some of the social reforms introduced over the last two years in an effort to preserve social peace and stability. In this respect, the announced proposal to roll back the monetization of privileges, if confirmed, would undo a centerpiece of the social reform package of late 2009.

A more direct, and far more efficient approach (in terms of poverty alleviation, including for children), would be to expand the MB in coverage and size in the post-June situation. This would help reach more of the poor and vulnerable, and provide better protection for those it reaches. It probably would also require direct donor support.

Categorical benefits (privileges), on the other hand, are an opaque and weakly targeted form of providing social assistance. As the Government is lacking alternative instruments for providing compensations to the victims of the June clash, there is a clear danger of them gaining ground in relative and absolute terms among the social protection programs, thereby reducing the targeting efficiency of the overall social protection system. This would act to reduce the fiscal space available for programs with better targeting performance, notably the MB and MSB, as well as for social services. A related issue is the possible reversal of the monetization of privileges (i.e., return to providing in-kind benefits). The demand effect of an effective reduction of the price of selected energy and other public services up to zero may well bring about rising fiscal and/or quasi-fiscal costs. The move would also inject unpredictability and non-transparency into the system, and saddle utilities with large quasi-fiscal burdens. This, in turn, would place those utilities in even worse financial shape, with dire implications for maintenance and investment.

Over time, Kyrgyzstan needs to continue building up a comprehensive and sustainable system of social protection. This would involve putting pension provision more firmly on a social insurance basis, with Social Fund finances on a sustainable basis. It would allow developing the safety-net

⁶³ Usually GMI is increased by a Government Decree.

⁶⁴ Simulation based on the pilot database of MB beneficiaries in ASW.

⁶⁵ Note that compensation budget was more than doubled in 2010 compared to 2009 against 73 percent increase of MB and MSB.

role of social assistance, with the budget guaranteeing adequate social assistance benefits to vulnerable households. Finally, it would involve sufficient provision of community and local services that respond flexibly to the special needs of different categories of the population. Some of these services can be provided by the non-governmental sector. The events in June showed a huge gap in the social service sector that needs to be bridged: rehabilitation assistance, linking medical, social and employment assistance together, counseling, shelters, outreach and information provision – should these services have been in place before June, the efforts to provide post-conflict relief would be more prompt and efficient.

The interim government intends to retain broadly unchanged employment and unemployment policies during the remainder of the year. Its posture relative to the private sector and the business environment will play an important—potentially positive—role in private sector job creation. In this regard, the interim government is already implementing public work schemes as a short-term emergency measure, with UN and USAID support.

Another area where substantial efforts have been made is revamping vocational education to better equip youth with skills to facilitate their employment. A pilot program with EU support has already been implemented, providing three-month training for youth from underprivileged regions. The Ministry also noted that vocational training was being reoriented toward areas where employers have expressed a desire to have more trained job applicants. It stressed that Kyrgyzstan has an inverted pyramid in post-secondary education, compared with other countries, with more than twice (70,000) the number of students in university studies than in vocational studies (33,000).

ANNEX V: ENERGY

Introduction

This annex focuses on the impact of the recent developments, including April events and the June riots in southern Kyrgyz Republic, on energy sector performance, including decisions made on: (i) electricity and heat tariff roll-backs; (ii) institutional and management changes in the sector; (iii) immediate damage of the June clashes; and (iv) capital and operating investment plans for 2010-11 and onwards. The decisions made by the interim government will have a sizeable impact on energy sector revenues, the energy companies, and the state budget. There is the possibility of a substantial shrinking of operational and investment plans of energy companies, including putting at risk the country's ability to successfully pass the 2010-11 winter energy needs.

Background

The energy sector is a key economic driver of the Kyrgyz economy. Hydropower production accounts for about 80 percent of the total primary energy production and electricity is the dominant energy. The power sector accounts for around 3.9 percent of GDP and 16 percent of industrial production. It also has huge export potential, which represents a significant contribution to sector financing as well as to the overall economy. Access to power is quasi-universal and the consumption per capita (at 2,400 kWh) is quite high for a developing country. In 2009, the power consumption was 6.95 TWh, of which about 54 percent for households, 23 percent for industry, 9 percent for government and other administration (budget), 1.5 percent for agriculture, and 12.5 percent for other purposes.

Box1: Structure of the energy sector

Currently the power sector is managed by six joint-stock companies (JSC):

- The state generation company JSC "Power Plants," which accounts for about 99 percent of total generation;
- The state transmission company JSC "National Power Grid of Kyrgyzstan," which enjoys a monopoly on the transmission segment, except for some large consumers close to and directly supplied by generation units;
- Four licensed state distribution companies: JSC "Severelectro," JSC "Vostokelectro," JSC "Jalalabadelectro," and JSC "Oshelectro"; each operating the distribution system with exclusive rights to supply consumers in its concession area.
- Twenty-seven licensed private wholesalers/small distributors buying power from the generation company (about 250 to 300 GWh in 2009) and selling it to consumers.
- In addition, the Bishkek District heat Distribution Company (BTS) distributes heat and hot water for the city. Osh CHP is responsible for production and distribution of heat and hot water there.

The sector is monopolistic and involves state involvement. The former vertically integrated JSC Kyrgyzenergo system was unbundled in 2001 into one generation company; one transmission company, and four distribution companies (see Box 1).

In mid-2008, the Kyrgyz Government intensified activities to privatize its “strategic assets,” including state-owned stakes in six energy companies. These included the Bishkek Combined Heating Power Plant (CHP), Bishkek Heating Distribution Company, BishkekTeploSet (BTS), and four power distribution companies. This resulted in a sale of 80.49 percent of shares in the two largest power distribution companies: Severelectro for about US\$3 million and Vostokelectro for about US\$1.2 million. The chronology of privatization tenders is detailed in Table 1.

Table 1: Energy sector privatization chronology

Company	Privatization process
Severelectro Power Distribution Company	<p>Single tender for privatization of the state-owned stake in Severelectro, BTS, and Bishkek CHP was initiated in late 2008 with bid submission date of January 27, 2009, and was declared void for lack of bids. The initial starting price was set at US\$137 million.</p> <p>The second attempt (separately) for Severelectro was declared void on July 8, 2009 for the same reason.</p> <p>The third attempt, without establishing the price, succeeded on December 29, 2009 with Chakan GES announced the winner. The terms of sale included payment of US\$3 million and capital investments of about US\$70 million in 10 years. Reportedly, no performance conditions were included in the tendering documents.</p>
Vostokelectro Power Distribution Company	<p>Two privatization attempts were declared void for lack of bids. The initial starting price was set at US\$40.9 million. The third attempt, without establishing the price, succeeded in February 2010 with the same Chakan GES announced the winner. The terms of sale included payment of about US\$1.2 million and capital investments of about US\$30 million in 10 years.</p>
Oshelectro Power Distribution Company	<p>Two attempts of privatization were declared void due for lack of bids. The initial starting price was set at US\$41.9 million.</p>
Jalal-Abadelectro Power Distribution Company	<p>Two attempts of privatization were declared void for lack of bids. The initial starting price was set at US\$26.8 million.</p>
Bishkek CHP and Heating Distribution Company, BTS	<p>A single tender for privatization of the state-owned stake in Severelectro, BTS, and Bishkek CHP was initiated in late 2008 with a bid submission date of January 27, 2009. It was declared void for lack of bids. The initial starting price was set at US\$137 million. No further attempts were made.</p>

The Governance structure in the sector weakened further few months ahead of the April 2010 event. The 1996 Energy Law and 1997 Electricity Law led to the creation of a State Energy Agency (SEA) as the regulatory body for the whole energy sector, while the policy formulation was in the hands of the Department of Energy and Mineral Resources under the Prime Minister. In 2008, the government established a new Ministry of Industry, Energy, and Fuel Resources that subsequently, after the government reorganization of November 2009, was restructured into the

Ministry of Energy (MOE), and the SEA became a department within the MOE. These changes, regardless of rationale, decreased the predictability of sector governance and decision-making.

Weakness in financial management hinders the transparency of the power and financial flows in the sector and impedes the commercialization of sector entities. The current contractual arrangements in the sector are sub-optimal. The four distribution companies purchase electricity directly from the generating company on the basis of a standard one-year Power Purchase Agreement at prices determined by the MOE's Regulatory Department. This approach reduces the role of the distribution companies to intermediaries, with no responsibility for business development. The generation, transmission, and distribution companies are not responsible for cash management: cash payments from end-users are collected and accumulated in escrow accounts and divided among the generation, transmission, and distribution companies on the basis of percentages set on a monthly basis by the MOE's Regulatory Department. Wholesalers, however, collect and retain their funds. Finally, barter and offsets are resorted to (though to a lesser extent) in settlements between sector entities as well as between sector entities and end-users. In addition, power utilities often submit monthly and quarterly reports late and with unbalanced power flows. The same power exchange numbers between generation-transmission-distribution companies submitted by different utilities differ from each other. Finally, utilities often change reporting numbers after the reports have been submitted.

Lack of reforms and investments in the system, increasing production costs, and population growth exacerbate energy insecurity. During the past two winters, these factors interacted with record low levels in the Toktogul hydro power complex—which generates the bulk of Kyrgyz Republic's electricity—resulting in severe shortfalls in electricity delivery, necessitating painful national electricity rationing.

The sector performance is also substantially below industry norms. Due to severe under-maintenance and related degradation of assets, the technical losses exceed industry norms. The commercial losses are related to legal, institutional, and governance issues. Apart from foregone revenue, such losses impose higher costs on the system. The losses are higher during winter and the additional generation to compensate for them is through the Bishkek CHP plant—which is very inefficient and increases the incremental costs of power supply well above the end-user tariffs. However, it must also be acknowledged that in the absence of adequate meters for proper energy flow accounting, it would be difficult to identify areas that need to be targeted as priorities.

The generation mix is inadequate. More than 90 percent of the country's electricity supply comes from the Toktogul and the downstream Naryn cascade reservoirs, which together accounts for 78 percent of the total installed power generation capacity in the country. This makes the power sector vulnerable to hydrology and reservoir management variability, especially during the winter. The generation mix needs to be optimized to meet the load reliably and cost effectively.

Civil society is not a significant driver for more transparency in the sector. Historically, civil society was not sufficiently involved, as the government kept it away from the sector. Absence of reliable data, lack of independent audits by reputable firms, and inadequate public participation in tariff hearings by companies, worsens the situation.

Tariffs are among the lowest in the Europe and Central Asia region, and below cost recovery, placing perennial pressure on energy sector cash flows and fiscal balance. The current tariff structure is sub-optimal and lacks a sufficient cost-of-service analysis that would underpin further increases. The tariffs do not provide incentives for efficient management of resources at the supply level or for efficient use of power at the end-user level. Sales tariffs between entities do not ensure minimal cash expenses for the transmission company, the distribution companies, or wholesalers. Consequently, the sector is continually cash-strapped, causing Kyrgyz households to experience perpetual winter energy insecurity, reducing the competitiveness of the national economy, and frustrating longer-term prospects for reducing poverty and meeting the Millennium Development Goals.

Prior to the April events, the Kyrgyz Government had introduced a major increase in energy tariffs in January 1, 2010. The aim was to bring energy tariffs closer to cost-recovery levels, thereby raising revenues and decreasing demand in the short run. The April 7-8 events clearly show that the tariff structure had strong socio-political dimensions that preclude “shock therapy” solutions. Table 3 (below) shows the changes in tariff rates. It is noteworthy that tariffs were significantly rolled back for the categories with dominant consumption: residential, industries, and pumping account for nearly 76 percent of total power consumed domestically. A second round of tariff increases was foreseen for July 2010, pending an evaluation of the effects of the first round in the first quarter of 2010.

Table 2: Power consumption and tariffs

Electricity Tariffs

Consumer Categories	Consumption by categories	July 2008		January 2010		April 2010	
		Som/kWh	US\$/kWh	Som/kWh	US\$/kWh	Som/kWh	US\$/kWh
Households							
of which: 1) up to 90 kWh							
2) 90-150 kWh							
3) 150-400 kWh							
Unified	60.6%	0.70	0.01979	1.50	0.03448	0.70	0.01573
Households with a 3-phase output for							
Households for cooking (Capacity > 6 kW)		0.70	0.01979				
heating during heating season		0.70	0.01979				
Industry and alike	13.3%	0.96	0.02713	1.50	0.03448	1.33	0.02982
Agriculture	1.7%	0.96	0.02713	1.50	0.03448	1.33	0.02982
For heating and hot tap water during heating							
season (Capacity > 6 kW), excluding population		1.02	0.02883			1.33	0.02982
Pumping stations and wells	2.1%	0.68	0.01922	1.50	0.03448	0.70	0.01573
Budgetary Organizations	10.6%	1.00	0.02827	1.50	0.03448	1.33	0.02982
Other consumers	11.7%	1.02	0.02883	1.50	0.03448	1.33	0.02982
Exchange Rates			35.38		43.50		44.50

Source: Ministry of Energy

Energy subsidies, which also increased substantially in the month before the April 2010 events, are widespread but poorly targeted. Simultaneously, the government introduced a number of social protection measures in January 1, 2010 to mitigate the immediate impact of the tariff increase. While the aim of the tariff reform was to eliminate the inherently universal subsidy in the old tariff structure, and the introduction of equitable cost recovery tariffs, the government did

not assess adequately the impact of this steep tariff increase on the population in general, and the poor and vulnerable in particular. Governance shortfalls also occurred in the management of the subsidies. Numerous privileges, discounts, and subsidies were provided to various end-user groups without clear targeting. Some subsidies were financed from the state budget, while the burden for the rest (the discounts) was left to the sector, adding to its financial deficit. Although fiscal data point to dramatic increases in the subsidies paid in early 2010, anecdotal evidence suggests that many of these funds failed to reach the intended beneficiaries. Forty percent Kyrgyz Republic households receive energy subsidies.

Table 3: Issues and Challenges in the Kyrgyz Energy Sector

Issues	Challenges
Financially unsustainable operations	With below cost-recovery tariffs, inadequate tariff structure and substantial losses, the financial performance of the power sector is lacklustre, leading to severe under maintenance of assets and accumulation of arrears. The sector collects less than 30 percent of what it needs to recover costs and ensure urgently needed investments.
Lack of transparency and commercialization and weak governance	The current contractual arrangements and payment mechanisms in the sector are sub-optimal; they impede the transparency and accountability of the sector and undermine performance and sound management
Power supply shortages in winter	Both base and peak loads in Kyrgyz Republic are covered by hydro-generation year-round. The country lacks winter base power generation to meet demand and a significant amount of winter power is not available in the Central Asia market.
Underutilized regional trade potential	The power sector has significant potential for summer surplus export of power, even without major investments in generation. Likewise, the power imports may be the least-cost option to meet peak winter power needs if proper arrangements can be found.
Significant investment needs	The sector needs sizable investments (estimated from US\$ 3 to 5.5 billion in the government's National Energy Strategy) for rehabilitation/addition of generation capacity, strengthening of the transmission system, metering, and rehabilitation of the distribution system.

Sector Impact

Impact of the April 2010 events

A – Reversal of tariffs increase

The direct impact on the state and sector budgets is estimated at KGS 6.8 billion (or about US\$151 million – see Table 5). On April 20, 2010, the interim government reduced electricity, heating, and hot water tariffs, reversing most of the increases, with the following impact:

Reversal of the power and heat tariffs led to a significant energy sector consolidated cash deficit for 2010, estimated at about KGS 2.5 billion⁶⁶ (US\$55.6 million). According to the interim government's decree, this deficit would be compensated by the state budget.

VAT and retail tax exemptions⁶⁷ for provision of electricity and heat service supply would result in about KGS 356 million (US\$7.9 million) of lost revenues.

Increase in state subsidies to KyrgyzJilKommunSoyuz (providing heating services to 23 urban centers) would increase by KGS 187 million (US\$4.1 million).

A decision to re-install the power tariff discounts for mountainous areas was taken by the previous government just before the April events and will require a state budget allocation of about KGS 118 million (US\$2.6 million).

B – Reversal of Privatization

The interim government has suspended implementation of the privatization program and annulled the results of energy company privatization tenders. The government has initiated a process of voluntary reversal dealing with the winning bidder, Chakan GES. In the deal, Chakan GES would return the shares back to the state and the government would return about US\$4.2 million to Chakan GES, which includes US\$3 million for Severelectro and US\$1.2 million for Vostokelectro. The reversal of privatization deals (considered to be carried out in haste through an inadequately prepared and managed process) would require the state budget to return US\$3.0 million equivalent for the sale of SeverElectro⁶⁸.

C – Ensuring supply of electricity

Beyond these immediate needs, additional financing will be required to ensure supply of electricity over the winter of 2010/11 in order to preserve social peace. With no certainty in 2010 about export agreements⁶⁹ for summer surplus electricity generated for water used for irrigation flows; no firm agreements with neighboring countries to use the Central Asia grid to transport large power in winter; and with budget deficits with the companies, it is likely that power and heat supply interruptions in winter will occur and may create a difficult situation for the interim government and its citizens. Similarly, a large reduction in the investment budget and a deficit would delay urgent repairs to thermal plants, district heating systems, and the generating stations in Toktogul complex, thus risking further disruption in the Kyrgyz power system. Several plans under consideration by the interim government, such as an accountability framework to track energy and cash flows in the sector, would need investment support for their implementation.

D – Burden on the State Budget

Sector debt and financial losses are a significant burden on the state budget (see Table 4). On December 31, 2009, the reported⁷⁰ total debt of the distribution companies amounted to KGS 4.6 billion (about US\$102 million). The total debt of the generation company as of December 31,

⁶⁶ Stated by Minister of Energy during a meeting with the JEA mission.

⁶⁷ Decrees of the interim government #21 and #17, both dated April 21, 2010, "On introducing changes in the Tax Code,"

⁶⁸ Payment of US\$1.2 million for the sale of VostokElectro is still in the Ministry of State Property's accounts.

⁶⁹ Except for 540 GWh to cover already received and utilized US\$18.4 million from Kazakhstan at the beginning of the 2009 winter.

⁷⁰ In absence of credible information mechanism, it is not possible verify the data behind these reports.

2007 (latest available audited financial statement) stood at KGS 5.5 billion (about US\$122 million). ⁷¹There are various forms of budget support to the sector, including loans (mainly to clear the arrears for fuel supplies), subsidies to finance urgent rehabilitation and some capital investments, cash transfers to vulnerable groups of the population to cover their electricity bill, and on-lending of guaranteed credits received from International Financial Institutions (IFIs). Finally, several debt restructurings and/or write-offs have been undertaken in the past, with the last large write-off of bad debts amounting to KGS 2.42 billion in December 2009.

Table 4: Budget allocations (KGS million)

Annual outflows	2008	2009
Cash subsidies to the vulnerable ⁷²	971	1,027
Budgetary loans ⁷³	583	670

Source: Ministry of Energy

E - Impact Assessment of Recent Key Decisions in the Energy Sector

The interim government has initiated development of an updated sector strategy with much more focus on transparency and improved sector governance. Prior to the April events, the energy strategy of the Kyrgyz Republic was guided by the: “National Energy Program 2008-10” (NEP), the “2025 Fuel and Energy Complex Development,” and the Mid-term Tariff Policy (2010-2012), approved by GOK. The new strategy aims at reversing the loss-making financial performance of the sector by introduction of transparency mechanisms to retain cash in the sector and ensure its proper use.

Impact of the June 2010 events

The overall direct damage to Osh and Jalalabad regions is estimated⁷⁴ in amount of about KGS 90 mln (equivalent of about US\$ 2.3 million). A number of poles, wires, transformers have been burned up, damaged, and/or stolen. A number of the gas distribution network parts are not operable. The revenues losses are estimated to have reached US\$ 0.5 million.

The impact of key decisions by the interim government to date is delineated below.

Change in administrative ministry and senior management of the energy companies. The right to represent the government on the Board of Energy Sector Joint Stock Companies was temporarily given to the Ministry of Energy. The majority of staff in key positions has been replaced by new managers.

Enhanced focus on governance and transparency. The interim government has identified transparency and proper governance in the energy sector as one of the highest priorities on its agenda. The advisors to the ministry noted that the MOE is drafting a decree on a fuel and energy transparency initiative and examining immediate implementation measures. A metering and data acquisition system is being considered as one of the key priorities, with support of the ongoing

⁷¹ No information was available regarding the debt of the transmission company.

⁷² According to the USAID-financed study on Household Energy Analysis and Proposed Social Protection Measures, 60.3 percent of recipients of electricity subsidies are non-poor.

⁷³ The loans include amounts provided to the generation company as well as Kyrgyzgas to pay gas supply arrears.

⁷⁴ Estimates were provided by the Ministry of Energy and utility companies

distribution metering project from KfW, and the planned high-voltage metering project being prepared jointly with ADB.

Capital and operating investment plans for 2010-11. After April 2010, the Public Investment Program (PIP) financed by donors was revised to reflect reduction of the investment plans under KfW-funded projects; however, this was not linked to the April events and occurred as a routine planning exercise.

Priorities

Immediate needs to restore service supply in the South. The power and gas supply to the affected regions has to be restored as urgently as possible, before the winter season approaches. Various equipment and materials, including transformers, wires, poles, etc, need to be procured along with possible provision of funding for rehabilitation and construction works. Funding for supply of critically needed fuel (mazout) needs to be considered for the Osh CHP.

Short-term needs. The energy sector presents an excellent opportunity for the authorities to build public confidence and demonstrate its intentions and ability to properly and transparently manage the sector for the benefit of the Kyrgyz people through the implementation of a well conceived strategy. The short-term objective might be to ensure that the energy supply situation is no worse than the previous year and actually improves. There are significant efforts needed as well to bring transparency to the transactions and to build partnership with civil society in managing the current difficult situation. Some key areas that need immediate attention by the authorities are:

Ensuring the 2010 winter power situation is not worse than 2009. The budget for urgent rehabilitation of equipment and fuel required to operate the district heating systems at Bishkek , Osh and other urban centers is insufficient. This should become a top priority, so that adequate arrangements are in place to ensure supply of required fuel (gas, coal and mazout) and undertake urgent repairs to these plants to preclude any suffering to majority of the urban population, especially in Bishkek and Osh. No sources have been identified to cover the 2010 cash deficit of KGS 2.5 billion for the energy sector, thus risking fuel supply plans for the 2010 winter. In 2009, the energy sector experienced a cash deficit of about KGS 1.7 billion, the majority of which was covered by government loans totaling KGS 670 million, and deferred payments of KGS 859 million (an increase from KGS 6.532 billion to KGS 7.391 billion). In addition, a US\$18.3 million advance payment received from Kazakhstan for summer 2010 power exports was used for sourcing fuel supplies for Bishkek CHP. Arrangements would also need to be worked out for moving electricity to the northern and southern parts of the country, which are dependent on the Central Asia grid, under the control of neighboring countries. Funding also would be needed for urgent spare parts and routine maintenance to avoid the collapse of thermal plants, key power generation plants, and the electricity and heat distribution system.

Starting a high-level dialogue with neighboring and downstream countries. Recently, the Toktogul inflows became much higher than long-term averages, which helped it to reach a volume close to the maximum level reached in 2009.⁷⁵ It may be prudent to seek a high-level dialogue with neighboring countries to agree on summer exports linked with the irrigation water

⁷⁵ Though the current storage level of 12.7 billion cubic meters is still significantly below the full reservoir level of 19 billion cubic meters.

flows and on an arrangement to move power to areas in the north and south of the country in the summer and winter seasons.

Improving the financial viability of the power sector to avoid its collapse. In combination with efficiency improvements (decreased losses, better collection), a well-defined tariff trajectory to bring predictable cash flows to the sector would be essential to secure sustainable operations. Funds would be required for adequate maintenance to avoid further deterioration of sector assets and meet the significant investment needs to ensure reliable supply. Some immediate steps to improve the financial status would be: finalizing export arrangements for the summer power surplus; and reducing the significant inefficiencies (high losses, low collections, etc.) in the sector. Preparation of a medium-term tariff strategy, based on wider discussion, with an adequate social protection scheme for vulnerable populations, would also be needed in parallel to ensure sustainable improvement in financial viability. In addition, the donor community could consider provision of set of investment and technical assistance activities within a broader energy sector engagement strategy.

Enhancing sector transparency and strengthening governance. The acting Minister of Energy spoke of the new government's intentions to immediately work on the above mentioned sector weaknesses. This could also be achieved by dramatic increases in civil society engagement and implementation of an Energy Transparency Initiative announced by the interim government. Such initiatives could underpin efforts to reduce corruption, increase transparency, improve targeting of social benefits, and accelerate the adoption of better practices in energy sector management and regulation. Some suggested areas for consideration include: establishing an appropriate accountability framework for energy and cash flows for each sector entity and the sector as a whole; regular reporting to secure oversight and disseminate information on operations of sector entities; holding annual tariff hearings with civil society participation; as joint stock companies, ensuring timely annual financial audits under Kyrgyz laws by independent and reputable audit firms; and competitive public procurement for exports, purchase of fuels and other equipment and material, and publishing the results.

Address the most pressing investment needs. The energy sector has made no investments to maintain its assets to ensure reliability, to augment the system to meet its growing needs, or to attain energy security. The grid does not have sufficient capacity and flexibility to move power to all the areas of the country and the distribution system lacks a system and processes to meter, bill, and collect revenue from sales of heat and electricity. In the absence of adequate cash flows, new investments have been put on hold and urgent repairs and maintenance to run the old plants and other assets are neglected. There is serious risk of a catastrophic system failure that could cause serious hardship and financial loss. Unfortunately, meeting needs on an ad hoc basis in a cash-starved environment has led to systemic needs in all areas. It is recommended that serious consideration be given to meet minimal investment needs. Tables 5 and 6 indicate minimum investments required over the 2010-12 period.

Table 5: Urgent Funding (Investment) Needs by December 2010

Activity	Rationale	Estimated amount (US\$ million)
District Heating		
Supply of required fuel (gas, coal and mazout) for Bishkek and Osh CHPs	To avoid disruption of heat supply to the majority of populations in Bishkek and Osh	50.00
Urgent rehabilitation of district heating distribution system for Bishkek and Osh	To ensure minimum level of reliability of heat supply to Bishkek and Osh residents	10.00
Supply of urgently-needed equipment and materials for Bishkek CHP and HPPs	To provide benefits in the coming winter, for smoother and more reliable running of the plant.	10.00
Urgent rehabilitation of district heating distribution system for 23 urban centers	To ensure minimum level of reliability of heat supply to 23 urban centers	10.00
Total – District Heating		80.00
Electricity		
Supply of cables, switches and other essential spares for Toktogul HPP	To help avoid any unforeseen breakdown of plant electrical systems.	20.00
Rehabilitation of thermal power supply systems in Osh and Jalalabad	To continue power generation and transmission	2.13
Rehabilitation of transmission systems in Osh and Jalalabad	To continue power transmission	2.27
Rehabilitation of electricity distribution network in Osh and Jalalabad	To continue power distribution	14.34
Total - Electricity		38.74
Rehabilitation of gas supply networks in Osh and Jalalabad	To continue gas supply	1.75
Total - Energy		120.49

Source: MOE and JEA estimates.

Table 6: Investment Needs for 2011 and 2012

Activity	Rationale	Amount in US\$ million
Replacement and expansion of district heating network in Bishkek and Osh	To restore and expand the basic level of service supply to the population	10.00
Replacement and expansion of district heating network in 23 urban centers	To restore and expand the basic level of service supply to the population	15.00
Wholesale electricity metering and automated data acquisition; transmission rehabilitation and modernization.	To bring transparency and accountability in the power sector by establishing an automated metering and data acquisition system at commercial boundaries (i) between the power companies, (ii) between companies and users (end-users and large industrial consumers), and (iii) export/import nodes. Also urgent rehabilitation of instrument transformers and circuit-breakers to improve reliability of the transmission grid, and modernization of the grid to enhance efficiency and stability of the system.	15.00
Providing essential equipment and tools (meters, billing system, etc.) to the distribution companies, and transparency in tariff setting and regulatory processes and inform public of sector goals and issues	To set up an accountability framework and improve their cash flows To coordinate with the Civil Society and initiate dialogues on tariff setting.	10.00
Identifying quick return energy efficiency (both demand and supply side) measures	To partially reduce the impact of shortages and the future tariff increases	5.00
Rehabilitation of gas supply network in Osh and Jalalabad	Gas supply network rehabilitation	4.00
Total - Energy		59.00

Source: MOE and JEA estimates.

Table 7: Critical Energy Investments

(\$ million)

Item	2010	2011	2012	Total
District heating – fuel	50.00	-	-	50.00
District heating – CHP	10.00	-	-	10.00
District heating network - Bishkek and Osh	10.01	6.00	4.00	20.01
District heating network – 23 urban centers	10.00	9.00	6.00	25.00
Gas distribution rehab. – Osh and Jalalabad	1.75	4.00	-	5.75
Electricity generation	22.13	-	-	22.13
Electricity transmission	2.27	-	-	2.27
Electricity distribution	14.34	18.00	12.00	44.34
Total – Energy	120.49	37.00	22.00	179.49

Source: JEA estimates.

Other critical medium-to-long terms investments are listed below:

Essential repair, maintenance spares for the thermal and hydro power plants (which are old and starved of regular maintenance) including:

US\$150 million–rehabilitation of Bishkek CHP to 350 MW

US\$64 million–rehabilitation of Uch-Kurgan HPP

Identifying critical transmission bottlenecks, to provide energy security to the system. These are essential transmission grid strengthening proposals to provide energy security for the country; providing independence from using networks controlled and managed by other countries (Uzbekistan and Kazakhstan); remove the key transmission constraints and strengthen the regional grid for contingencies.

US\$342 million–Datka-Kemin 500kV PTL and Kemin SS

US\$192 million–Datka-Khodjent 500kV PTL

US\$140 million–Kemin-Almaty 500kV PTL

Note: Details on investment needs plans are preliminary and would need to be agreed jointly with the companies and Ministry of Energy.

ANNEX VI: INFRASTRUCTURE: TRANSPORT AND COMMUNICATION

Introduction

The transport and communication infrastructure assessment covers (i) roads, (ii) railways, (iii) civil aviation, and (iv) urban and rural communications infrastructure. The transport and communications sector, particularly the roads subsector, plays a crucial role in the Kyrgyz Republic's economy by providing cost-effective access to regional and domestic markets, generating employment opportunities, and providing services. The dominance of the road subsector is evident from the modal split trends in freight and passenger traffic as shown in Table 8. Over 90 percent of the passengers and more than 50 percent of the freight in the Kyrgyz Republic move by road. Railways carry increasing amounts of bulk commodities and machinery, but the 320 km of single track within the country comprises several spurs from two branches: one from Kazakhstan railways (in the north) and the other from Uzbekistan railways (in the southeast). Air transport constitutes a varying share of the demand—predominantly international passengers and freight—carrying less than 5 percent of total traffic. Domestic air services are mainly between Bishkek and Osh.

Table 8: National Freight and Passenger Traffic Flows

Transport Mode	2002	2004	2006	2008
Freight (million ton-kilometers)				
Rail	394.6	714.9	752.0	943.1
Road	875.1	847.4	864.0	1059.0
Air	38.8	45.5	34.2	58.6
Total	1,308.5	1,607.8	1,650.2	2,061.6
Passenger (million passenger-kilometers)				
Rail	43.1	45.3	61.5	89.6
Road	4,857.3	5,407.3	5,936.4	6,509.6
Air	341.9	458.9	360.2	632.7
Total	5,242.3	5,911.5	6,358.1	7,231.3

Source: Ministry of Transport and Communications

Background

Roads. The road network in the Kyrgyz Republic spans all seven oblasts (provinces), and provides connections to remote communities and links to neighboring countries. The road network comprises 34,720 km of roads—18,810 km of public (republican) roads and 15,910 km of urban, rural, agricultural, industrial, and other roads. Roads carry about 95 percent of the country's passenger traffic and more than half of the freight traffic (90 percent of domestic traffic). The total length of international roads is 4,163 km, national roads total 5,678 km, and local roads total 8,969 km. About 40 percent (7,500 km) of the republican roads are paved, 50 percent are gravel, and the others are unpaved.

The Automobile Roads Act assigns the main responsibility for planning and administration of road policies, programs, and projects to the Ministry of Transport and Communications (MOTC). Policy, regulation, planning, and development of other modes of transport and communications are also under the jurisdiction of MOTC. Parts of it are being reorganized, such as the unit

responsible for implementing donor-financed projects, which was restructured in 2007 and again in early 2009. This is part of the government's drive to increase infrastructure efficiency and meet rapidly changing market conditions. There are plans in the near future to downsize the existing regional road agencies and privatize 58 local road maintenance units. The government is planning to consolidate other regional operations gradually. It has created six separate corridor management departments to replace existing regional roads departments. These departments are responsible for operating and maintaining the core international road network and the feeder roads.

The existing Road Sector Development Strategy for 2007–2010 (RSDS) has outlined ways to: (i) rehabilitate and maintain key roads; (ii) create transport independence; (iii) improve road financing; (iv) involve the private sector in construction and maintenance; (v) involve local communities in local road maintenance; (vi) reform MOTC and road network management; (vii) improve road safety; and (viii) use modern technologies in construction and management of roads.

While MOTC manages all republican level roads that are under the jurisdiction of the central government, the remaining 16,000 km of urban, rural, agricultural, industrial, and other roads are under the jurisdiction of local governments.

The Road Fund enacted in 1998 has not served its intended purpose up to now. Taxes are collected in the name of the Road Fund, but are consolidated under the government's central budget of the Ministry of Finance (MOF). The Road Fund Council, with the responsibility to oversee the management of the Road Fund, was decreed in 2003, but has not yet met. A clearer and predictable financing mechanism, including a fully functional Road Fund, and revisions to the revenue structure and sources are expected when the RSDS is fully implemented.

The primary concern in the roads subsector is not expansion or major upgrading of the roads but rehabilitation and preservation. Roads at all levels are deteriorating: over 60 percent now require periodic maintenance or rehabilitation. Management of about 16,000 km, which was formerly under the state and collective farms, is now the responsibility of the district administrations.

The average road maintenance expenditure of the MOTC network is US\$1,320 per km, which is far lower than the estimated US\$2,000 per km needed to maintain a road network adequately. Moreover, only 20 percent of the maintenance work is routine, yielding a very low average maintenance figure per km for the network. The damage to roads is severe and no further routine maintenance is possible and require major rehabilitation.

Of about 16,000 km of other roads that are outside MOTC's jurisdiction, less than 1,000km are urban roads and streets, which is the responsibility of city governments. In Bishkek and Osh, maintenance efforts have intensified in the last few years. However, in other municipalities, there is almost no local budget for O&M of roads. These deferred O&M works could lead to larger investment needs later in municipalities across the country.

Railways. The 100 percent state-owned Kyrgyz Railways enterprise owns the track and operates the services. The railway network comprises one line in the north running from Kazakhstan through Kara Balta, Bishkek and Balykchy cities and eight branch lines off the Uzbek railway in the south of the country. Track condition is basically adequate for the present low level of traffic, but will require substantial improvements if it is to play a larger role in the economy.

The government has not directed any public funds to the railways since the country's independence in 1991, and the Kyrgyz Railways finances its capital and operating expenditures from its own revenues. Profits of the Kyrgyz Railways peaked in 2008 but then decreased to KGS 372 million in 2009 due to the impact of the world economic crisis. Outgoing (export) freight traffic was down by about 30 percent and incoming (import) freight traffic declined by about 20 percent in 2009 compared to 2008. Freight services are profitable and increasing in volume (Table 8) but passenger services are at almost zero profit (fares are regulated by the anti-monopoly authorities) and remain insignificant compared to road and air traffic.

Civil Aviation. The civil aviation sector comprises three independent entities: (i) the national airline; (ii) airports; and (iii) air traffic control. The first two are joint-stock companies under the State Property Ministry and the third is a 100 percent state-owned enterprise. A number of companies have registered to operate as private airlines. There are no subsidies from the state to either the national or the private airlines. The airport company, Manas International Airport, is a state-controlled entity (the government holds a 79.1 percent share), and includes three international airports of the country: Manas (Bishkek), Osh, and Issyk-Kul (Tamchi). Other small airports and landing strips have virtually been abandoned. The airport company is presently financially self-sufficient with a net income peaking in 2007 (about KGS 400 million) and falling slightly over the last two years due to the world economic crisis. There are no subsidies from the state, and the airport company finances its capital and operating budgets from its revenues, which are supported by US transit airbase service payments.

Communications. The telecommunication subsector of the country has grown rapidly over the last few years, mainly due to mobile services. Kyrgyztelecom (KT) is the largest national fixed telecom operator, with a 78 percent stake of the government. KT provides a broad range of telecommunications services, including basic phone services (local, domestic, long distance and international), access to the internet, telegraph, and others. In 2008, the total installed capacity was 722,000 phone lines. KT is the only fixed-line operator that covers all regions and towns of Kyrgyz Republic, and therefore is of strategic importance for the country's communication services.

The KT's net income was KGS 266 million in 2008. Capital and operating expenditures are entirely financed from KT's own resources or non-sovereign borrowing. In recent years, KT undertook a number of network expansion projects, and digital broadcasting in the Batken region. The KT borrowed a US\$60 million commercial loan from the China Development Bank for fiber-optic laying.

A consortium of four investors won the tender for the government's 78 percent stake in Kyrgyztelecom in February 2010 with a US\$40 million offer. Immediately after the April 2010 events, the interim government cancelled the results of the KT privatization tender. The State budget is not likely to be affected by cancellation of the privatization deal, as no financial transaction was made after the tender. Kyrgyztelecom's revenues are expected to decrease as a result of the cancellation and the plan to introduce intra-city calls fee under the plan. Also, the privatization deal envisaged injection of considerable capital to finance investment needs in the medium term, which now will have to be revisited.

Postal services are provided by the state-owned company Kyrgyz Post, under MOTC, which operates national, regional, city, and local post offices across the country (in total 920 postal service points).

Sector Impact

Roads. There was no direct damage to road infrastructure as a result of April 2010 event but municipal roads in Osh was damaged due to movement of defense equipment after the June 2010 event. Capital investments in the road subsector are channeled mainly through the PIP. Development partners have provided more than US\$400 million (on average about US\$30 million per year) for road improvement and this helped rehabilitate nearly 1,600 km of roads (40 percent of international roads) between 1995 and 2009. However, more than 50 percent of the international roads, including parts of the Bishkek-Torugart road, have yet to be rehabilitated.

In 2010, the approved state budget committed capital investments through the PIP in the road subsector amount to US\$169.0 million or 60 percent of the total PIP resources. In comparison, the approved 2010 state budget allocated US\$14.5 million of the capital expenditures from domestically financed sources in the road subsector. While funds for improvement of regional corridors will be sourced mainly from international financial institutions, financing road maintenance at the required level remains a challenge. Since most of the roads were originally designed for higher traffic volumes, the existing capacity is adequate for the level of economic activity likely to occur in the medium term.

Table 9: 2010 PIP in Road Subsector

Projects	<i>KGS million</i>					
	GOKR Plan (P)	GOKR Plan ®	GOKR Variance	Donor 2010 (P)	Donor 2010 ®	Donor Variance
Taraz-Talas-Suusamyr Road Rehabilitation (IDB)	-	-	-	52.80	53.88	1.08
Taraz-Talas-Suusamyr Road Rehabilitation 2 (IDB)	21.45	21.45	-	157.34	160.56	3.22
Osh-Irkeshtam Road Rehabilitation	44.88	28.34	(16.54)	299.20	297.13	(2.07)
Southern Transport Corridor (ADB)	10.80	34.93	24.13	78.41	136.35	57.94
CAREC Regional Corridor Improvement (ADB)	66.00	51.06	(14.94)	462.44	696.09	233.65
Bishkek-Torugart road rehabilitation 1 (ADB)	18.50	18.78	0.28	154.88	157.50	2.62
Bishkek-Torugart road rehabilitation 2 (ADB)	79.20	53.79	(25.41)	338.80	302.30	(36.50)
Bishkek-Torugart road rehabilitation (ACG)	96.80	-	(96.80)	387.20	-	(387.20)
Osh-Isfana road rehabilitation (WB)	95.20	57.16	(38.04)	380.83	272.43	(108.40)
Osh-Isfana road rehabilitation (EC)	-	-	-	-	44.90	44.90
Osh-Isfana road rehabilitation (EBRD)	50.00	3.95	(46.05)	703.84	475.47	(228.36)
Osh-Irkeshtam road rehabilitation (PRC)	-	-	-	1,490.56	1,521.05	30.49
Bishkek-Torugart road rehabilitation (PRC)	-	-	-	3,080.00	3,143.00	63.00
Total	482.83	269.48	(213.35)	7,586.30	7,260.66	(325.64)

Source: Ministry of Finance

In the 2010 approved state budget, committed current expenditures for O&M amount to KGS 1.114 billion (US\$24.5 million). Table 10 shows the trend in domestic budgetary allocation to the road subsector, excluding external financing.

Table 10: Budgetary Allocation to the Road Subsector, 2000–2010

Item	<i>(KGS '000)</i>				
	2000	2003	2005	2007	2010
Capital Investments	38,919	93,219	209,350	319,430	650,000
Road Maintenance	74,339	99,996	221,674	1,058,758	1,114,358
Total	113,258	193,215	431,024	1,378,188	1,764,358

Source: Ministry of Transport and Communications.

Railways. According to railway authorities there was no impact of the April and June events on the operation and financial positions of the Kyrgyz Railways. There were no damages to the company's property or interests. All departments and units of the company have been operating since then without interruption or shut-down. The border closure by Kazakhstan from April 7 to May 20, 2010 did not affect the Kyrgyz Railways activity as railway traffic was permitted, while closure of the borders by Uzbekistan had almost no effect due to negligible railway traffic in that direction. Freight and passenger traffic slightly increased in April-May, substituting for temporary suspension of road traffic, as international road corridors were closed at border points with neighboring Kazakhstan and Uzbekistan. There are no plans to change freight or passenger tariffs in the short- and medium term.

Civil Aviation. There were no damages to infrastructure as a result of the April and June events and operations of the airports have not been affected. Some international airlines interrupted their regular flights but resumed them after a few days. Increase in fuel prices as a result of introduction of a fuel export duty by the Russian Federation on April 1, 2010 led to some decrease in freight and passenger (charter flight) traffic. There are no plans to change freight or passenger tariffs in the short term.

Communications. Telecommunication and postal entities have been operating without interruption and shutdowns throughout the country during and after the events. There were no major damages to their property and facilities. The state enterprise for governmental telecommunication under MOTC reported KGS 1 million in damage to its assets in the Governmental House building in Bishkek, and KGS 104,000 monthly revenue loss caused by non-operation of the building since April 7, 2010. No plans for tariff changes are expected this year.

Priorities

Roads. The state budget for 2010 has been revised, but with no change in the allocation for capital expenditures from domestic sources for the road subsector. The allocation for the road subsector in the 2010 PIP has been slightly reduced, from US\$169.0 million to US\$159.8 million. The revision to the PIP allocation is not related to the April or June 2010 events but to the changes in disbursement projections. Reduction in PIP allocations in the road subsector was mainly due to disbursement deferral from 2010 to later years, namely: (i) US\$8.6 million disbursement from the Arab Coordination Group (ACG) for the planned section of Bishkek-

Naryn-Torugart road (due to delay in concluding agreements with all members of the ACG on financing),⁷⁶ and (ii) US\$7 million from EBRD for the Osh-Isfana road (due to a delay in tender of the civil works).

Since major investments are financed through PIP, which have already been committed, no major changes in investment plans in the medium term are expected, except for ACG-proposed financing of US\$69.2 million for 93 km (section from 272 km to 365 km of the road). If the Government does not reach agreement with all members of ACG, there might be a need for additional external financing to complete the road.⁷⁷ The Government could also request additional financing of about US\$150 million for rehabilitation of non-critical sections of Osh-Isfana road. For the short-term budgetary effect, for 2010, landslides and floods throughout the country resulted in unplanned expenditures from the state budget O&M allocation.

The crisis will have an impact on the work execution; because works were impeded or stopped for about 3 months, it is likely that only 75 percent of the program will be performed in 2010, maybe more as it took place during the construction season. Prices sharply increased for construction materials and petroleum products (bitumen, cement, steel, diesel fuel) because of the prolonged closure of the borders with Kazakhstan and Uzbekistan, and interrupted operations of domestic cement factories. An increase in the price of bitumen (mainly imported from Uzbekistan) by almost 100 percent is unrelated to April events and mainly caused by increased demand for Uzbekistan bitumen from Afghanistan. Russian Federation provides 96 percent of fuel and lubricants imports to the Kyrgyz Republic. Prices of fuel and lubricants have increased on average by 30 percent after introduction of export duty on these materials by the Russian Federation. Cement prices have also increased significantly, as the local cement plants had to temporarily suspend operations due to a stoppage of imports of oil products necessary for production after the April events. Potential price escalation of construction items may significantly affect the State budget, especially the PIP, under which most capital expenditures in the road subsector are financed. Some of these are permanent and unrelated to the April and June 2010 events. The State budget allocation of Government counterpart financing will require adjustment to pay for the price increases and identifying this early will be critical for planning the State budget. It is estimated that such significant price increases could lead to about US\$20 million increase over 2010-12 PIP. The total requirement for the road sector including rehabilitation of urban roads is US\$30 million over 2010-12 period.

Table 11: Critical Transport and Communication Investments

	(\$ million)			
Item	2010	2011	2012	Total
Regional roads	-	12.00	8.00	20.00
Municipal roads ^{1/}	5.00	5.00	0.00	10.00
Total – Transport and Communication	5.00	17.00	8.00	30.00

Source: JEA estimates.

1/ Drawn from local government infrastructure section.

⁷⁶ Arab Coordination Group includes the Islamic Development Bank, Saudi Fund for Development, Kuwait Fund for Arab Economic Development, OPEC Fund for International Development, and Abu Dhabi Fund for Development.

⁷⁷ The Government has already reached an agreement with the Islamic Development Bank for financing of about US\$20 million. The agreements with the other four members of ACG are expected to be reached by the end of 2010.

Railways. There is a national plan to expand the rail network in the long term to end the Kyrgyz Republic's dependence on neighboring countries' railway systems and to link the north and south of the country. This would establish the country as an alternative corridor for trans-Asian rail traffic. According to a pre-feasibility study, the cost of the trans-Asian railway through the country is about US\$2 billion, and the government proposes to attract foreign investment to execute the plan. Apart from this mega-project, Kyrgyz Railways is seeking external assistance for two other projects: electrification of the Bishkek-Lugovaya railway section (US\$100 million) and renovation of its wagon fleet and railway facilities. Significant investments will be required to improve the efficiency of the existing system as the entire equipment inventory is old or obsolete and requires replacement.

Civil Aviation. Currently, the airport company is implementing two projects with own resources: (i) construction of the second terminal in the Manas airport; and (ii) expansion and improvement of the Issyk-Kul airport runway, at a total cost of KGS 1,750 million. Other major projects—such as construction of the second runway in the Manas Airport, modernization of the Osh Airport (US\$105 million, as per 2009 feasibility study) and upgrading of the Issyk-Kul airport facilities—will require external financing, with a focus on PPP arrangements or dual-purpose investments of the US transit airbase (including ATC system expansion).

Operations Plan

The road maintenance expenditures (from the state budget) have been increasing steadily over the last 10 years, and the 2010 state budget allocation for the roads subsector has not been revised downwards after the April and June events. However, road maintenance expenditures still remain below requirements and further increases are needed to avoid greater investment requirements in future because of deferred maintenance.

Companies in the railways, civil aviation, and telecommunication subsectors are all financially viable and generate sufficient revenues from their economic activities to cover immediate operating and capital expenditures. In the short- and medium term, financial sustainability of these subsectors is expected to be maintained without government or donor support. However, it would be worthwhile to look at the efficiency of these sectors as sub-optimal performance would be affecting the whole economy of the country.

ANNEX VII: LOCAL GOVERNMENT INFRASTRUCTURE

Introduction

The local government infrastructure assessment covers urban and rural infrastructure. Main subsectors include water supply and sanitation, and small town infrastructure, including buildings, roads and heating. The review was carried out for (i) cities including Bishkek and Osh; (ii) 23 small towns; and (iii) rural communities.

Background

The Kyrgyz Republic faces immense challenges in rebuilding and maintaining the basic infrastructure of its urban areas. Since the collapse of the former Soviet Union, there has been a rapid deterioration in the availability and quality of public infrastructure and basic services. Services once taken for granted (drinking water, solid waste collection, waste water treatment, etc.) are now often only intermittently available, if at all and the steady decline in the quality of these services has created serious risks to public health. The capacity of local governments, which are responsible for delivering these services and providing the necessary infrastructure, is severely limited by lack of available fiscal resources, as well as the managerial weaknesses of their utilities. To some extent, the April and June events may highlight the need to strengthen the delivery of basic infrastructure services in local communities as a way of alleviating social tensions.

There are 25 urban settlements in the Kyrgyz Republic, including the country's two largest cities Bishkek (1.2 million persons) and Osh (600,000 persons), and 23 small towns (668,000 persons). To control the effects of growing migrations on urban development in the two cities, the Kyrgyz authorities began in the early years of independence allocating agricultural land to migrants for housing construction in semi-informal settlements, so-called novostroiki (literally "areas containing new constructions"). Creation of such novostroiki continued throughout the 1990's and early 2000's at a relatively moderate scale, but accelerated significantly after 2005. Today, Bishkek has about fifty such settlements with a population of, depending on the estimates, between 125,000 and 200,000 or up to one-fifth of the city's total population. Osh has eight with a total population of possibly in excess of 50,000. Developing these novostroiki was instrumental in preserving an orderly urban fabric and averting the emergence of slum-like neighborhoods. It did little to provide minimally acceptable living conditions to the residents of these areas or help secure their integration into the urban community. As a result, the two cities are surrounded by a ring of settlements whose inhabitants are generally poor, lack basic infrastructure, have limited access to social, educational and other services, and are therefore at risk of falling prey to political agitations.

Sector performance, problems and opportunities

Service Delivery

Water Supply and Sanitation. About 56 percent of urban residents have piped water in their homes, and another 42.3 percent rely on street water taps. Water quality is poor; in 2007, about 11 percent of water tests failed on microbiological parameters. The water quantity is limited, and the supply is intermittent. Most of the water supply infrastructure was built in 1960s and is in poor condition today. In addition, about 75 percent of the urban population has access to

sanitation services. Population access to sewerage facilities is 21 percent—in Bishkek, it is 78 percent, while in other regions, it is about 10 percent. Most sewage treatment plants are not operational, or are barely operational. Waterborne illnesses, such as typhoid and parasitic diseases, are a major problem.

A recent socioeconomic survey⁷⁸ indicated that urban residents' top priority is improved water supply and sanitation services (i) water supply, about one quarter of households indicated inadequate water supply for household needs. Waterborne illnesses due to poor water quality were significant, with 82 percent of households reporting incidences in the past 5 years; and (ii) sanitation, about 75 percent of households use dry-pit latrines, and 24 percent use flush or pour toilets. About 66 percent of households surveyed stated they would be willing to pay for connection to a sewerage system, indicating citizens' priority for improved sanitation.

Lack of reliable data makes it difficult to present a precise assessment of water supply and sanitation service levels and quality in rural areas. In 2008, only about 66 percent of the population had access to water supply services and 51 percent had access to sanitation services. In the southern oblasts of Jalalabad and Osh, only about 40 percent of the villages have operable water systems. Rural communities rely on on-site solutions, primarily latrines and drain fields.

Solid Waste Management. Solid waste collection and disposal systems are inadequate. Data on the solid waste management are scarce, but 1997 statistics indicate that only 28.5 percent of the population is served by regular municipal waste collection services. Out of 155 dumps around the country, only one can be considered a full sanitary landfill. Due to the lack of resources, cities have focused on providing solid waste collection services while waste disposal issues have been left unattended. Dumpsites are major contamination risks in the local communities and poses environmental hazard.

As per the above mentioned socioeconomic survey, approximately 84 percent of households stated that a solid waste collection service was unavailable on a daily basis. Waste disposal practices included plastic bottle and packaging collection by the tazalyk enterprise from 50 percent of households, waste incineration by 36 percent of households, and waste disposal into the nearest landfill or waste receptacle by 8 percent of households.

Urban Roads and Public Transport. Urban roads suffer from lack of regular maintenance. Sub-surface water leakages caused by broken water supply pipes as well as harsh climatic conditions in the winter add to deterioration of roads. Road maintenance is carried out by the local/municipal government and lack of funds result in irregular and inadequate maintenance schedules.

Cities are served by municipally owned public transport companies and/or a network of privately operated minibuses. The minibus sector is generally un-regulated, lacking transparent tenders and performance guarantees. The main city streets tend to be well served while outskirts of town tend to lack reliable public transport. The sector needs a regulatory framework and an integrated ticket system to ensure full coverage of affordable and reliable public transport covering entire cities.⁷⁹

⁷⁸ ADB. 2009. *Issyk-Kul Sustainable Development Project*. Manila.

⁷⁹ Bishkek Trolleybus Company (BTC) and Bishkek Passenger Transport Company (BPTC) are independent legal entities owned by the municipality with directors appointed by the Mayor of Bishkek. The bus company operates a relatively modern fleet of approximately 260 buses and carried 41 million passengers in 2009. The trolleybus company operates a dated fleet of approximately 80 trolleybuses and carried 19 million passengers in 2009.

District Heating.⁸⁰ District heating services in Bishkek and Osh are provided through a central heating plant (CHP) in the two cities. The KyrgyzZhil Kommun Soyuz Enterprise, a state-owned enterprise, provides district heating services to the remaining 23 urban centers. Operations peak from November to March and the enterprise is dependent on pricing of raw materials to generate heat for distribution during winter. Lack of capital expansion and rehabilitation investments over the past 20 years have resulted in inefficient services. Sustaining the service is important for GOKR as it's critical for local population during winters.

Institutional Issues

Urban Services. The oblast administration oversees the functioning of local self-governments (including city administrations) in the region through rayon centers. *Vodokanal enterprises*, through a contractual arrangement with cities, provide water supply and sanitation services, and *tazalyk enterprises* provide solid waste management services based on similar contractual arrangements with the city administration. To improve efficiency and effectiveness of public administration, the Government of Kyrgyz Republic embarked on reform initiatives in 2004, and functional decentralization to local governments was a key initiative. However, paucity of capital investment funds, lack of human resources, and poor cost recovery has resulted in inefficient service delivery.

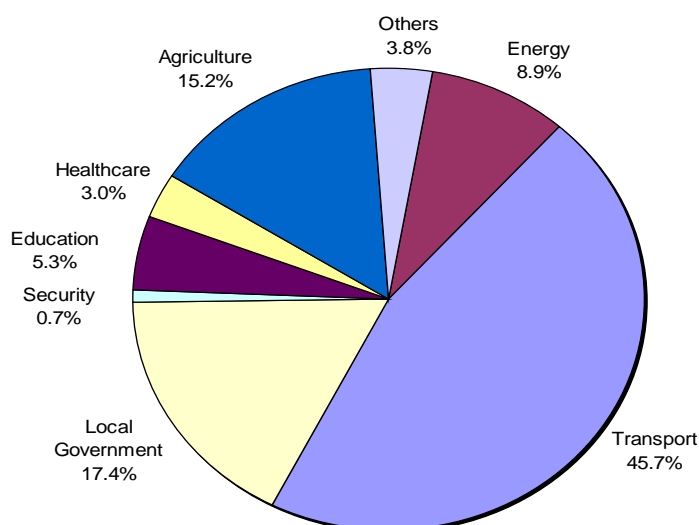
Sustainable Financing

Infrastructure Creation. Local government infrastructure development accounts for 17.4 percent (refer Figure 1) of the donor financed public investment program (Som 63.55 billion). Donor financed local government infrastructure is Som 11.08 billion, and loans account for 49 percent of the portfolio. The planned donor financed public investment program (PIP) for 2010 is Som 12.16 billion with local government infrastructure spending at Som 1.498 billion (Table 12).

Key Donor PIP in the urban WSS subsector includes (i) World Bank financed small towns infrastructure project; (ii) ADB financed Issyk-Kul Sustainable Development Project; and (iii) EBRD and Swiss SECO financed Bishkek, Osh and Jalalabad water supply projects. GOKR financed PIP is limited to Bishkek and Osh, specifically addressing housing, water, sanitation and roads in newly developed areas. There have been no major capital investments in the district heating subsector in the 23 urban centers, and the current maintenance expenditure barely sustains the existing infrastructure. Key Donor PIP in the rural WSS subsector includes (i) World Bank and DFID financed rural water supply and sanitation project; and (ii) ADB financed Community-based Infrastructure Services Sector Project.

⁸⁰ Investment estimates for district heating expansion and rehabilitation are detailed in the energy sector.

Figure 1: Total Public Investment Program – Sectoral Distribution



Source: Ministry of Finance, May 2010.

Table 12: 2010 Public Investment Program

(in Som million)

Item	GOKR Plan (P)	GOKR Plan ®	GOKR Variance	Donor 2010 (P)	Donor 2010 ®	Donor Variance
I. Urban Infrastructure						
Small Towns Infrastructure (WB)	-	-	-	162.45	130.91	(31.53)
Issyk-Kul Sustainable Development Project (ADB)	4.40	5.88	1.48	44.00	98.36	54.36
Bishkek and Osh Infrastructure (WB)	31.75	26.75	(5.00)	300.56	306.70	6.15
Bishkek Water Supply (EBRD and SECO)	-	-	-	66.00	67.35	1.35
Osh Water Supply (EBRD and SECO)	-	-	-	-	-	-
Jalalabad Water Supply (EBRD and SECO)	-	-	-	-	-	-
Karakol Water Supply (SECO)	-	-	-	89.25	91.07	1.83
Local Govt. Infrastructure Financing (KfW)	-	-	-	-	7.11	7.11
Subtotal – Urban	35.56	37.04	(3.52)	662.25	701.51	39.26
II. Rural Infrastructure						
Rural Water Supply & Sanitation (WB & DFID)	31.16	31.16	-	448.39	415.55	(32.83)
Community-based Infrastructure Services Sector Project (ADB)	51.36	42.24	(9.12)	354.99	300.83	(54.16)
Rural Investments (KfW)	-	-	-	-	80.82	80.82
Housing Construction (KfW)	-	-	-	-	-	-
Subtotal – Rural	85.52	73.40	(9.12)	803.38	797.20	(6.17)
Total - Local Govt. Infrastructure	118.67	106.03	(12.64)	1,465.63	1,498.71	33.09

Source: Ministry of Finance, May 2010.

Impact, Needs Assessment and Service Delivery

Impact

The April 2010 event had no damage on water supply and sanitation infrastructure, roads, electricity and heating infrastructure. Major cities affected include Bishkek, Tokmok, Talas and Naryn. Public transport and buildings were affected in Bishkek; other cities witnessed damages to buildings. The Ministry of Finance coordinated information from the following commissions to assess damages to public and government infrastructure (i) President's Office reviewing damages to federal buildings; (ii) Ministry of Economic Regulation reviewing damages to commercial establishment; (iii) Victims Compensation Commission; and (iv) Bishkek Mayor's Office reviewing damages to Bishkek city structures.

The June 2010 events had a larger impact on civil structures. Osh City and Karasuysky District were affected in Osh Oblast, and Jalalabad Town, Bazar-Korgon, Suzaksky, Ala-Bukinsky districts were affected in Jalalabad Oblast. Osh city roads were damaged and public transport buses severely damaged. Approximately 1,840 residences were burnt. Damage is currently assessed by the Ministry of Emergency and State Registration Services. Subsequently, the State Directorate on Reconstruction of Damaged Property will be responsible for reconstruction and rehabilitation.

Needs Assessment

Ongoing Public Investment Programs. Figure 2 provides a snapshot of the plan for completion of ongoing and planned local government infrastructure projects. While urban infrastructure projects will continue till 2014, rural infrastructure projects are expected to achieve completion by 2012. The plans are in line with approved project documents of all donors.

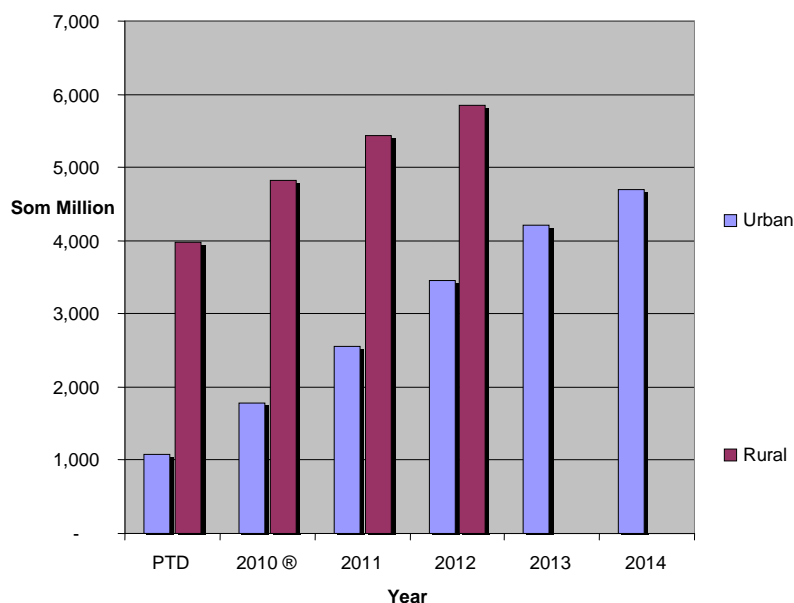
While the government has ensured capital and rehabilitation investments will continue through donor financed PIP, state subsidy transfers to local governments and state-owned enterprises (SOEs) should be protected. During 2007-09, transfers and subsidies accounted for 27 percent of the state current expenditure; transfers to local governments accounting for 17 percent and to SOEs accounting for 3 percent of the total current expenditure.

Except Bishkek, state subsidy transfers account for 20 percent-50 percent of the local governments' operating/current income. The transfers account for teachers' salary, staff salary and grants for infrastructure improvement and maintenance. With low tax and non-tax revenue collection by local governments, transfers play a significant role in maintaining core basic services including water and sanitation. Existing infrastructure in most local governments is significantly dilapidated and warrants replacement; compromising subsidy transfers during the current period may result in a system collapse. While *vodokanal enterprises'* cash flow breaks even, the quality of service delivery is far below required efficiency level. A large part of the water and sanitation infrastructure requires complete replacement.

The Kyrgyz Communal Service, is dependent on state transfers to maintain services, which account for 73 percent of the entity's income (Som 1,361 million for 2009). Tariff roll back has also affected the planned income for the entity and any reduction in state transfer will severely affect purchase of raw material required to provide heating in small towns across the country. The government's exposure on transfer to the Kyrgyz Communal Service is about a Som 1,000 million, annually.

In the immediate term, state subsidy transfers to the subsectors should be continued till accurate and complete information is available on (i) capital improvement and rehabilitation planning; and (ii) cash flow, asset and liability information of local governments and SOEs. Transfers to local governments and SOEs currently constitute 17 percent of the Republican budget's current expenditure. To ensure systems are sustainable till a long-term urban services policy is formulated, performance-based transfers to the subsectors should account for at least 20 percent of the Republican budget's current expenditure plan.

Figure 2: Cumulative Investments in the Sector



Source: Ministry of Finance

Sectoral Needs. Rural water supply and sanitation is currently covered through sector development projects of the World Bank and ADB. Investments needs for the urban sector include capital investment and replacement costs ensuring basic service delivery to a population of 2 million persons by 2012. Based on per capita estimates (to be confirmed through feasibility and detailed engineering studies), the estimated investment need is Som 83.25 billion (US\$1.85 billion). However, for the joint needs assessment resulting from the April and June 2010 events, investments are limited to urban/public transport rolling stock. Table 17 provides a breakdown of critical local government infrastructure investments between 2010 and 2012, which is limited to urban/public transport interventions at approximately US\$10 million.

Table 17: Critical Local Government Infrastructure Investments

(\$ million)

Item	2010	2011	2012	Total
Urban transport	5.00	5.00	0.00	10.00
Total – Local Government Infrastructure	5.00	5.00	0.00	10.00

Source: JEA estimates.

Long-term Service Delivery Interventions

Service Sustainability. The WSS and district heating sectors lack funds for infrastructure expansion and system rehabilitation or replacement. Donor PIP contributes less than 25 percent of the requirement in the WSS subsector while there is no investment planned for district heating in the 23 urban settlements. With no improvements in the past 20 years, systems are dilapidated and staff technical capacity has also not improved to ensure system maintenance. Donor PIPs have focused on collating WSS asset information to design system improvements in a few urban settlements. This approach should be scaled-up to more settlements and should also focus on the district heating sector.

Financial Sustainability. Public finance policy on cost recovery of basic urban services is weak and needs strengthening. Tariffs in both subsectors are low and cumulative arrears on revenue are substantially high; consequently, the quality of service is affected. A culture of generating revenue surpluses for asset creation or to leverage debt is absent, and both local governments and state-owned enterprises continue to depend on state transfers to sustain services. State subsidy transfers to local governments and state-owned enterprises should be performance-based and linked to revenue enhancement and expenditure management efforts of beneficiary agencies. Robust data on assets and liabilities are absent in most local governments. To overcome information shortcomings, donor PIPs have introduced support on improving financial management of local governments and *vodokanal enterprises* and include programs on accounting and management information system improvement. These programs should also be scaled up to other urban settlements and the district heating sector.

Institutional Sustainability. GoKR lacks a policy on WSS and district heating sector development and the assistance program will develop an urban services policy framework based on the following thematic areas planning, service delivery, institutional effectiveness, financial management, and legislative and regulatory framework.

ANNEX VIII: PUBLIC BUILDINGS AND STRUCTURES⁸¹

Introduction

This annex covers buildings infrastructure assessment, which includes public and private buildings, particularly housing. Construction of larger public and private sector buildings in Kyrgyz Republic may typically be divided into two categories: older buildings built primarily of unreinforced masonry (URM, typically not more than four stories and of fired brick although some older buildings will use unfired [adobe] masonry), and newer buildings mostly reinforced concrete (RC) frame with masonry infill (the masonry infill being either fired brick or concrete block). Smaller (i.e., one and two storey) commercial buildings will typically be URM, or RC frame with masonry infill.

Residential construction may be large apartment blocks, or single family dwellings (one or two story). Lower apartment blocks again will be URM or RC frame with masonry infill, while taller apartment blocks will be RC frame or shear wall with masonry infill. Unusually, in the 1980s some 30 apartment blocks were built in Bishkek using sliding block (i.e., base isolation) technology, which was quite advanced for its time⁸². Single family dwellings will typically be one or two story URM, with or without an RC frame. Reportedly 80 percent of housing in Osh City is earthen (adobe) URM⁸³.

Background

Much of Kyrgyz Republic is highly seismic, so that engineered construction must be specially designed for earthquake forces. Design norms typically employed are based on or similar to the Russian code,⁸⁴ so that larger engineered buildings built since about 1981 should nominally have adequate seismic design, although information on building code enforcement and construction quality was not available for this assessment. Smaller buildings and particularly single family dwellings are often owner-built, and at best may have an RC 'ring beam' at top of wall, which is an important improvement. This only occasional seismic provision, combined in most cases with use of adobe masonry, means that most single family dwellings are collapse hazards if subjected to strong shaking (i.e., MSK 8 or greater), which can be expected in much of Kyrgyz Republic.

Sector Impact

Much of the damage in both the April and June events was borne by the building sector. Table 18 details damage to building structures by sector (Public, Private Commercial, Private Residential) that was sustained in affected jurisdictions during the April and June 2010 Events. In summary, damage to 2,314 residential buildings accounts for about 50 percent of the overall building damage of KGS 6.64 billion, followed by damage to several dozen public buildings

⁸¹ This section includes a discussion on damage and losses associated with residential housing but needs associated with these losses are included in a line item under social recovery and reconciliation (see Annex 1). Housing issues are also dealt with in an annex on reconciliation within the context of rehabilitation of IDPs.

⁸² Brezv (2002) <http://www.world-housing.net/whereport1view.php?id=100085>

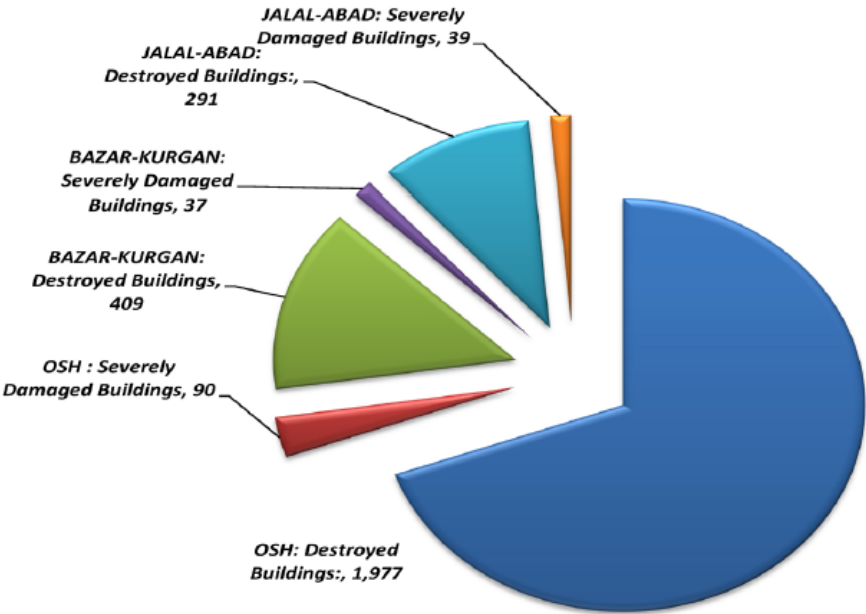
⁸³ D.M. Abdirusalam, Comm. on Damage Assessment in Osh and Jalal-abat.

⁸⁴ SNIP II-07-81 (1982) Basic Norms and Rules for Civil Engineering Loads and Actions, Gosstroj USSR, Moscow (and subsequent editions).

accounting for 34 percent, and damage to over 700 commercial establishments, accounting for 16 percent. These figures are independently corroborated by remote sensing, Figure 5.

Table 18 only accounts for direct damage to building structures, and does not account for damage to contents or ensuing economic losses. A detailed accounting of contents or even economic activity for the various affected buildings is unavailable at this time. In lieu of detailed data, Table 19 is based on simplifying assumptions drawn from experience to approximate contents damage and ensuing economic loss. Economic loss in this case refers to losses other than property damage. Based on these simplifying assumptions (explained in a footnote), the total of building and contents damage is shown in Table 19 to be about KGS 12 billion (or US\$ 262 million), with public buildings and residential each constituting about 40 percent of this total and private commercial the remainder.

Figure 5: UNOSAT Estimates of Building Damage



Credit: UNOSAT (2010) *Damage Analysis Summary for the Affected Cities of Osh, Jalal-Abad and Bazar-Kurgan, Kyrgyzstan, Damage Analysis based on Post-Crisis Satellite Imagery Recorded on 18 & 21 June 2010, 9 July 2010, CE-2010-000113-KGZ*

Table 18: Damage to Physical Structures

Public Sector		Value millions KGS <i>except as noted</i>	Comments
Bishkek	Damage to the building of the House of Government and the President's Office	224	MOER
	Damage to the General Prosecutor's office	64	MOER
	Damage to Ministry of Interior of the Kyrgyz Republic	95	MOER
	Damage to Talas oblast	13	MOER
	Damage to the City Hall of Bishkek	24	MOER
	Damage to the <i>Pervomolsky</i> district tax office of Bishkek	6	MOER
Osh City, Osh Oblast	Cultural and social community facilities	850	MOER con.
	Hamza Secondary School	30	MOER con.
	State Automobile Inspection building	35	MOER con.
	Other facilities	180	MOER con.
Karasuysky District, Osh Oblast	Cultural and social community facilities	69	MOER con.
	Southern Regional Response Center	7	MOER con.
Jalalabad Town, Jalalabad Oblast	7 public buildings	268	see Note 1
Bazar-Korgon District, Jalalabad Oblast	2 public offices	77	see Note 1
Ala-Buklinsky District, Jalalabad Oblast	9 public buildings	345	see Note 1
Subtotal: Public Sector		KGS 2,288	
Private Sector (Commercial)			
Osh City, Osh Oblast	171 Commercial properties	245	see Note 2
Karasuysky District, Osh Oblast	92 Office buildings	132	see Note 2
Bazar-Korgon District, Jalalabad Oblast	20 sales point, 66 canteens, 31 barns, 25 sheds, 1 warehouse	205	see Note 2
Suzaksky District, Jalalabad Oblast	8 canteens, 5 barns, 15 sheds, 3 warehouses, 7 bathhouses	54	see Note 2
Ala-Buklinsky District, Jalalabad Oblast	8 sales point and 1 café	13	see Note 2
	74 canteens, 43 barns, 41 sheds, 4 warehouses, 7 bathhouses, 52 sales point, 49 cafe:	387	see Note 2
Subtotal: Private Sector (Commercial)		KGS 1,036	
Total No. Commercial Buildings reported damaged:		723	bdgs
Private Sector (Residential)			
Osh City, Osh Oblast	656 Residential Buildings)	940	see Note 3
Karasuysky District, Osh Oblast	707 Residential buildings	1,013	see Note 4
Jalalabad Town, Jalalabad Oblast	197 Residential buildings	282	see Note 5
Bazar-Korgon District, Jalalabad Oblast	219 Residential buildings	314	see Note 5
Suzaksky District, Jalalabad Oblast	57 Residential buildings	82	see Note 5
Ala-Buklinsky District, Jalalabad Oblast	478 Residential buildings	685	see Note 5
Subtotal: Private Sector (Residential)		KGS 3,316	
Total No. Residential Buildings reported damaged:		2,314	bdgs
Subtotal: Private Sector (Commercial and Residential)		KGS 4,352	
Total (Buildings, All Sectors)		KGS 6,639	

Notes

- 1 based on average loss per building where loss known, excluding House of Govt. and Presid. Office
38.3 = average loss per typical public building
- 2 based on Gosstroi unit costs, use value = 1 house
- 3 1.43 = 940/656 for Osh City, which agrees well with Gosstroi value for typical dwelling cost in Kyrgyzstan
- 4 274 million was reported, but appears unrealistically low, so use value from Note 3
- 5 no breakout available for these districts, so use value from Note 3.

Table 19: Summary of Building and Contents Damage, and Economic Loss⁸⁵

In US\$ million

Item	Building	Content	Economic	Total
Public buildings	49.73	37.30	3.36	90.38
Private buildings – Commercial	22.52	15.77	1.58	39.86
Private buildings – Residential	72.08	36.04	2.88	111.01
Total – Buildings and Structures	144.33	89.10	7.82	241.25

Note: costs associated with their losses are included in a line item under social recovery and reconciliation (see Annex 1 of the main report).

Priorities

All three aspects of the Building Sector (Public, Private Commercial and Private Residential) are high priorities for recovery and reconstruction.

Of the three, Private Residential may be the highest priority. Winters in the affected area are harsh, requiring any transitional shelters to be particularly robust thermally as well as with regard to wind and snow. Such transitional shelters will require substantial resources to construct, which resources might as well be devoted to permanent dwellings, thereby avoiding double-building. The construction season permits outdoor construction until about late November, thus allowing almost four months for construction, if it can begin by early August. Four months are sufficient to permit construction of a permanent ‘core’ house of perhaps 50 or more sq. m, which in many cases will serve households through the winter. Therefore, a streamlined building materials provisioned, technically assisted owner-builder would appear appropriate, beginning as quickly as possible.

Constraints on such a program include:

Material support: As usual, lining up support (funds, building materials, technical assistance) for the program in a timely manner will be challenging, and should be tackled early.

Community support: Lining up community support for such a program, particularly buy-in by the victims, will be vital. Moving too quickly may feed suspicions, so building community support must happen first.

Equity: That is, tuning reconstruction in such a manner so as not to feed further animosities. This point has been emphasized by a number of parties – that victims should not be perceived by the larger community as gaining from the Events, thereby feeding jealousy and touching off further rounds of violence. Building only a core house initially helps mitigate this issue.

Design: One size doesn’t fit all and neither does one housing design. Ethnic Kyrgyzs housing needs differ significantly from ethnic Uzbeks, so that design and reconstruction should anticipate and be flexible to accommodate these needs.

⁸⁵ Contents are valued at 50 percent of residential building value, 70 percent of commercial, and 75 percent of public building value. Economic activity were calculated based on commercial rates of return of 20% with restoration of business activities after 6 months, and corresponding public sector equivalent IRR=8% with 12 months disruption and residential equivalent IRR=6% with 18 months disruption. USD was calculated at 46 KGS/USD.

Seismic: Given the high seismic risk in the region, reconstructed buildings should not be collapse-prone – to achieve adequate seismic resistance is not very difficult, but does require some training of owners and builders. Experience in other regions (e.g., in Latin America and in reconstruction following the 2001 Gujarat, India, 2005 Pakistan and 2006 Yogyakarta, Indonesia, earthquakes) shows how to effectively provide this training and assure seismic adequacy.

These and other issues cannot each be addressed in isolation – rather, they need to be addressed in an integrated social program that not only addresses the issues of physical reconstruction, but also at the same time addresses issues of physical, psychological and social trauma, livelihoods, gender and economic needs. Given the socio-economic roots of the April and June events, the need for such an integrated social program is even more pressing than in say a natural disaster. It therefore is vital that development and implementation of an integrated social program precede and be concurrent with actual construction. These issues are discussed in more detail in Annex I on recovery and reconciliation.

Following Private Residential, Private Commercial and Public Building reconstruction probably have equal priority, with Public Building probably being less problematic. There were relatively few public buildings damaged, and in most cases their functions can be temporarily housed in other public or rented space. Restoration of Public Buildings should not be neglected however, as these buildings are symbols of governance whose restoration is vital to Kyrgyz Republic.

The Private Commercial building reconstruction is a sizable task, and vital for restoration of the economy. However, commerce is inherently more flexible, and a combination of compensation and selected reconstruction may be the most feasible approach.

ANNEX IX: BUSINESS ENVIRONMENT AND PRIVATE SECTOR DEVELOPMENT

Introduction

The political and social unrest of April 7-9, 2010 followed by widespread ethnic violence in June disrupted both public security and business activity. The episodes of looting and destruction of public and private property that occurred in Bishkek and other main cities heightened security concerns and disrupted businesses. The consequences of these disruptive events and the way neighboring countries reacted to the political developments in Kyrgyz Republic (e.g., border closures) have lingered well into May, bringing new challenges to both businesses and the interim government. In June, community and ethnic violence in the south further contributed to a less favorable business environment and negatively affect private sector development potential.

Background

The Kyrgyz Republic implemented price, trade, and foreign exchange liberalization and small-scale privatization in the early years of transition. Less progress was made in the implementation of more difficult reform areas such as large-scale privatization, governance and enterprise restructuring, competition policy, banking reform, non-bank financial sector reform, and infrastructure reform. Transition challenges continue to remain large in all sectors of the economy, and particularly daunting for establishing sound market-supporting institutions. Progress in recent years includes the streamlining of bureaucratic procedures. A number of measures were introduced, including introduction of a “one-stop-shop” for business registration to facilitate the formalization of businesses, and the streamlining of license procedures to reduce regulatory compliance costs in the construction sector.

Enterprises found the quality of electricity supply services very problematic, according to the EBRD/World Bank 2008 Business Environment and Enterprise Performance survey (BEEPS). Although electricity charges were inexpensive, and thus a potential enabler of "competitiveness" for firms, there were significant episodes of disruption in power supply between 2007 and 2008. A medium-term tariff plan (2008-12) for the electricity sector was announced in late 2008, with the aim of signaling the future elimination of large losses incurred by electricity companies and cross-subsidies between households and industry. Implementation of this plan was suspended in 2009, which was considered a way to mitigate the effects of the global economic crisis. In November 2009, a new plan was adopted based on the original objectives but tariff increases at the beginning of 2010 were reversed by the new interim government. In May 2010, the Toktogul Reservoir has reached its full capacity, which should greatly reduce the frequency of scheduled brownouts for the winter period.

Taxation, access to credit and governance issues stifle private sector development. Enterprises have cited taxes as the most problematic aspect in their compliance efforts. Access to financing by enterprises also became more costly in 2009, as an indirect result of the tightening of international liquidity in Kazakh bank subsidiaries. Privatization of state-owned companies, like Severelectro (an electricity distribution company in the Bishkek region) and Kyrgyz Telecom (dominant fixed line operator), occurred through international tenders, but the process fell short of full transparency and their privatizations have been reversed. The key areas for improvement and reform identified by business environment stakeholders are summarized below:

- Strengthening the rule of law in general, and ensuring the independence and reinforcing the capacity of the judiciary in particular to significantly reduce the forms of corruption that impair business investment. This would reduce perceived credit risk in financial transactions in the Kyrgyz Republic and bring down the cost of finance. Further, rules governing the enforcement of financial contracts and extrajudicial settlement mechanisms need to be strengthened.
- Establishment of the independence of the regulator in the financial sector and review of the overall regulatory framework. This is an essential step for the sustainable development of the sector, including microfinance institutions. Stakeholders called for more policy attention to the need to develop a local currency funding base and lending products.
- Full transparency during the future privatization processes and strengthening market-supporting institutions, including competition policy.
- Acceleration of infrastructure reforms needed to attract private sector investment. The lack of good infrastructure has become a serious business impediment, a result of years of under-investment. An appropriate tariff methodology that takes into account cost-recovery principles, a public-private partnership framework to address infrastructure financing, and a concession law that clarifies the legal obligations and rights of concessionaires and an independent regulator need to be established. Tariff increases and metering of utilities are a prerequisite for aligning incentives for energy efficiency.

Sector Impact

Impact on Tourism and Trade. Tourism is among the hardest hit sectors in the economy. Even though security concerns had to some extent subsided before the first week of June, tourism operators continued to report significant cancellations in bookings, and expect reductions in foreign tourist arrivals well into May. The June events certainly dashed hopes for recovery in the tourism. Tourist reservations are down 80 percent from last year's levels. The disturbance and continued tension in the south have brought security fears back as a priority, and business in this sector has not recovered by early July and the impact to the sector could be significant if the recovery does not materialize any time soon as July-August is the usual peak of the tourist season. This does not bode well, as tourism-related economic activity represents close to 5 percent of GDP. Episodes of political instability may continue to happen until the October elections, which will keep tourists away from the Kyrgyz Republic. A large percentage of the usual seasonal employment generated in tourist-related economic activity would thus be significantly affected by this scenario as well.

The community and ethnic violence in the south has also resulted in disruptions to businesses. The Ministry of Emergency Situation reported damaged structures for 248 trade establishments in the south. An independent enterprise survey⁸⁶ conducted by the World Bank found that all its small and medium enterprise (SME) respondents, except for two, stopped operating due to the

⁸⁶ The survey conducted in July 2-6, 2010 included 250 respondents: 100 in Osh, 100 in Jalal-Abad, and 50 in Kara-Suu.

June events. This was mainly attributed to the lack of power. Further, it was the small enterprises that suffered physical damage most among its respondents. In Osh, 91 percent of respondent SMEs indicated they were unable to resume commercial operations. Job losses were also registered as respondent SMEs downsized their operations. Respondent SMEs in Osh indicated that their average number of employees significantly dropped from 22 to 2. In Jalal-Abad, it fell from 21 to 13. This was mainly due to the dislocation of workers.

Box 1 – Damage Cost to Business

Estimating the direct damage to private property from the April and June events is challenging. For the April events, the interim government, through the Ministry of Economic Regulation, put in place a comprehensive effort to record claims made by businesses arising from incurred damages incurred. The table below summarizes the costs of the April events to private business:

Retail businesses	657
Wholesale distribution	71
Large Establishments	372
Total	1,100
<i>Unit: Million Som</i>	
<i>Source: MoER</i>	

Most of the businesses affected will have financial difficulty undertaking needed repairs, restocking, and resuming commercial activities. Access to finance is very limited under normal circumstances. The April damages are concentrated in three urban centers. Requested assistance coming from affected businesses cannot easily be met by the interim government in this year's state budget as the latter faces severe fiscal constraints.

The provisional government is still in the process of consolidating its damage estimates incurred by businesses in the south. A World Bank survey conducted in July 2-6, 2010 provides some indicative information on the damage in the south. Most of the respondents of Osh reported damage of buildings (71%), other assets (77%), and inventories (71%). According to the respondents evaluation, rehabilitation of damaged buildings is on average KGS 202,000. For rehabilitation of other assets it is required an average of KGS 450,000, and for rehabilitation of inventories KGS 186,000. In Jalal-Abad the buildings, other assets and inventories also were significantly damaged, as reported by 49%, 47% and 54% of respondents respectively. According to the respondents' evaluation for rehabilitation of damaged buildings about KGS 831,000 are required on average. For rehabilitation of other assets the required average sum would be KGS 1,226,000, and for rehabilitation of inventories about KGS 210,000. In Karasuu the scale of damages is smaller. Damage to buildings was reported by 14% of respondents, at an average cost of KGS 119,000. Damage to other assets (18%) would cost KGS 171,000 on average. About 38% report inventory losses, at an average cost of KGS 34,000.

Neighboring countries' decisions to close borders for movement of goods and people significantly impacted formal and informal trade in April and May. The observable decline in exports of garments, fruits, vegetables, and dairy products is expected to be reflected in trade figures once they become available. The closure of Kazakh and Uzbek borders not only made it difficult for the continuation of re-export activities but also made it difficult for bank borrowers

from the trading sector to unload already imported stocks and repay working-capital loans (Trading activities represented around 16 percent of GDP in 2009.)

Border passages to a large extent have been open from end-May, but the large backlog of merchandise awaiting clearance will take some time to process.⁸⁷ A large part of the re-export trading activity that did not take place during the six to eight weeks of border closure cannot be totally forgone. This depends largely on whether the orders made by buyers in Kazakhstan and Russia have found alternative suppliers in the meantime--or the borders remain open in June. Some input prices have been impacted by supply shortages. More clarity will be possible when price data become available.

Impact on Banking and Risks to Investor Confidence. The April change in political leadership of the country was accompanied by rumors of capital flight from specific financial institutions, which contributed to a short-lived episode of no confidence in some banks. There was some downward pressure in the value of the KGS, especially in the second and third weeks of April. The deposit base in the banking system was thus temporarily affected. The National Bank of the Kyrgyz Republic (NBKR) intervened decisively to sustain the value of the KGS against the dollar, at the cost of by US\$64.4 million in official foreign exchange reserves between April 7 and May 25. To minimize capital flight, and as part of a broader effort to eliminate asset-stripping opportunities triggered during the political transition, and ensure stability in the banking sector, the NBKR swiftly appointed temporary administrators to a number of banks. Thorough audits were initiated in banks of a systemic nature. The interim government nationalized Asia Universal Bank (AUB) in June 2010 (see Annex on Financial Sector).

Immediate decisions taken by the interim government to reverse privatization agreements of the recent past, and efforts to - as claimed by the interim government - review the legality in the ownership of a growing list of physical and immovable assets were interpreted as steps in direction of good governance. But due to the difficult interagency coordination of these actions, and the complex nature of the issues involved, they may have brought additional uncertainty to the business landscape. For example, specific efforts by the General Prosecutor's Office (GPO) to take control of properties associated with previous political figures may eventually impair specific banks' security interests in loan contracts, i.e., where those properties have been pledged as collateral. The threat of expropriation may further inhibit those borrowers' willingness to repay loans, and in that way slightly impact bank asset quality. These issues will naturally add more uncertainty to the business environment, and the consequences to foreign and domestic investor confidence going forward (e.g., perception of expropriation risk) will have to be assessed at a later stage. Unless these property-related issues are resolved in a swift and clearly transparent manner, the credibility of the political transition can be affected.

Impact on Investments. In parallel to a slight deterioration in some banks' *reported* asset quality, due to the short-lived disruption in real economic activity mentioned above, some financial institutions actually saw their deposit base rebound subsequently to initial withdrawals, without having to raise deposit rates. This has been interpreted as *flight-to-safety* by individual depositors and a sign of confidence in the overall soundness of the banking system. Thus, although liquidity difficulties remain in some banks, others' lending activity showed some resilience throughout the last few weeks, continuing to welcome loan applications.

⁸⁷ Priority has been given to medicine, fuel and food items.

The impact of the crisis on broad investor confidence is mixed. Some bank managers stepped up direct interactions with larger borrowers during these times of stress. The reported feedback from this interaction is that many investment projects initiated before the April events are to continue as planned. Other bank managers reported a drop in demand for new loans stemming from fears of further instability. Generally, banks believed that as long as the situation remained stable they anticipated some recovery following the October elections. The recent confirmation from Kumtor--that it will continue its large-scale investment project in mining--generates some confidence in the resilience of this year's private sector investment.⁸⁸ The recent estimates for aggregate private investment project a decline from 18 percent of GDP in 2009 to 15 percent in 2010 reflecting significant impact of the June crisis on the confidence of the private sector.

However, the most recent episodes of social unrest in the south confirm the risks to this outlook, mainly stemming from possible further political instability. Several medium-sized investments seeking IFI's direct lending, for example, had already decided to put plans on hold in May. The June events in the south will likely expand the number of cancelled investments. The episodes of looting in April already led to the cancellation of a number of Chinese and Turkish investments. There are also indications that the June events have further deterred potential new foreign direct investments.

Short-term stabilizing factors. Tariffs on electricity and heat energy for businesses and the population in general--which had been the focus of social discontentment early this year--have been restored to 2009 levels. At the same time, 2010 compensation measures remain in place. This has arguably helped to restore social stability, but it remains a potential source of social and economic policy problems in the near future that will need to be addressed structurally. Another mitigating factor has been the larger-than-expected gold extraction activity in the Kumtor mine, which are the main source of export revenue and an important component of the tax base. This helped support the balance of payments and public expenditure and avoid even worse macroeconomic shocks to business. Importantly, remittances are up from last year's level, as economies where many Kyrgyz nationals work recover from the 2009 slump. This will continue to support domestic consumption. Similar to 2009, investments in retail services are expected to continue benefiting (directly, through funding, and indirectly through positive effects on private consumption) from the ongoing recovery in remittances, which can always be promptly channeled to precautionary savings in the face of the current events.⁸⁹

Priorities

The Kyrgyz authorities have pursued institutional reforms to improve certain measurable aspects of the investment climate in the last few years, often with donor support (e.g., ADB, IFC, and EBRD). Some results in terms of published rankings have been achieved. The Kyrgyz Republic was considered one of the top 10 reformers in the 2010 World Bank "Doing Business Report," having improved its position in the ranking to 41 out of 183 countries. In other classifications, such as the World Economic Forum's Global Competitiveness Report, the country ranks 122 out

⁸⁸ The momentum in investment behavior during the first quarter of 2010 was indeed very strong.

⁸⁹ Even though there are reported cases of some projects funded by commercial banks being temporarily brought to a halt, this may not be representative of overall investment behavior at this stage. Banks fund only between 3-6 % of fixed capital formation in the Kyrgyz economy, whereas the vast majority of investments in the economy are funded by retained earnings (20-23%) and individuals savings (27-30%). Both these are likely to benefit in 2010 from the expected increase of 30% in remittances against 2009.

of 134 countries. Many of the institutional problems highlighted in opinion surveys - usually combined under the generic heading of investment climate (or business environment) and collapsed into indexes or rankings (for cross-country comparisons) in a more or less arbitrary manner--do differ substantially in nature (legal, regulatory, institutional) and in how they impact businesses. For these and other reasons, both the value of cross-country rankings, and the methodological approaches in use may be – and have indeed been – questioned.⁹⁰

Impact on Reform Focus and Momentum. Some specific long-standing problems do constrain economic growth and business investment, which also implies that within the broad heading of "investment climate," some problems are more relevant (or binding) than others. Unless those truly binding problems are prioritized by well-coordinated policy agendas, and effectively addressed, firms in the Kyrgyz Republic will not be able to cope, e.g., with the foreseeable changes in neighboring trade blocs (such as the soon-to-be established customs union, which leaves the Kyrgyz Republic out). The macroeconomic consequence of this would be below-potential, non-resource economic growth and employment generation. Going forward, it is important that the government and donors undertake a growth diagnostics approach to identifying the constraints that are binding on private sector expansion, rather than continuing to extend the already long list of problems. A long period of political transition will not help to meet that objective.

Business climate rankings have signaled improvements in the last two years. But there is a growing perception, recently highlighted by an IFC survey of businesses (See Box 2), that there is a wide gap between the legislative changes regularly announced to the business community and the actual implementation of reforms on the ground.⁹¹ The real investment climate and business environment is thus worse than the rankings indicate, and the resilience of businesses and their capacity to adjust to the current shocks less than expected. There is also a risk of a permanent loss of credibility in business climate reforms.

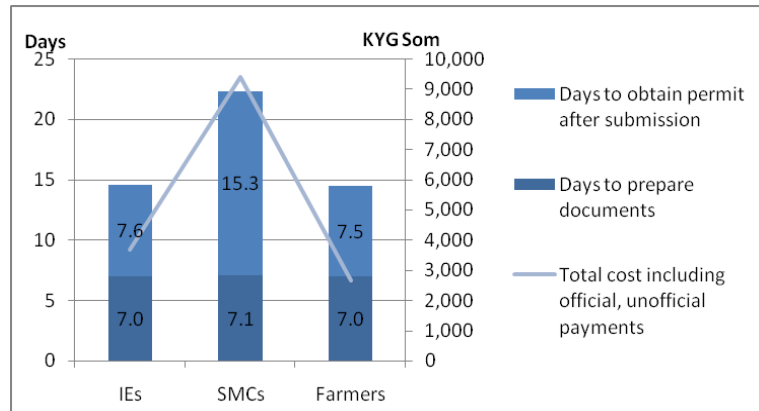
Box 2 – Kyrgyz Republic gradually improved quality of legislation, but enforcement remains problematic

Since 2007 the Government of the Kyrgyz Republic has made considerable steps to improve business-relevant legislation. The following laws have been adopted from 2007 through 2009: Inspections Law (2007), Tax Code (2008), Law on Registration of Legal Entities (2009). However, despite improvement of the regulatory framework, the practice of business administration in the country remains burdensome, especially for small- and medium businesses. Many legislative improvements have simply not been implemented properly.

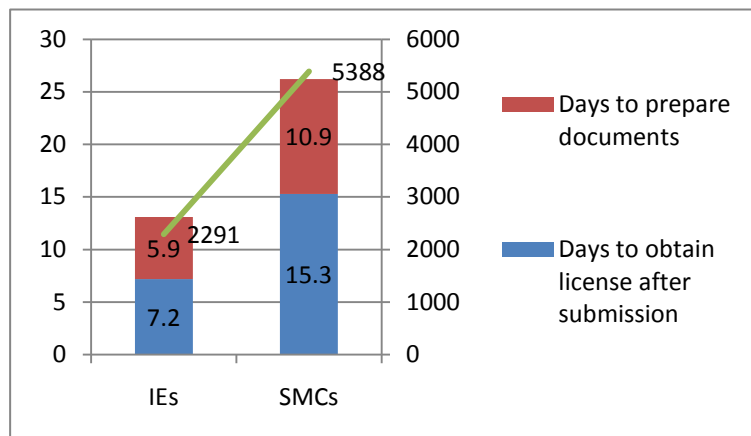
Business Registration: The 2009 Law on Registration of Legal Entities introduced the one-stop-shop principle in registration of business entities by combining registration at the State Registration Office with registration at the State Statistics Committee, the State Tax Service and the Social Fund. The law reduced the number of required documents and the time period for registration to three days. However, in practice, the provisions of the law are not enforced and registration of legal entities on average takes over 30 days.

⁹⁰ See: Hausmann, 2008. "High Bandwidth Development Policy", paper presented at Brookings Global Economy and Development Conference, May 29-30, 2008; Lin, J.Y and Monga, C., 2010. "Growth Identification and Facilitation", Policy Research Working Paper Series, no. 5313, Washington D.C., World Bank.

⁹¹ This may either be due to a lack of necessary implementation regulations or simply because of a lack of observance with newly introduced reforms.



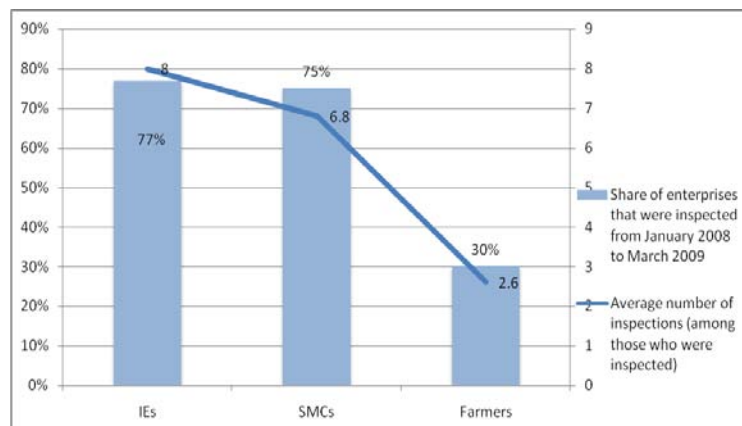
Licenses and Permits: Licenses and permit requirements remain quite widespread in the Kyrgyz Republic. Despite legal reforms directed at reduction of the number of licenses and permits, at present, about 25 percent of SMEs are required to have permits to conduct business operations and the average number of permits per business ranges from 1.5 to 3. Licenses are held by more than half of business in the SME sector. In May 2008, the one-stop shop and “silent is consent” principles were introduced for permits in the construction sector only. Even so, obtaining licensing and permits remain quite complex, lengthy, and represents a high-cost for business.



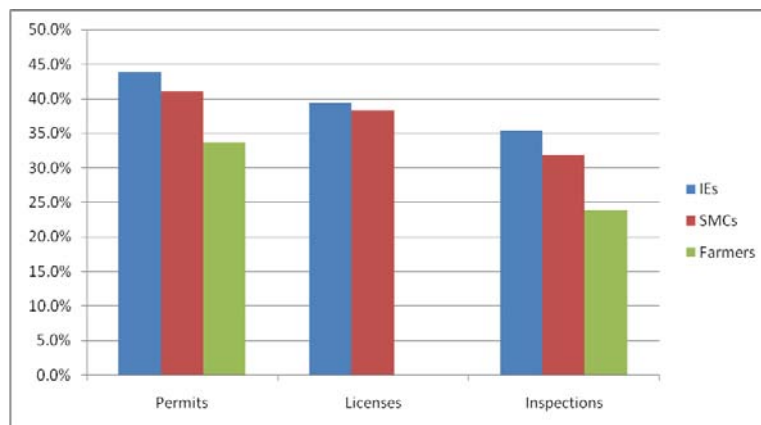
Tax Administration: The new Tax Code, which became effective on January 1, 2009, was designed to streamline the tax administration (for example, by reducing the number of taxes and introducing the concept of *tax contract*, which actually substantially reduces the burden of tax inspections) and to introduce modern taxation principles (risk-based tax management, the principle of good faith, and so on) as well as modern tax administration management with a view to reducing the tax burden on businesses while optimizing efficiency. Under the new Tax Code the number of taxes under general tax regime had been reduced from 15 to 8, what simplified the taxation system and reduced costs for the tax authorities. However, the compliance burden for businesses remains high, because of complicated tax reporting, excessive tax audits and other issues. Risk-based audit provided for by the Tax Code, has not been implemented in practice. The tax authorities claim using risk criteria while selecting businesses for audit, but in practice, selection is made based on subjective judgments of tax inspectors, rather based on formal methodology.

Inspections: The 2007 Inspections Law introduced additional procedural guarantees to protect the rights of businesses in the course of inspections. However, the law does not support a risk-based approach to inspections and as a result businesses remain unprotected against excessive and unreasonable inspections. IFC Investment Climate Survey results suggest that procedural violations are quite common during

inspections and a large share of inspections are conducted by inspectors illegally without proper authorization or registration. Over 75 small and medium-size companies and individual entrepreneurs are inspected in the Kyrgyz Republic. The share of inspected business and average number of inspections, which a business receives in one year, is higher than in many other countries of the region.



Unofficial practices (bribery) are quite common in state administration of business activities. About one-third of SMEs indicated involvement in unofficial practices to facilitate compliance with administrative procedures. The graphs below show the share of companies that admitted to have made unofficial payments in a recent IFC Survey:



Direct impact on ongoing reforms. In early 2010 many of the de jure reform processes under implementation for some time were at crucial stages of legal enactment. The political transition between constitutional frameworks underway will likely put these reform processes on hold for some time – especially if they involved creation of or changes to legal frameworks – effectively risking the loss of momentum in long-awaited reform agendas.

Immediately after the April events, and subsequent to the formation of the interim government, the business community and the Investment Council (a donor-supported organization to facilitate public-private dialogue on investment climate issues) realized the: (i) opportunity to propose urgent actions to stabilize the business situation, and (ii) the risks to ongoing reform processes from recent political changes. A time-bound road-map of objectives has been proposed, and approval by the interim government is at advanced stages. Parallel initiatives are likely to come

from other collective bodies (industry associations and professional bodies), as the opportunity to renew the impetus behind their reform agendas becomes clear to each stakeholder. Obviously, the possibility of crowding-out between competing reform requests can also arise in this process, and coordination will be of crucial importance.

The reported increase in international and domestic perceptions of corruption and expropriation risks in the country, which made international news throughout 2008-2009, have now been compounded by the unavoidable increase in uncertainty that political processes like the current one always impose. It is thus natural that investors consider of utmost urgency the stabilization of the economic situation, for example, by avoiding the lag in resolving property-related cases initiated by the General Prosecutor Office, and quickly wrapping-up the risk-mitigating measures taken in the banking system.

Development partner support. The damage to commercial establishments, business disruptions, and border closures arising from the April and June events resulted in losses to the private sector, particularly in tourism and retail trade. Displacement of people, lack of security and restriction to movement (e.g., imposition of curfews) in the south have further reduced consumer demand for goods and services. Taking into account the April events, the government estimates that retail trade, and hotel and restaurant sectors will contract by 7.9 percent, and 4.5 percent, respectively.

Tourism export receipts in 2009 were about \$445 million, 20 percent of which would be tourism-related retail sales. With the significant cancellations in tourist bookings, tourism export receipts for 2010 may fall as much as 60 percent. With this drastic drop in receipts, profits of tourist operators and retailers-linked to tourism will be drastically cut. There will be limited reinvestment of profits. The foregone profits that would have been used for reinvestment would be around \$20 million. As such, the private sector, particularly, the tourism and related retail trade establishments can have access to project financing and bridging facility from development partners, amounting to around \$20 million, to allow them to maintain and rehabilitate their establishments, and recoup foregone revenue in 2011, when more economic stability is achieved.⁹²

⁹² Economic losses incurred by the tourism sector, such as losses arising from foregone wages to workers, foregone revenue by suppliers and servicing of existing financial liabilities, is likely to be significantly higher than the estimated development partner financing support. Additional development partner support can be requested in the future.

ANNEX X: TAX AND CUSTOMS ADMINISTRATION

Introduction

This annex assesses the impact of the April 2010 events and the ethnic violence of June 2010 on the institutional capacities of the State Tax Service (STS) and the State Customs Service (SCS). The key findings are:

The April and June 2010 events have had no significant impact on tax and customs administration. The weaknesses of tax administration identified by the 2009 PEFA Assessment remain.

There are only two identified impacts on tax administration: (i) complete destruction by fire of the Pervomay Tax Office; and (ii) closure of the STS “special means” funds, which are being used for the roll-out of one-stop shops in tax offices.

Background

The STS employs 2,228 personnel, with 169 staff located in its central office. Departments include: taxpayers service, local tax methodology, taxpayer appeals, internal audit, organizational work and supervision, revenues, tax collection control and taxpayer registration and investigation, tax off-set and refund control, taxpayer audit, legal support, IT, personnel, administration, press service, and international cooperation. STS has 62 tax offices with total number of staff at 2,059. The largest tax offices in terms of personnel are Sverdlosky (132), Pervomaiskyi (126), Oktiabrsky (121), Leninsky (119), and Bishkek unit (63). There are ongoing tax administration and modernization programs in STS.

The SCS consists of central office and 40 customs posts, with total personnel of 1,275 staff, of which 158 are in the central office. Departments consist of: customs regulation, legal, financial, payments, IT, statistics, customs security, post-customs control, anti-smuggling and drug trafficking, investigation, personnel, administration, audit, inspection and monitoring, international cooperation, press service, and training center. The customs modernization program has been ongoing since 2002.

The 2009 PEFA Assessment pointed to the challenges facing the tax administration. Overall, tax administration is weak, and most PEFA indicators either remained the same or deteriorated in 2009 compared to 2005. Although there were improvements in the 2009 Tax Code, the PEFA Assessment found that transparency in taxpayer obligations and liabilities remain weak; In particular, the administration of some taxes, such as the new sales tax and non-standard exemptions on VAT, appears problematic. The tax appeals mechanism was also found to be cumbersome and time-consuming. The existing tax administration IT system is fragmented. There is also lack of integration with other systems, such as those used for business registration and the Social Fund. No risk-based approach to audits has been adopted. Finally, while the STS has indicated its commitment to collect tax arrears, it has so far been ineffective in doing so, and, in fact, the collection rate for tax arrears was rated lower in the 2009 PEFA Assessment than in 2005.

Sector Impact

Tax Administration. The April and June 2010 events had minimal impact on the institutional capacity of the STS. The staff complement remains generally intact. One of the STS deputy chairmen was designated as Acting Chairman, and this provides the institutional memory with respect to operations. Except for a deputy chairman and four heads of tax offices, senior management of STS was unchanged.⁹³ There were no changes in the Large Taxpayers Unit (LTU) which collects around 40 percent of tax revenue.

Operations of tax offices have not been disrupted, except for one rayon tax office which was affected by the April disturbance. The Pervomaiskiy Tax Office, the largest and most significant rayon tax office in the country and located in central Bishkek, was looted and completely burned down on 7 April. This office employed more than 120 staff that collect in excess of KGS 200 million each month. MER estimates the damage on office equipment (excluding the building)—is around \$124.7 thousand (KGS5.613 million). STS acted quickly to restore its operations. The tax office has been relocated in a nearby building and some limited resources have been redirected to this office from headquarters and other tax offices. Also, while all tax files were destroyed, the STS managed to recover taxpayer data stored on the office server's hard drive. This tax office was able to collect KGS 150,000 for April, which was not significantly lower than the monthly average. However, the tax office is far from being adequately equipped.

STS continues to conduct its mandated tasks, except for routine audits, which have been placed on hold pending introduction of risk-based audit selection procedures. However, audits relating to cases of tax evasion will continue. The April 2010 event caused IT problems in banks with respect to processing of tax payments, but this did not persist and was fixed by May.

Ongoing donor-supported reform programs being undertaken by the STS have not been reversed, and the new STS management has reaffirmed its commitment to pursue the reforms.

Customs Administration. All customs posts remain operational, and no physical damage was incurred during the April and June 2010 events. There have been no major changes in the SCS staff. Only two heads of border posts (out of 40) have been changed since the April 2010 events, but this was not related to such events. All operating procedures, systems, and organizational structure have remained the same. The designated Acting Chairman was formerly a deputy chairman, hence has institutional knowledge of the SCS. The modernization program, which started in 2002, will continue. The special means fund generated from customs receipts to support customs operations remains operational.

Priorities

STS will have to continue its tax administration modernization reforms to improve its efficiency and effectiveness. In particular, the roll-out of one-stop shops should be continued and complemented with improvements of the IT systems used for tax administration. This continues efforts to lessen contact between tax officials and taxpayers, which removes discretion among tax officials.

⁹³ Specifically, these are Bishkek, Osh, Leninskii, and Southern Inter-regional Office.

In 2010, the Russia-Kazakhstan-Belarus customs union is not likely to pose a significant risk to the country's international trade as existing customs procedures and tariffs are maintained, even with customs union in operation by July. However, as the customs union harmonizes its procedures and tariffs, it will pose risk to Kyrgyz international trade in 2011, and, subsequently will have implications on customs receipts and operations.

ANNEX XI: FINANCIAL SECTOR

This annex discusses issues related to banking stability and microfinance institutions. It provides a background of the banking sector prior to the crisis and a discussion of how the crisis has affected the banking system and its stability, the actions of the government and policy implications for the future.

Background (pre-April crisis)

Prior to the crisis, the Kyrgyz banking system comprised 22 commercial banks. There was significant foreign ownership; 10 banks were majority foreign-owned and they comprised around 60 percent of the system's assets and 66 percent of deposits. On the deposit side, the system was dominated by one large bank, Asia Universal Bank (AUB), foreign-owned at the time, which, as of April 2010, accounted for 23 percent of system deposits. State ownership in the banking system was low, with state-owned banks (Savings and Settlement Company and Aiyl Bank) accounting for 14 percent of assets and 11 percent of deposits in May 2010. The top five banks together accounted for 55 percent of total system assets. The banking system has offered low level of financial intermediation, with loans and deposits accounting for 12 percent of GDP.

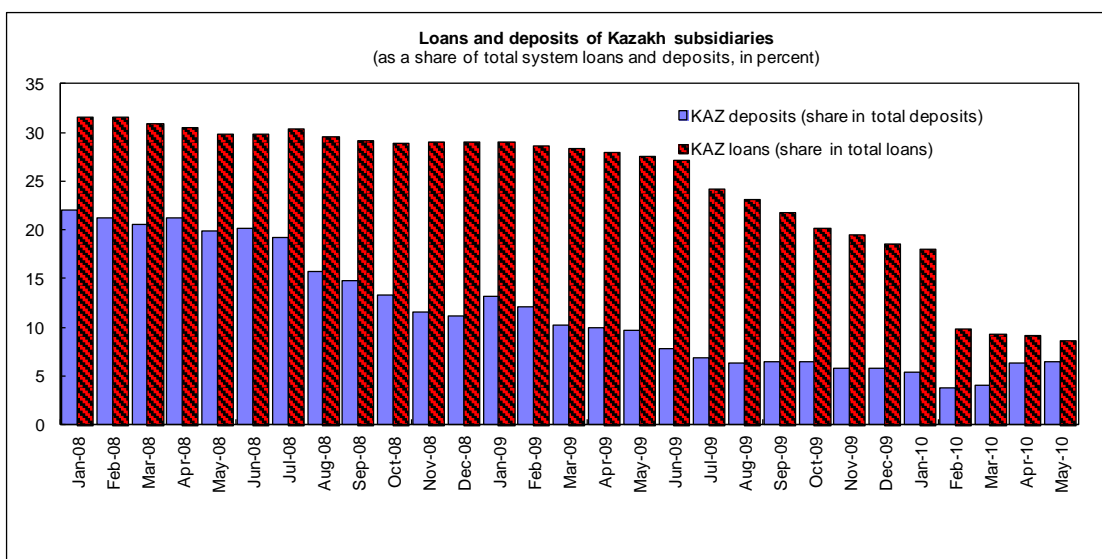
Table: Structure of the Kyrgyz banking system

	Assets		Deposits		Loans	
	Dec-09	May-10	Dec-09	May-10	Dec-09	May-10
	(in percent of all banks)					
Foreign-owned banks 1/	74	59	79	66	68	58
Kazakh banks	14	9	6	6	19	9
State-owned banks	8	14	4	11	13	14
All banks						
in percent of GDP	35	27	17	12	13	12
in millions of U.S. dollars	1542	1182	752	518	570	552

Source: NBKR

1/ Includes AUB

The Kyrgyz banking system went through a significant transformation over the past two years in terms of its exposure to foreign banks—through the significant reduction of Kazakh ownership in the banking system. At the beginning of 2008, Kazakh banks accounted for more than 30 percent of loans and more than 20 percent of deposits. By May 2010 this share had dropped to less than 10 percent for both deposits and loans. Two subsidiaries were sold to local buyers.



On the eve of the April crisis, financial soundness indicators had begun to show gradual improvement, as the Kyrgyz economy began to recover from the 2008-09 global crisis. The banking system showed large liquidity and capital buffers, a moderate level of non-performing loans (NPLs)—below 10 percent, though also a high level of dollarization. The deposit insurance fund reached its target capitalization of KGS 340 million by end 2009. Funding was initially contributed by the government, and was to be reimbursed gradually by commercial banks.

Impacts of the Crisis

Financial stability has been adversely affected by the crisis as the April and June events have taken a significant toll on the financial sector. Loan quality has worsened—the non-performing loan ratio has risen from 8 percent before April to 11 percent by end-May. The deterioration in loan quality is mainly concentrated in trade and commerce—and is expected to continue as the economy contracts later this year. The deterioration in loan quality has also affected profitability (see below). The business confidence effects of the continued political uncertainty suggest that credit growth this year will be weak.

Kyrgyz Republic: Selected Financial Indicators
(In percent, unless otherwise indicated)

	31-Dec-08	30-Jun-09	30-Sep-09	31-Dec-09	31-Mar-10	30-Apr-10	31-May-10
Capital adequacy							
Net total capital/risk-weighted assets	32.6%	27.5%	29.4%	33.5%	31.7%	35.3%	27.3%
Liquidity							
Liquidity ratio	82.0%	82.8%	85.3%	86.8%	86.7%	90.8%	85.1%
Excess reserves/total reserves	30.4%	25.7%	25.3%	33.2%	15.8%	39.7%	45.2%
Asset quality							
Nonperforming loans/total loans	5.3%	8.7%	9.2%	8.2%	7.9%	9.4%	11.2%
Loan-loss provisioning/nonperforming loans	55.9%	52.8%	56.5%	58.4%	57.5%	53.0%	51.3%
Profitability							
Return on equity	20.7%	13.2%	13.2%	13.6%	12.5%	10.3%	-52.7%
Return on assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	-10.0%
Loans and deposits							
Loans/deposits	110.2%	97.2%	86.5%	75.7%	70.8%	108.5%	106.6%
Loans/total assets	46.6%	39.0%	36.2%	36.9%	36.4%	45.2%	46.7%
Foreign currency exposure							
Share of foreign currency deposits in total deposits	63.6%	67.6%	70.4%	68.3%	68.5%	54.0%	54.5%
Share of foreign currency loans in total loans	64.7%	64.0%	63.3%	62.3%	59.1%	59.1%	58.2%

Source: National Bank of the Kyrgyz Republic

Whilst most banks appear sufficiently liquid and capitalized, there have been problems at some banks, including Asia Universal Bank (AUB)—the largest, with over 20 percent of system deposits. NBKR introduced temporary administration in AUB and 6 other banks (later reduced to four) after AUB saw a significant non-resident deposit outflow, allegedly linked to the previous regime (see Box). The banks are undergoing audits. The authorities are developing action plans accordingly—these could involve a change in management, and/or capital injections, if necessary.

Box: NBKR's actions to preserve systemic stability in the immediate aftermath of the April crisis

Following the large outflow of non-resident deposits, the NBKR took seven banks (accounting for 45 percent of the system's assets) under temporary administration (TA). Board and management authority was suspended. The authorities' motivation was as follows: "Due to the volatile situation in the Kyrgyz Republic, and in order to control the movement of capital and preservation of assets for the benefit of depositors and other creditors of banks, given the systemic importance and interconnectedness, as well as the facts of a robbery and the threat of robbery."

The NBKR also imposed direct supervision—a less restrictive form of supervision than TA—in 10 banks, and issued instructions to senior officials of 3 additional banks.

Since that period, the NBKR has lifted the TA of two banks and loosened the range of allowed transactions in the banks under TA. After a gradual loosening of restrictions, including on the withdrawal of deposits, on April 19 the NBKR allowed regular transactions at these banks, prohibited them from extending new credit (rollovers only), and disallowed investments in debt and equity (except for government securities). Specific restrictions remain on two banks with respect to transactions with nonresidents, and insiders and affiliates. TA of two other small banks has been lifted, though they remain under direct supervision. Restrictions remain on transactions with insiders, affiliates, and persons for which relevant decisions of law enforcement agencies exist. Further actions were taken regarding AUB (see below).

Box: Impact of the June crisis: results from EBRD interviews of banks

The five interviewed banks (which have significant portfolio in the southern region) reported damages on some of their branch buildings and equipment and lootings on several ATMs although the level of overall loss is insignificant.

All interviewed banks reported a material hike in delinquencies. These banks have launched impact assessment missions of their own (which are still ongoing) and categorized the impact of events on their borrowers along the following lines:

- Borrowers killed;
- Collateral and/or businesses destroyed;
- Borrowers on which no data is available (borrower is missing);
- Businesses exist, but significantly decreased turnover; and
- Unaffected borrowers.

Depending on each case the banks have prepared several restructuring options for their borrowers. They include:

- Introduction of the grace period up to 12 months, combined with zero accrual of interest and penalty fees during the grace period for the most affected borrowers;
- Extension of the loan tenor for the period of 2-18 months;
- Reduction of interest rates by 2-4 per cent; and
- Rescheduling of repayments.

The impact on overall portfolio quality varies from bank to bank because of the difference in the level of exposure to southern regions with the highest exposure of 55 per cent of the gross loan portfolio for one bank. The most affected sectors reported are trade and services, concentrated in Osh and Jalal-Abad cities. The level of affected borrowers ranges from 8 per cent to 52 per cent of their loan portfolio in the southern regions. In the most affected bank, the borrowers with collateral and/or business destroyed accounted for 31 per cent of the total number of borrowers in these regions or, 45 per cent of its total gross loan portfolio in the south.

All banks suspended lending activities in the affected regions and most of them reported significant slowdown of the economic activity in the south.

All banks have significantly increased provisioning in June and as per interviewed banks estimates, their capital base enables them to absorb the damage.

The June events have also impacted the banks' lending activities in the north of the country. One of the banks expressed serious concerns on the repayment capacity of their clients, operating in tourism sector in Issyk-Kul region, known tourist destination mostly serving Kazakh and Russian tourists. The tourist season has been seriously hit amid concerns of security, which is expected to have a significant negative impact on the population of the region that sources the majority of its annual income from servicing tourists during the two summer months (July and August).

Generally, all banks report significant slowdown of the economic activity in country and they expect loan portfolio deterioration for all regions of the country. Borders with Kazakhstan remain closed for most of the products, which negatively affect export-oriented sectors, e.g. textiles. The assessment of the impact of the June events by banks is still on-going and delinquency and provisioning levels are expected to rise in the next few months. There may also be a lag in the effects of the April/June events on some regions in the north (e.g., Issyk-Kul region) therefore, delinquency could rise in coming months in the northern branches as well.

None of the interviewed banks has reported any significant deposit runs and most of them reported excess liquidity.

The effects on AUB

AUB has been seriously affected by the crisis and since it is a systemically important bank, this raises important issues for financial stability. A large portion of the bank's loan portfolio has been affected by connected and insider lending, and loan quality has deteriorated, particularly following the events in the south where the bank has significant exposure. A sizable portion of its liquid assets placed with asset management companies prior to the crisis may not be recoverable.

With the bank facing liquidity problems, the authorities took action to safeguard the assets of the bank and protect the interest of depositors and creditors. On June 4, 2010 temporary administration in AUB was terminated and conservatorship was introduced in the interest of protecting depositors and creditors of the bank. The bank was subsequently nationalized. Operations have been restricted, including (i) deposits from individuals will not be accepted, and (ii) transactions of legal entities will be restricted to a limited type of transactions, including salary-related payments, social fund payments and AUB loan repayments. The situation has been further complicated by a recent court decision to hand over AUB assets that were acquired from Kyrgyz Promstroi Bank in 2007, back to original owners. This decision is now under consideration in the courts.

The authorities are considering a number of options for resolving the bank. These could include (i) outright bankruptcy and liquidation; (ii) rehabilitation and sale and; (iii) restructuring through purchase and assumption—a good bank, bad bank solution or; (iv) sale to a foreign buyer. In considering these options, the authorities are cognizant of the systemic implications, fiscal costs and the need for the system to recover quickly and start providing an impetus to growth again.

Legal complications will also likely result in a lengthy process to resolve disputes on assets. While the legal pursuit of criminal activity is warranted, the Prosecutor Office's arrest of assets and properties of those associated with the previous regime has complicated the situation of many banks. Assets of around 150 legal bodies have been seized and over 300 physical persons have been arrested. These arrests also affected the shareholders and clients of many of these banks. In addition, there are reports that some properties, pledged as collateral for some of the bank loans, have been seized, and the possibility of their recovery is uncertain. The arrest on the assets of AUB was released in mid July.

Plans for the remaining banks under TA will depend on an ongoing assessment of their balance sheets. Large Social Fund and Development Fund deposits in some of these banks are also a complication, as their sudden withdrawal could complicate liquidity management at the banks. Indeed, such movements have caused difficulties in the past. The authorities are negotiating an inter-agency agreement on how to address this challenge.

Priorities:

- How to handle AUB in a manner that minimizes the impact on financial stability and public finances;

- How to exit from the remaining banks under temporary administration;
- How to manage the large government deposits;
- The legal complications from arrests on assets and property by the Prosecutor’s Office, and other court cases.

Microfinance

Introduction

Microfinance organizations (MFOs) have played an increasingly important role in providing credit to the private sector in the Kyrgyz Republic. In recent years, MFOs have grown in number and expanded their operations. By the end of 2009, there were 360 MFOs (including 4 microfinance companies, 237 microcredit companies, and 128 microfinance agencies (see Table 1).

Table 1. Number of MFOs, end of year

	2004	2005	2006	2007	2008	2009*
Microfinance organizations	75	106	147	232	291	360
<i>of which:</i>						
microcredit companies	21	35	57	103	170	237
microcredit agencies	54	71	89	127	119	128
micro-finance companies	-	-	1	2	2	4

Source: NBKR

* As of May 2010, there were 369 MFOs.

MFOs are the fastest growing segment of the financial system. With a combined loan portfolio of KGS 7.9 billion at the end of 2009, they account for 23 percent of all credit provided by the financial system. MFO lending increased from 1.5 percent of GDP in 2005 to 4 percent of GDP in 2009, and the number of borrowers increased from 42,000 in 2004 to 306,391 at end-2009. At that time MFO loans in the country averaged KGS 26,070, and average lending interest rates were 34.5 percent. Loan performance has been strong, with classified loans falling from 3.7 percent of the credit portfolio in 2006 to 2.9 percent in 2009.

The microfinance sector is concentrated in the three largest entities: FINCA, Bai Tushum, and Kompanion. These three accounted for 75 percent of the loan portfolio of MFOs at end 2009. All three have hopes of obtaining a deposit-taking MFO license, or even a bank license, in 2011. Among the 369 MFOs, many are effectively non-operational but not officially closed because of the difficulty in formally closing a business in the Kyrgyz Republic.

MFOs have been successful in expanding credit to rural areas. They are primarily concentrated in financing agriculture (41 percent) and trade (35 percent). Figure 1 presents MFO lending by sector and oblast.

Credit unions account for a small share of credit to the private sector. There were 231 credit unions as of April 2010, operating in all regions of the country, about 80 percent in the rural areas. With total lending of KGS 959 million at end-2009, credit unions provide 2.8 percent of total financial sector credit. They provide larger loans and slightly lower interest rates (29.6 percent) than MFOs. The average loan size averaged KGS 52,469. As of end-2009, the bulk of their credit (50 percent) was allocated to agriculture, with 33 percent to trade and commerce. The number of borrowers decreased from 22,000 in 2004 to 18,274 at the end of 2009. Figure 2 presents credit union lending by sector and oblast. Credit unions currently lack the governance and operational skills to manage larger credit portfolios, although they maintain strong performance, with only 2.7 percent of loans classified at the end of 2009. In late 2009, a decision was taken to transfer the Financial Company for Support and Development of the Credit Unions (FCSDCU) -- which is the primary funding source for credit unions and is currently owned by NBKR-- to the Development Fund. This was intended to provide FCSDCU with additional equity and funding for its onlending operations; however, this transfer did not take place before the events of April 2010 occurred.

In March 2010, parliament passed amendments to the Microfinance Law. If signed into the law by the president, the amendments would authorize the four microfinance companies, but not other MFOs, to lend in foreign currency. In late 2009 and early 2010, parliament also debated the merits of imposing interest rate ceilings on microfinance loans, as some members of parliament were concerned about high microfinance interest rates. Ultimately, parliament passed an amendment authorizing NBKR to impose interest rates ceilings in the case of monopolistic behavior by MFOs. These and other amendments to the Microfinance Law are in limbo as they were not signed into law before April 7.

Sector Impact

Impact of April and May events. The impact of the events of April and May 2010 on MFO and credit union lending has mostly been small or temporary. Some MFOs and credit unions had accounts in banks that were placed under temporary administration and therefore did not have access to these accounts for 7 to 10 days in April. Moreover, collateral registries were not operating for about three weeks in April, so MFOs and credit unions were unable to register borrower collateral. One MFO was the victim of an apparent arson attack on May 5, although it is unclear whether this was linked to the political events. Another MFO reported that some branch offices suffered minor damage during the disturbances. Some of the smaller MFOs operating in the southern regions were affected because of greater operational security risks for clients and staff. For these reasons, some MFOs reduced lending by as much as 30% compared to their targets for April and May.

Most MFOs, however, reported that their overall lending volume was unaffected, or that there was only a temporary slowdown in lending. Hard data are available only on four large MFOs. Total disbursements by these MFOs actually increased in April 2010 by 24 percent over the

previous year; and outstanding loan volumes at the end of April 2010 were 20 percent higher than end April 2009.⁹⁴ In four large MFOs, disbursements were available for the first five months of 2010.

As shown in Figure 3, on a consolidated basis, these MFOs continued to increase their lending in April despite the disturbances; in fact, each MFO increased its lending in April compared to the earlier months of the year. Still, based on interviews with the MFOs, this increase was somewhat lower than targeted. However, normal lending has largely resumed, and the effects of the slowdown in lending are considered minimal for most MFOs.⁹⁵ The exception is the smaller MFOs operating in the south, which experienced a proportionally larger disruption and have not fully recovered. In May though, the consolidated disbursements have fallen by 7.6 percent.

The impact on loan recovery in April-May has been small but was expected to grow slightly in the following few months. Most MFOs and credit unions reported that their portfolio at risk (PAR) has not changed or increased only slightly based on end-April and end-May data. For the four large MFOs for which there is data, classified loans increased to 1.66 percent of the loan portfolio at the end of April 2010, compared to 1.44 percent at the end of April 2009 and 1.62 percent at the end of March 2010 (see Figure 4). Provisioning levels have not increased in April-May, as MFOs already have adequate provisions per NBKR regulations. Some of the increase in PAR is of a technical nature, i.e., due to the security situation and the temporary closure of bank branches some borrowers were not able to visit branches to make their payments. As a result, PAR for some smaller MFOs increased by as much as 10 percent in mid April; however, they have largely recovered, and PAR has fallen below 5 percent. In May, MFOs have reported increased collection of delinquent loans. Some borrowers requested to repay their loans early, as they were unable to resume normal business operations. A few clients were affected by looting or other damage to assets, and some restructuring of loans has occurred (generally delaying a few early payments, but maintaining the same overall tenor of the loan).⁹⁶ Some MFOs report mild concerns that PAR may increase few percentage points in the next few months because some borrowers, especially traders, were adversely affected by border closings--which temporarily cut off export markets and lowered the price of agricultural output inside of the Kyrgyz Republic.

In April-May MFOs reported that their funding sources remained solid and reliable. One MFO, however, reported that international creditors had increased interest rates by just over 1 percent because of higher perceived risks in lending to Kyrgyz MFOs. Another MFO's main shareholder delayed disbursement to the MFO in April because of the increased risks and political uncertainty.

⁹⁴ Disbursements of four of the five MFOs increased in April 2010 compared to April 2009; one MFO's disbursements decreased by 10 percent. However, the portfolios of all five were larger at the end of April 2010 compared to April 2009.

⁹⁵ Indeed, one MFO reported exceeding its lending targets in April, since it gained clients of AUB Agro after the latter's closure.

⁹⁶ A couple of MFOs reported that a borrower had been killed. In at least one of these cases, the MFO wrote off the loan, incurring a small loss of a few hundred dollars.

Liquidity in local currency has significantly tightened. MFOs are allowed to lend only in KGS, but most of their funding comes in USD.⁹⁷ To obtain KGS, MFOs typically engage in swaps or back-to-back loans with local banks. However, AUB was the largest source of these operations, accounting for about 80 percent of the market and charging a spread of 4.5 percent.⁹⁸ With AUB's operations suspended, MFOs have limited options to obtain local currency. KGS liquidity in other banks has tightened since April, as interest rates on government T-bills have risen and as the government intervened in FX markets to maintain the strength of the local currency. Hence, other banks' swaps and back-to-back loans are more expensive (spreads of 7 to 9 percent) and have shorter tenors. Uncertainty about AUB reopening raises the question about whether MFOs will be able to obtain local currency in future. However, for the time being, AUB has agreed to roll over current swap and back-to-back loan arrangements, thus temporarily providing MFOs with KGS liquidity. However, AUB is not conducting new swaps or back-to-back loans.

MFOs have approached NBKR to address their liquidity needs, and NBKR is considering two options. Option 1 would be for NBKR to do swaps directly with MFOs. MFOs have proposed a spread of 4.5 percent (the same spread charged by AUB); NBKR, in turn, has suggested that it provide KGS funding to MFOs at 7 percent, but with the restriction that MFOs onlend at no more than 17 percent. This is not attractive to MFOs, as their operational costs are significantly higher. Option 2 would be for NBKR to do swaps with banks, which in turn would do swaps with MFOs, with an additional mark-up.

Impact of June events. The impact of the June events in the southern cities of Osh and Jalalabad has been much more severe compared to the April events. Virtually all lending has been suspended in the affected regions, and all MFOs reported a material spike in delinquencies. Overall disbursements in June contracted by close to 24 percent from the previous month. Major MFOs have launched impact assessment missions of their own (which are still ongoing) and categorized the impact of events on their borrowers along the following lines:

- Borrower and/or member of household killed or seriously injured
- Homes and/or businesses burnt/destroyed
- Homes and/or businesses robbed
- Borrowers on which no data is available (borrower is missing)
- Businesses exist, but no turnover or temporary close downs (due to security situation)
- Unaffected borrowers

⁹⁷ FCSDCU's initial funding from ADB came in KGS from MOF, and it continues to rely on its internal funding, rather than relying on foreign credit lines. Its liquidity was not affected by the events of April.

⁹⁸ As of May 1, MFOs had foreign-denominated borrowings of US\$134.8 million, of which US\$104 million was used for swaps or back-to-back loans.

Based on preliminary data, on average 12-15 percent of borrowers have been seriously affected with their homes or businesses robbed or destroyed; another 15 percent of borrowers reported temporary suspension of business due to the security situation and trade disruptions. Information on around 20-50 percent of borrowers is not available due to missing borrower. About 20-25 percent of borrowers in the south are reported not to be affected in the events.

The June events have also impacted some branches in the North. Some MFOs reported decreased disbursements and increased delinquencies in Issyk-Kul region, a known tourist destination mostly serving Kazakh tourists from Almaty. The tourist season has been seriously hit amid concerns of security, which is expected to have a significant negative impact on the population of the region that sourced the majority of its annual income from servicing tourists during two summer months.

The impact on overall portfolio quality varied from MFO to MFO due to varying exposure to southern regions. On a consolidated basis, close to 37 percent of the total portfolios of the four largest MFOs was allocated in the affected southern regions, with consolidated classified loans in these regions reaching 15.2 percent. Their consolidated classified loans throughout the country rose in June by over USD 6.1 million, reaching 5.9 percent of the consolidated gross loan portfolio compared to 1.6 percent as of end-May.

Based on preliminary results of the MFOs' own assessments (which are expected to be finalized by the end of July) MFOs have prepared restructuring plans for their borrowers. Most of MFOs allowed seriously affected borrowers to postpone their repayments for two-three months (one MFO still requires monthly payments but decreased the interest rate significantly; this has been done to be able to maintain contact with the borrower on a monthly basis).

Direct losses suffered by MFOs due to the death of a borrower did not exceed ten cases (based on the preliminary assessments). Due to the low average loan size at MFOs, the outstanding balances from such cases comprise less than 0.1 percent of the consolidated total portfolio of the largest four MFOs. Overall, the four largest MFOs estimate losses from the June events to reach approximately USD 3 million under a worst case scenario, which accounts for about 7 percent of the consolidated capital of these MFOs as of end-March 2010.⁹⁹ Generally, however, per the MFOs' estimates, the current year's projected profits would be sufficient to cover losses from the June events. All four MFOs increased the level of provisioning in June; however, since they historically maintained quite high levels of loan loss reserves, this spike did not have a significant impact on capital -- the combined loan loss reserves amounted to 3.4 percent of the consolidated portfolio of the four largest MFOs at end-June. Further increases in provisioning are expected in the following two-three months. Still, only one of the four MFOs reported the possible need for additional capitalization under the worst case scenario assumptions in their stress testing analysis.

One of the negative effects of the June events is a lack of funding since most traditional funders (international microfinance funds) have downgraded their country ratings for Kyrgyzstan and

⁹⁹ The total capital figure for one of the MFOs was as of end-May due to a significant capital increase that was recorded in Q2 2010.

decided to postpone planned loans to MFOs until at least November (after the planned parliament elections in October). This threatens to slow or even suspend new lending by MFOs since external funding is the major source of funding for them. Some of the MFOs have significant scheduled repayments in the next two-three months and will have to restrict loan growth and use customer repayments to make their own payments. MFOs have not yet applied for any restructuring of their debts and the management of the major four MFOs do not expect the need for such restructuring at the moment.

Another important issue that was already mentioned above is the lack of viable FX hedging instruments. AUB remains the main source for swaps and back-to-back arrangements in the local market – major MFOs reported a total of USD 60 million in swaps and back-to-backs with AUB. In a recent development, MFOs are no longer allowed to withdraw their funds from AUB since the conservation of the bank has been introduced in June. MFOs' swaps and back-to-backs with AUB are rolled over with the same terms and exchange rates fixed as of the original transaction dates before the April events. Therefore, with continued depreciation of Kyrgyz som, there is an increasing uncovered gap between som MFOs are holding and equivalent FX at AUB. This gap is estimated currently at USD 5-6 million (currently not provisioned by MFOs), which in case of AUB bankruptcy may wipe another 13-14% off of the MFOs' capital, which, combined with the effect of expected losses from southern branches may have a much more material negative impact on the MFOs' sustainability.

As noted above, amendments to the Microfinance Law were passed by parliament in March, but were not signed into law before the president fled the country in April. In addition, NBKR recently issued two new microfinance regulations. One of them changes the way in which the capital adequacy ratio (CAR) for deposit-taking MFCs is calculated. Minimum CAR has been reduced from 18 percent to 8 percent, and these MFCs may subtract deposits used for hedging in banks from the asset base.¹⁰⁰ The second regulation reduces provisioning requirements for MFO loans that are secured with a group guarantee, recognizing such guarantees as similar to physical collateral.¹⁰¹ Both are viewed favorably by MFOs. After the June 27 referendum in the country it is expected that the president will sign the new Microfinance Law into effect.

Some MFOs say they have received several visits from various investigative bodies. While no MFOs appear to be implicated in any wrongdoing, some have had to devote considerable management and staff time in receiving investigators in their institutions and responding to their requests. Some MFOs have been closed for short periods during these investigations.

Some MFOs suggested that the overall environment for their business is safer now than before. Prior to the events of April, some MFOs felt threatened by the market growth of AUB and AUB-

¹⁰⁰ Assets in this calculation remain gross (i.e., do not carry risk weights). Since there are currently no deposit-taking MFCs, however, this regulation does not have any direct impact for now.

¹⁰¹ Neither regulation is effective yet, as both still need to be registered at the Ministry of Justice.

Agro, which were perceived as benefiting from favoritism by the previous authorities. They indicated their expectation of a level playing field in future.

Priorities

MFOs and credit unions, like all businesses, need stability and security to operate. Since all operate through commercial bank accounts, bank closures or suspended operations restrict their ability to function and serve their clients. Civil disturbances and risks of violence prevent clients from engaging in their normal economic activities and prevent MFO and credit union staff from disbursing and collecting loans. Similarly, open borders are essential for traders, who represent more than 30 percent of microfinance clients. Re-establishing and maintaining stability and security are critical pre-requisites for a healthy microfinance sector and economy.

The assessment of the impact of the June events by MFOs is still on-going and delinquency and provisioning levels are expected to rise in the next few months. There also may be a lag in the effects of the April/June events on some regions in the North (e.g., Issyk-Kul region), so delinquency could rise in coming months in the northern branches as well. MFOs and credit unions will need to remain vigilant in monitoring their performance and prudently perform restructurings to ensure minimal defaults.

KGS liquidity will likely remain tight in the coming months, which could limit MFO operations and increase their costs. This is irrevocably linked to the issue of currency risk. MFOs in the Kyrgyz Republic hedge this risk by swaps or back-to-back loans with banks, which are in a better position to bear the currency risk. With AUB's operations suspended, the authorities may need to provide a temporary facility to ensure access to KGS at market interest rates while undertaking appropriate policies to promote the resumption of swaps from commercial banks. The pending Microfinance Law amendments would allow the four microfinance companies (which represent over 50 percent of the market) to lend in foreign currency. However, such lending will pass the currency risk to the borrower, who may be in a worse position to manage this risk than the MFO. In the long term, local currency liquidity facilities and/or derivatives markets (including swaps), as well as deposit taking by qualified MFOs (including transformation into banks for some), may provide the best alternative to MFOs' KGS liquidity needs.

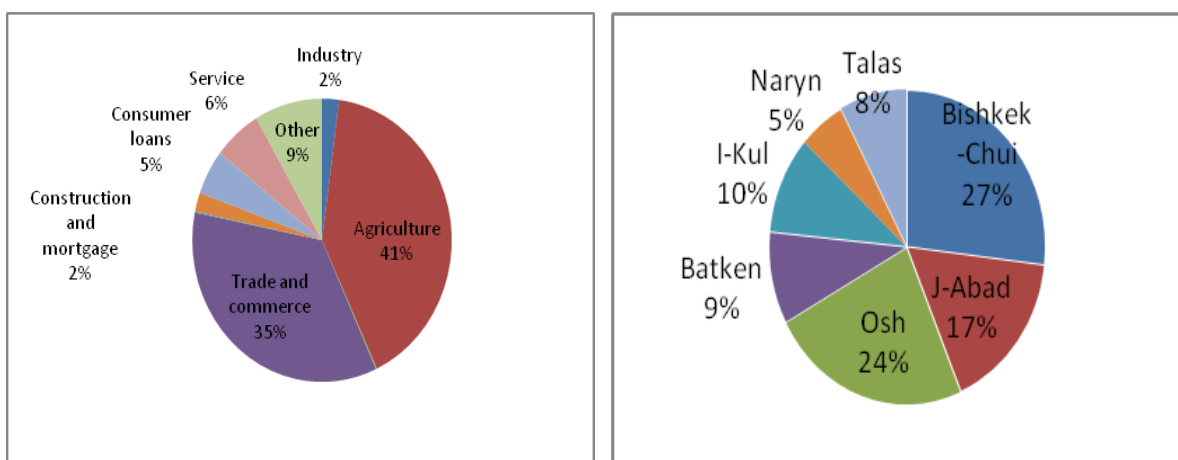
Reaffirming the principle of market-based operations and interest rates in microfinance is essential. Some politicians, members of the IG, and NBKR have made statements criticizing MFOs for high interest rates. Some are reviving the idea of capping interest rates. MFOs are concerned that such caps would distort loan allocations to less efficient uses and jeopardize their sustainability and the availability of foreign credit lines. Most foreign creditors will lend only to MFOs that operate on market principles and are sustainable. The Kyrgyz microfinance sector has been among the most successful in the world largely because it has followed market principles. A reaffirmation of such policies would contribute to continued access to finance for the Kyrgyz population. This may be especially important as MFO costs may increase in the short run as KGS liquidity dries up and swaps become more expensive. To the extent that there are concerns about

unscrupulous microfinance lenders, the authorities could review and strengthen the consumer protection regime in the sector, as well as consider fit-and-proper tests for MFO owners and managers.¹⁰²

A strategy to strengthen governance in credit unions and FCSDCU, including privatization of FCSDCU, will help realize the potential of credit unions in the Kyrgyz Republic. Credit unions continue to suffer from poor governance. NBKR's ownership of FCSDCU greatly limits its access to resources. A commitment to, and strategy for, privatization of FCSDCU is needed to ensure the safe, sound growth of credit unions so they can fulfill their potential to increase access to financial services in rural areas.

Subsidies channeled through Aiyl Bank will need to be done in a way that does not distort the interest rate policy of Aiyl Bank or the financial sector as a whole. While the closure of AUB-Agro is viewed positively by most market participants, Aiyl Bank's access to subsidized credit lines and plans to extend loans at 12 percent interest rates are also being viewed with concern. This has reduced demand for MFO loans, as some clients are waiting for Aiyl Bank loans. The authorities will need to monitor the effect of Aiyl Bank's loans on the market and ensure that it remains independent in setting its interest rates to ensure that the competitive microfinance market that has developed over many years is not undermined. A reaffirmation of the government's commitment to privatize Aiyl Bank through a strategic investor may be useful to reassure the market.

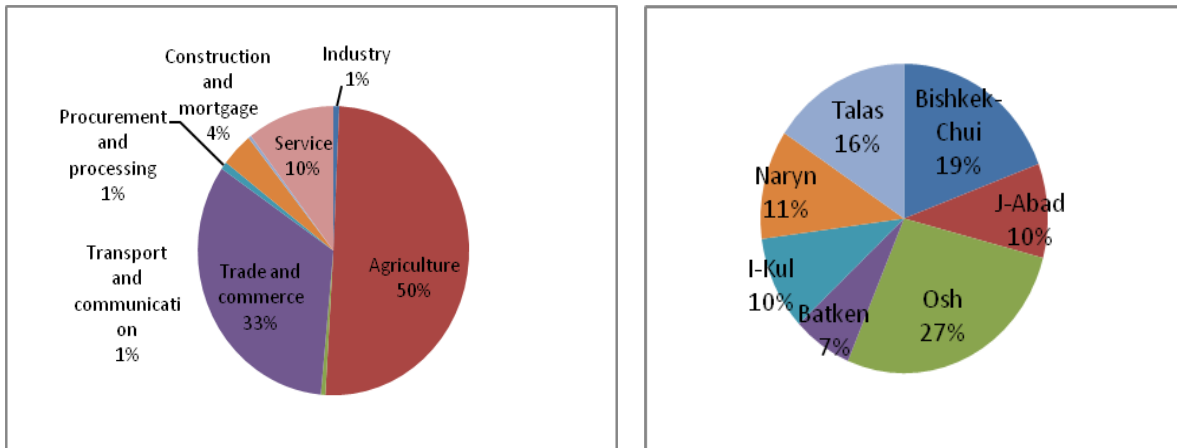
Figure 1. MFO Credit Portfolio by Sector and Oblast, end 2009



Source: NBKR

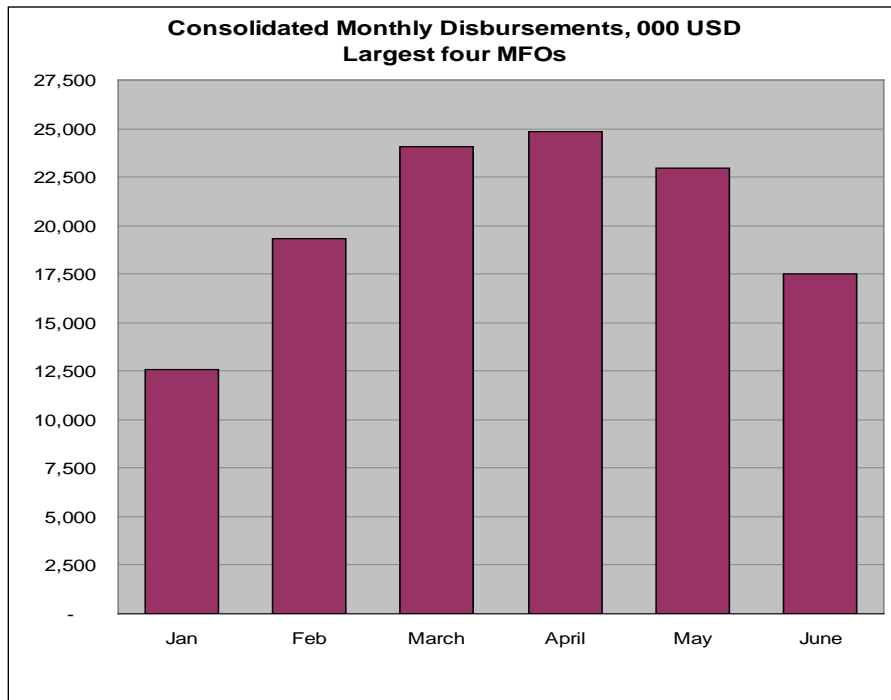
¹⁰² The Association of Microfinance Organizations of the Kyrgyz Republic, which includes 31 MFOs representing over 90 percent of the market, adopted a code of conduct in March 2010, so some self-regulation is taking place.

Figure 2. Loan Portfolio of Credit Unions by Sector and Oblast, 2009



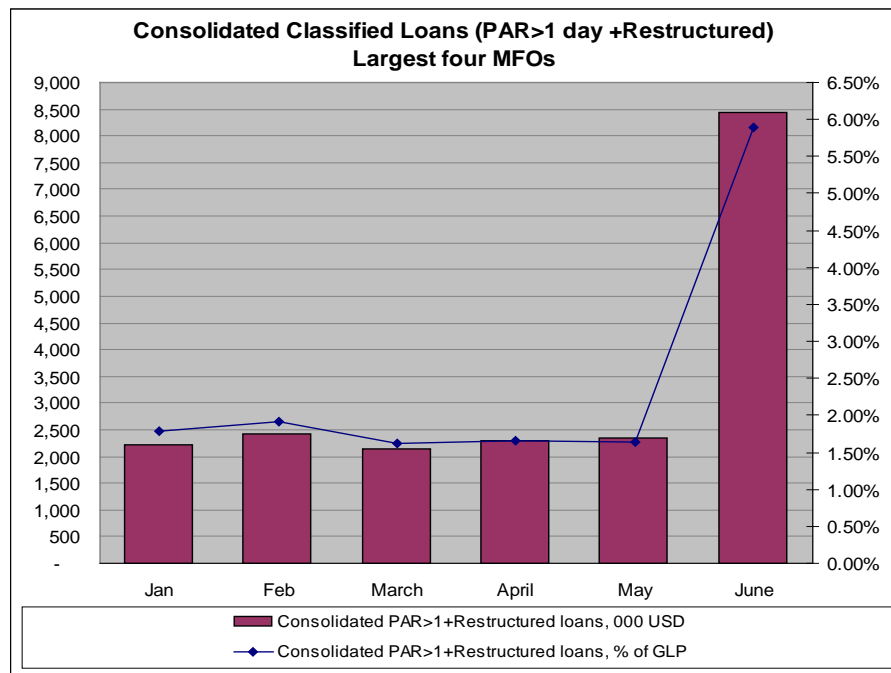
Source: NBKR

Figure 3. Consolidated Monthly Disbursements by Largest Four MFOs



Source: JEA calculations

Figure 4. Consolidated Classified Loans, Largest Four MFOs



Source: JEA calculations

ANNEX XII: AGRICULTURE

This annex provides an assessment of the impact of the early political crisis following the events of April 6th 2010, and the ethnic violence in Southern Kyrgyzstan from after June 10th, on the agricultural sector output, and suggests short term (to December 31st 2010), medium term (to June 30th 2012) and long term measures (to June 30th 2014) to address the immediate shock to farm incomes and regenerate the rural economy. It also considers the costs of damage from mudslides in Southern Kyrgyzstan in June.

It is based on discussions with the Ministry of Agriculture (MOA), the UN Food and Agriculture Cluster members (including FAO, WFP and ACTED), rural advisory services located in each of the oblasts, the Association of Agribusinessmen in Kyrgyzstan (AAK), which supports input and machinery traders, the Kyrgyz Agricultural Market Information Service (KAMIS), which collects price data from all regions, major fertilizer importers, and the Agribusiness and Marketing Project, which supports agricultural processors. The mission also briefly conducted joint field visits with German Agroaction and ACTED in Osh oblast.

Background

The importance of agriculture in the rural economy. The agricultural sector is the backbone of the rural economy and central to the food security and livelihoods of both Uzbek and Kyrgyz communities. Agriculture in southern Kyrgyzstan is highly dependent on trade with the North.

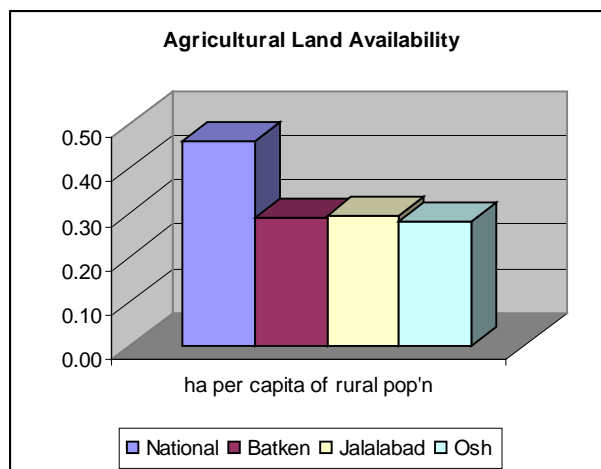
The sector contributed 25 percent to GDP in 2008 and the sector employs about one-third of the workforce. Household plots and small scale livestock production provide an important social safety net to rural households employed in other sectors. The sector is dominated by small-scale irrigated agriculture and mountainous pastures. Forty-one percent of cultivated land is farmed by farms of between 0.2 ha and 10 ha. Small farms, along with household plots, generate 98 percent of gross agricultural output. There are also a small number of much larger farms, particularly in the north. About 1.0 million of the 1.3 million hectares of arable land are irrigated and 9 million hectares of mountainous pastures supports the livestock sector. The sector is highly dependent on regional trade. The Kazakh border is a major route for livestock, dairy, fruit and vegetable exports to Kazakhstan and Russia, and a route for wheat, flour, oil and sugar, fuel and spare-part imports to Kyrgyzstan. The Uzbek border is major route for the seasonal import and export in vegetables and import of nitrogen fertilizer to Kyrgyzstan as well as for livestock exports. The border with Tajikistan is mainly a route for livestock trade. The border with China is a major route for a diverse range of imports and exports.

Competition for natural resources in Southern Kyrgyzstan. Competition over access to land, irrigation, pastures and markets have been long-term contributory factors to ethnic tensions in the South.

There is intense agricultural land pressure in the South. Availability of agricultural land per capita of rural population is lower in the three Southern oblasts than nationally by 36 to 40 percent (Figure 1). Similarly, the Land Reallocation Fund (LRF) is markedly smaller in the south; nationally the LRF is 0.11ha per capita of rural population available, while in the south there is

only 0.07 ha per capita of rural population available in all 3 oblasts - about 36 percent less than the national average. In some places the situation is likely to be worse than official figures indicate. For example, in Kadamjay Rayon in Batken Oblast, officially there are 8,941 ha of rainfed arable land, but in practice about 75 percent of this is not suitable for cropping.

Figure 1. Availability of Agricultural Land



Competition over access to land, irrigation, pastures and markets have been long-term contributory factors to ethnic tensions in the South - allocation of land and pasture leases by local government have both resulted in grievances about inequitable access to natural resources; irrigation water flows back and forth across ethnic and national boundaries, allowing one group to restrict the access of other; access to markets is disrupted by restricted access across Uzbek enclaves, and poor alternative domestic routes; and, poor farm to market roads and weak storage infrastructure limit Kyrgyz farmers flexibility

in marketing produce to Uzbek traders - Therefore, while the short-term shock to farm incomes and food security resulting from the crisis may be addressed through cash transfers, the longer-term response to the crisis should be a renewed program of investment in rural communities to improve equitable access to natural resources for both communities, increase agricultural productivity, stimulate trade between the two communities and re-establish their economic inter-dependence as a basis for peace.

Past approach to addressing food insecurity. The former government's involvement in private sector business and markets contributed to mistrust of the government. In formulating its long term response to the crisis and policies to achieve food security, the new government should be cognizant of the strengths and weaknesses of the former government's approach.

The crisis took place at a time of increasing government concern over food insecurity. The World Food Program estimated that in 2008, 35 percent of households were food insecure. Kyrgyzstan has been considered one of the most advanced countries in Central Asia in terms of agricultural reform but recent food security concerns led to an apparent shift in policy towards more government intervention in markets. Following a period of decline after independence, the sector expanded rapidly, but in recent years growth has stagnated, fuelling debate over an appropriate policy response. Real growth in the agricultural sector in 2005, 2006, 2007, 2008, and 2009 was - 4.2 percent, 1.7 percent, 1.5 percent, 0.7 percent, and 7.4 percent, compared to -0.2 percent, 3.1 percent, 8.2 percent, 7.6 percent, and 2.3 percent respectively, for the economy as a whole, although official data, particularly on livestock production, are thought to under-estimate output.

The previous government responded to these concerns with the Law on Food Security 2008, which resulted in the establishment of the Agri-Food Corporation (AFC), which implied a greater role for government in food importation, price stabilization and direct involvement in agribusiness. It is unclear to what extent these policies will be adopted by the new government. Public involvement in private business created mistrust of former government. Public

announcements about the government's intension to purchase outputs at guaranteed prices, which were not fulfilled, also caused mis-trust amongst farmers.

In formulating its long term response to the crisis and approach to food security, the new government should be cognizant of the strengths and weaknesses of the former government's approach. In order to re-establish trust in government, it should be cautious in intervening in private markets unless there is a clear market failure and should focus its efforts on private sector based growth. The government should also build on those positive aspects of the former government's policies in terms of increasing private sector provision of public services and promoting community based management of natural resources.

Sector Impact

Framework for the analysis. The analysis examines the impact of a series of crises on the agricultural sector. These include:

- a. the political crisis of April 2010;
- b. the subsequent ethnic violence in Southern Kyrgyzstan in June 2010;
- c. the mudslides in isolated parts of Southern Kyrgyzstan in June 2010.

These impacts were exacerbated by a wet spring and early summer, the effects of which are included in the quantitative assessment of agricultural output as they are strongly inter-related with other impacts. For the purposes of quantitative assessment, the effects of the crises on agricultural output are categorized as impacts on:

- a. Crop area and yield due to late spring planting.
- b. Crop yield due to lower fertilizer availability.
- c. Crop field operations due to insecurity.
- d. Crop marketing and output price due to insecurity.
- e. Crop input prices due to insecurity and border closure.

The following possible effects on agricultural output are also discussed in the assessment but not included in the quantitative assessment either because the effects are relatively small or unclear at this stage.

- a. Crop destruction due to mudslides.
- b. Poorer livestock nutrition due to disruption to grazing and fodder production.
- c. Reduced livestock output due to theft.
- d. Reduced agro-processing output due to reduced availability of raw material and insecurity.

The crises have affected geographical areas differently. The quantitative assessment of the effect of the crisis on agricultural output considers the impact on three geographical areas:

Area A: Areas farmed by severely insecure ethnic minorities in the South.

Area B: The remaining areas of Osh, Jalalabad and Batken oblast

Area C: Northern Kyrgyzstan, including Chui, Talas, Issyk-Kul and Naryn Oblast.

The assessment also discusses the impact of the crises on agricultural trade and investment. Finally the assessment sets out short, medium and term measures to address the crisis in rural areas.

Impact on Output. Agricultural GDP is expected to decline by approximately 19 percent in 2010 due to: late spring planting; reduced fertilizer availability; reduced irrigation, pest and disease control, weeding and timely harvesting due to the insecurity of ethnic minorities in the South; a severe contraction in crop trading activity in the South due to insecurity; higher fuel and input prices; lower output prices; and to a lesser extent, disruption to livestock grazing. The impact of the crisis has been exacerbated by a wet spring and early summer as well as mudslides in isolated areas.

Crop area and yield impact due to late spring planting. Late planting caused by a wet spring and a lack of fuel following the closure of the Kazak border in April led to a 2% reduction in the total planted area and will reduce yields. The April crisis caused a delay in planting of between 5 and 10 days. A wet spring, rather than the crisis, was a major cause of late planting and responsible for a further delay of around 10 days. Late planting was partly a result of the low availability of fuel for cultivation and planting. The delay varied according to latitude and altitude of the region– broadly speaking, the South, which had planted a higher proportion of its crops before the crisis, was less affected than in the north, except for higher areas such as Alay and Chon Alay raions. Similarly, spring wheat was less affected in lower altitude areas than in higher altitude areas. Delayed planting in 2010 resulted in a decline in the spring planting area of 6% compared to 2009. The spring wheat area declined by 15%. There were also significant declines the area of oilseeds and maize, while areas of fodder crops, cotton and sugar beet increased considerably. The overall planted area of winter and spring crops declined by 2% in 2010 compared to 2009 (Table 1). The mission estimates that yields of spring crops planted late will be reduced by between 1% and 10% depending on the crop and location.

Table 1 Planting Areas 2009 and 2010

	Planted area, '000 ha			Percent Change
	2009	2010	Change	
Grain crops	654.5	626.4	-28.1	-4%
wheat	402.6	376.8	-25.8	-6%
barley	124.2	125.9	1.7	1%
food maize	78.9	73.4	-5.5	-7%
rice	6.3	6.6	0.3	5%
legumes	41.0	42.1	1.1	3%
Technical crops	93	94.8	1.8	2%
cotton	16.9	26.7	9.8	58%
sugar beets	4.9	8.4	3.5	71%
tobacco	4.9	4.1	-0.8	-16%
oil crops	66.2	55.3	-10.9	-16%
Potato & melons	137.2	133.6	-3.6	-3%
potatoes	87.2	84.3	-2.9	-3%
vegetables	43.4	41.9	-1.5	-3%
Fodder crops	284.9	290.9	6.0	2%
Total	1,169.6	1,145.7	-23.9	-2%

Source: Ministry of Agriculture

Crop yield impact due to reduced fertilizer availability. The suspension of fertilizer imports from Uzbekistan following the June events will significantly affect yields. Crop yields will be affected by reduced fertilizer availability as a result of disruptions to imports. The April events had a relatively limited affect on fertilizer supply, although there were sporadic and temporary shortages. MOA data on fertilizer supply suggests that fertilizer imports as of April 2010 were approximately 105 percent of those at the same time in 2009. Imports by OshKrustek, a private trading company, which provides the vast majority of fertilizer, were temporarily disrupted by the temporary closure of the Uzbek border. Russian traders in the North, which provide a much smaller proportion of the market, reduced or ceased imports because of security concerns. Prices rose only slightly during this period

The June crisis had a much more severe affect on supplies, which will be sustained, affecting the 2011 crop unless addressed. OshKrustek ceased operations in June for legally related issues after which only small amounts of fertilizer are available on the market. This will significantly affect the production of maize, potatoes, cotton and vegetables on which fertilizer would normally be applied through the summer. The analysis assumes a decline in yield of up to 5 percent for different crops as a result of reduced fertilizer application.

Crop field operations impact due to insecurity. Uzbek minorities in Kyrgyz dominated villages and Kyrgyz minorities in Uzbek dominated villages, do not feel sufficiently secure to work in the fields. While much of the violence was concentrated in urban areas, a number of Uzbek dominated AO in rural areas were also affected and the rural population may have been significantly involved in the urban violence. These events took place again a back-drop of long standing competition over arable land, pastures, irrigation water and tensions over access to markets. Consequently, severe tensions exist between the two communities in rural as well as urban areas and minority groups do not feel sufficiently secure to work in the fields. This is evidenced by cases of minorities (both Uzbek minorities in Kyrgyz majority villages and Kyrgyz minorities in Uzbek majority villages) selling their standing crops to the members of the majority ethnic group in their village. It is also understood that Kyrgyz and Uzbek minorities are migrating to villages where their respective majorities live. Given that mixed communities have tended to be less affected than communities with a single ethnic group, the apparently polarization of Kyrgyz and Uzbek communities is not conducive to establishing peaceful multi-ethnic communities. The extent of this polarization is unclear at this stage.

The impact of the insecurity on agricultural output from the land farmed by ethnic minorities is substantial. On affected farms, crops planted before the crisis are not being irrigated or weeded, pesticides are not being applied to potatoes and vegetables (at a time where there a high pest and disease burden because of wet weather) and crops are being left in the ground not harvested and may at some point, start to rot. For example in Aslanbob AO in Jalalabad Oblast, the fields were apparently entirely abandoned between June 10th and 20th. The wheat harvest may also be affected to a limited extent by insecurity. Operators based in Karasuu are unwilling to travel to Aravan to harvest the crop and there is a shortage of combine harvesters. The analysis assumes that 15% of arable land in the South is affected. The analysis assumes that agricultural output in affected farms will decline by 20-30% as a result of inadequate husbandry of crops due to the insecurity.

Crop marketing and output price impact due to insecurity. Insecurity is severely undermining trading activity, particularly between Southern Kyrgyzstan, Bishkek and Kazakhstan. The temporary closure of the Kazak and Uzbek borders in April had a limited effect

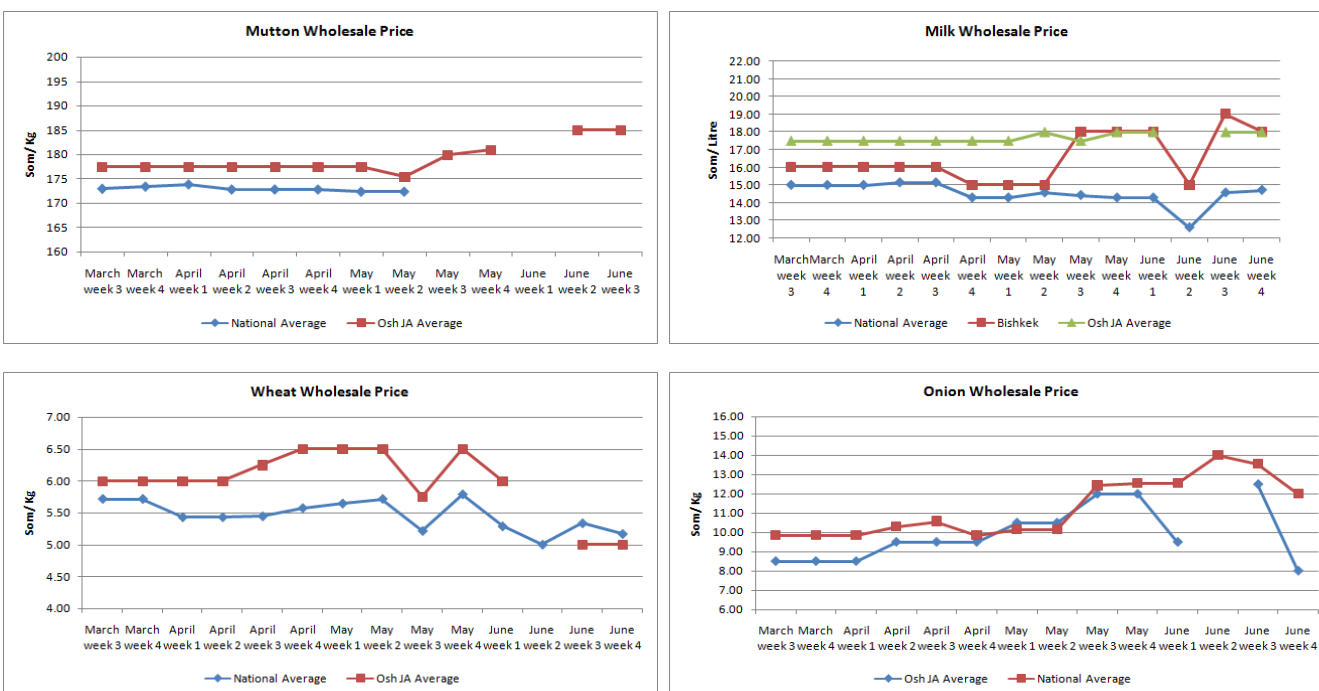
on most average wholesale output prices, which remained relatively stable following the crisis, although there were some regional exceptions, such as a sharp drop in potato prices in Osh and erratic milk prices in Bishkek.

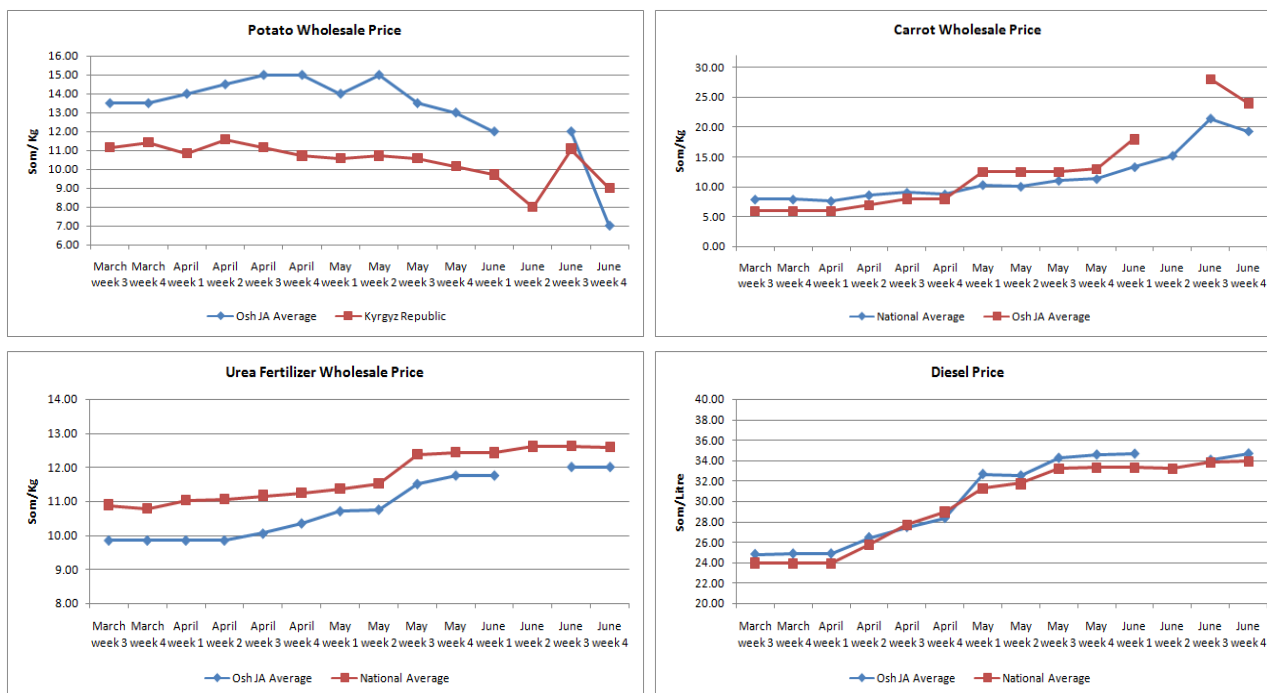
The June events are likely to have had a more substantial and longer term effect. Insecurity is undermining domestic and export trade. Traders of one ethnic group are reluctant to travel to villages dominated by other ethnic groups to purchase produce and farmers are reluctant to travel to markets. Buyers from Bishkek and Russian traders, are also understandably reluctant to travel South to buy produce. Traders are also seeking much higher margins to cover the increased cost of risk, which will erode farm profitability.

While so far, early crops, including cabbage, potatoes, cherries and apricots have been affected because of the loss the Bishkek and export markets, later vegetables and melons will be similarly affected in future as stocks build up. These tensions will seriously affect agricultural output in the South. Some produce will be sold at lower prices and some will not be sold at all. While some unsold produce may be utilized through increased home consumption, there will be increased losses because of: a) rotting of non-harvested crop in the field, given the unusually high rainfall this year and b) increased storage losses, given the poor storage facilities in many communities.

Figure 2 shows the changes in wholesale prices for selected products from March 1st to June 30th. The analysis assumes that between 10% and 30% of produce in affected farms will not be sold or consumed as a result of reduced trading activity. The analysis also assumes a sustained decline in output prices of between 10% and 30%. While there has been a sharp fall in prices for some products, notably a 50% decline in potatoes prices in the South, due to reduced trader confidence, this cannot all be attributed to the crises. Analysis of price trends over the last 5 years shows that on average, potato prices in the South fall by 15-25% between May and June. However, many crops have yet to be harvested and as stocks accumulate within the currently stagnant trading environment, prices are likely to fall.

Figure 2 Price fluctuations during the 2010 crises





Crop input prices impact due to insecurity and border closure. On average, the price of nitrogen fertilizer increased by 16% during the crisis due to the cessation of imports. Machinery prices have also risen due to increasing fuel prices and security concerns to some extent.

Fertilizer: The price of fertilizer increased only slightly following the April events and closure of Uzbek border (the average wholesale price of ammonium nitrate fertilizer increased slightly by 6 percent), but increased dramatically in June as imports of nitrogen fertilizer from Uzbekistan ceased following the suspension of trading activity by Oshkrastek, the main fertilizer importer. On average, the wholesale price of nitrogen fertilizer increased by 16% during the crisis due to the cessation of imports but some areas reported farm gate prices increasing from 12 KGS/ Kg to 18 KGS/ Kg. This will affect irrigated maize, potatoes, vegetable and cotton which would normally receive applications through the summer. It is unclear if and when imports of fertilizer from Uzbekistan will resume.

Fuel and machinery service prices: The cost of crop production will increase because of higher fuel and machinery service costs. Diesel fuel increased by approximately 30 percent (from 24 KGS/litre in March to 32 KGS/litre by mid May) and again to 34 KGS by the end of June. The provision of fuel vouchers in April, which allowed farmers to purchase a total of 3500 MT of fuel at a subsidized price of 24 KGS/litre, alleviated the fuel shortage to some extent. The Russian government have offered to provide a further 20,000 MT of diesel for the agricultural sector, which would be sold at a subsidized price of 31 KGS/ litre. A lack of spare parts is also driving up machinery prices and machinery services, which increased by between 50 percent and 100 percent following the April events.

Overall impact. Agricultural GDP for 2010 is expected to decline by about 19 percent, as a result of reduced GDP from crop production which is estimated to decline by about 32 percent.

The combined impact of the April and June events is expected to cause a 32 percent decline in GDP from crop production of because of:

- a. a decline in cropping area and yield due to late planting;
- b. a decline in yield because of reduced fertilizer application; and following the June events,
- c. suspension of field operations by some ethnic minorities due to insecurity;
- d. reduced trading activity, particularly between Southern Kyrgyzstan, Bishkek and Kazakhstan; and
- e. increased input and machinery prices.

Given that crop production contributes about 59 percent to agricultural output in 2008, this approximately translates into a 19 percent decline in agricultural GDP for the sector as a whole. Table 2 shows the assumptions used in estimating the impact of the crises on agricultural GDP. The results are summarized in Table 3. The analysis assumes that 15 percent of farmers in the South are severely restricted in undertaking field work because of security concerns.

Table 2 Assumptions for Estimation of the Impact of the Crisis on Agricultural Output

Impact	Irrigated/ Rainfed	Crop	AREA		
			A	B	C
Crop Yield Fertilizer Impact	Irrigated	Spring Wheat / Oilcrops/ Pulses	-2.50%	-2.50%	-2.50%
Crop Yield Fertilizer Impact	Irrigated	Other crops	-5.00%	-5.00%	-5.00%
Crop Yield Fertilizer Impact	Rainfed	Spring Wheat / Oilcrops/ Pulses	-1.25%	-1.25%	-1.25%
Crop Yield Fertilizer Impact	Rainfed	Other crops	-2.50%	-2.50%	-2.50%
Crop Husbandry Impact	All	Wheat / Oilcrops/ Pulses	-20.00%	0.00%	0.00%
		Other crops	-30.00%	0.00%	0.00%
Crop Marketing Impact	All	Wheat / Oilcrops/ Pulses	-10.00%	-5.00%	0.00%
	All	Other crops	-30.00%	-15.00%	0.00%

Source: JEA estimates

Table 3 Summary of Estimated Impact of the Crisis on Agricultural GDP

	A	B	(B/C)*100	
Area (ha)	GDP from Crop Production Without Crisis (KGS)	Incremental GDP from Crop Production With Crises (KGS)	Percentage Change	
AREA A	53,195	2,256,671	-1,898,460	-84%
AREA B	355,410	15,077,312	-5,190,584	-34%
AREA C	792,224	22,109,839	-5,690,949	-26%
Total	1,200,829	39,443,822	-12,779,993	-32%

Source: JEA Estimates

Incremental GDP from Crop Production With Crises (KGS)	-12,779,993
Percentage Change in GDP from Crop Production With Crisis	-32%
Contribution of Crop Production to Agricultural Output	59%
Percentage Change in Agricultural GDP	-19%

Source: JEA Estimates

Other impacts

Crop destruction due to mudslides. Nine villages have been affected by serious mudslides in the South caused by intensive precipitation and unstable soils. The impact is limited to small very areas but is severe. The mud flows have destroyed small crop areas (e.g. Nookat raion, Kyrgyz Ata AO 20 ha) but have damaged irrigation structures serving larger areas (e.g. Nookat raion, Kyrgyz Ata AO 85 ha). The greater potential loss is the much larger agricultural area, as well as houses, which would be flooded if the mud diversion channels, several hundred metres long, now filled with rock, are not excavated and restored. The analysis assumes that the impact on overall agricultural output is very small, although very significant for those farms affected. A list of areas affected by the mudslides is attached Table 5.

Irrigation and Drainage Infrastructure. There are no reports of major damage to the irrigation and drainage infrastructure as a direct result of the violence in the South. The system did suffer from neglect during the crisis and some channels are now silted up and are not operational. Some gates and other structures have been damaged as a result. A list of affected systems and the cost of cleaning is attached in Table 7. While the system was not seriously damaged as a result of the crisis, inadequate repair and maintenance means that much of the system is in a poor state of repair, although there has been substantial investment in the system and development of water user associations under the public investment program over the last 12 years. Ensuring improved equitable access to irrigation water will be an important aspect of the recovery program.

Livestock sector. Livestock production will be less affected than crop production although grazing and winter nutrition will be affected to some extent. Lucerne and maize output will decline as a result of the crop husbandry issues discussed above. Summer grazing has also been affected to some extent - there are reports that some livestock owners were reluctant to graze their livestock on spring and summer pastures during the crisis because of security concerns. This means that livestock may enter the winter in worse condition and that less fodder may available during the winter. However, livestock that did graze spring and summer pastures this year, will have benefited from the high rainfall and pasture growth this year. The scale of the impact on the livestock sector is unclear but is assumed to be small compared to the impact on crop production. Livestock theft is reported to be widespread in those AO most affected by the violence. This will be devastating for the families affected but assuming the livestock stayed in the country will not affect overall output from livestock.

Agro-processing output due to reduced availability of raw material and security. A comprehensive assessment of the status of agroprocessors in Southern Kyrgyzstan is not available but several processors dealing with vegetable processing have indicated that they will not operate this year because of concerns about sourcing raw material from farmers in an

insecure environment and concerns about the marketing of their products. This exacerbates the aforementioned marketing problems faced by farmers, particularly for low quality produce. There are no reports of significant damage to agricultural processing businesses in the South.

Long term impact on trade. The temporary closure of the Kazakh border in April affected livestock, dairy, and vegetable exports to Kazakhstan and imports of fuel, spare parts wheat, flour, cooking oil and sugar. The tightening of controls on the Uzbek border affected the early export of vegetables from Uzbekistan to Kyrgyzstan and the timely import of nitrogen fertilizer. Deliveries by train, including those from Russia, were unaffected, but usually most fertilizer is supplied from Uzbekistan.

The June violence may have longer term effects on trade through reduced trader confidence. Reduced willingness to trade with Kyrgyzstan may result from a reluctance to build up stocks in Kyrgyzstan because of concerns over security and uncertainty over future demand, an unwillingness to provide trade credit or recognize bank guarantees and letters of credit issued by Kyrgyz banks, and uncertainty over the consistency of supply from Kyrgyz exporters.

Some specific examples of this lack of trader confidence include: a significant reduction in planned imports of fertilizer from one of the smaller Russian suppliers because of concerns over security and demand; the suspension of a contract with a milk processor because of concerns over continuity of supply; and a report that the availability of Russian spare parts may be affected because of Russian traders unwillingness to build up stocks in Kyrgyzstan. It remains to be seen how quickly trader confidence will recover.

Agricultural Finance & Investment. Investment in the sector may decline in the short to medium term because of falling confidence in the sector. Lenders are likely to face higher delinquency rate as farmers struggle to service loans.

The reported decline in land rental prices following the crisis, by around 50 percent in some cases, following the April events, suggests that farmers' confidence in the sector has declined. This may be a result of both increased production costs and uncertainty over security of tenure in an unstable political situation. Reduced farmer confidence may manifest itself in the form of reduced willingness to pay for services (irrigation service fees, veterinary fees, pasture fees, extension service charges), reduced demand for inputs, as well as lower demand for agricultural land. Foreign investor confidence in the sector is likely to have been eroded by the crisis and at least one foreign investor is known to have suspended a contract for investment in red bean production--at least temporarily.

The difficulty in securing inputs was exacerbated by the temporary suspension of credit for a short period during the April events, when bank and microfinance institution branches were closed, during which, there was a moratorium on registration of collateral. Aiyl Bank, however, reports that the interruption was short and did not significantly affect disbursements. It is also likely that input traders would be less willing to advance trade credit during this period.

The June events are likely to have more serious implications. Farmers facing higher input costs and reduced cash revenues from this year's crop will be less able to service their outstanding loan obligations. Some borrowers may choose to sell off livestock to meet their loan obligations to maintain a good credit record, which will further erode their future cash income. Aiyl Bank, MFIs and other lenders can expect to face higher delinquency rates and may have to restructure

some loans across all sectors. It is likely that financial institutions will be very cautious in lending to the South.

The Russian RosselhozBank agreed to provide a \$30 million credit line to two Kyrgyz banks--RSK bank and Aiyl Bank, each \$15 million--as an emergency assistance following the April events. The loan has a 5 year maturity with one year grace period and carries a one percent interest rate. It has been agreed that Aiyl Bank would on lend in KGS at around 12-18 percent interest rate to support farmers and agriculture processing businesses, and RSK bank would on lend in USD at 9 percent to help businesses that suffered during the events. While this credit line is not guaranteed by the Kyrgyz Government, the Ministry of Finance is assigned to monitor the use of the money.

According to the Ministry of Finance, the credit line agreements between RosselhozBank and these two banks have not been signed yet. However, the Ministry of Finance has been working on other documents to comply with the internal procedures. Thus, the MoF and RSK Bank and Aiyl Bank signed a memorandum on monitoring the use of this credit line. An agreement on the mechanism for monitoring has been drafted, which is supposed to be signed by the parties, following issuance of a relevant interim government resolution. The government resolution will also specify terms and conditions under which RSK Bank and Aiyl Bank will conduct on lending operations.

Short, Medium and Long term response

Rationale and Principles. While the most violent aspects of the crisis are most visible in urban areas, the rural community suffered considerably and dangerous tensions exist between rural Kyrgyz and Uzbek communities, evidenced by the fear of Uzbek or Kyrgyz minority in some villages to work their fields. Competition over access to natural resources (agricultural land, irrigation water, pastures) as well as access to markets through enclaves, have long been contributory factors to ethnic tensions in the South. These tensions have been exacerbated by weak and inequitable management of natural resources, resulting in low incomes, food insecurity, environmental degradation and a lack of trust in local government.

Despite these long standing tensions, there has also been a high degree of economic interdependence between the Uzbek and Kyrgyz communities. While reconciliation and peace building must be the initial focus of the recovery effort, these can best be sustained in a vibrant rural economy, in which the Uzbek and Kyrgyz communities re-establish their economic interdependent. Development of the sector to improve equitable access to natural resources for both communities, to increase agricultural productivity and stimulate trade between the two communities will therefore make an important contribution to long term peace and stability in Southern Kyrgyzstan. This section identifies short, medium and long term measures to achieve this.

In formulating its long term response to the crisis and achievement of food security, the new government should be cognizant of the strengths and weaknesses of the former government's policy approach. The former government's involvement in private sector business and markets contributed to mistrust of the government. In order to re-establish trust in government, the new government should be cautious in intervening in private markets unless there is a clear market failure and should focus its efforts on private sector based growth. The government should also

build on those positive aspects of the former government’s policies in terms of increasing private sector provision of public services and promoting community based management of natural resources.

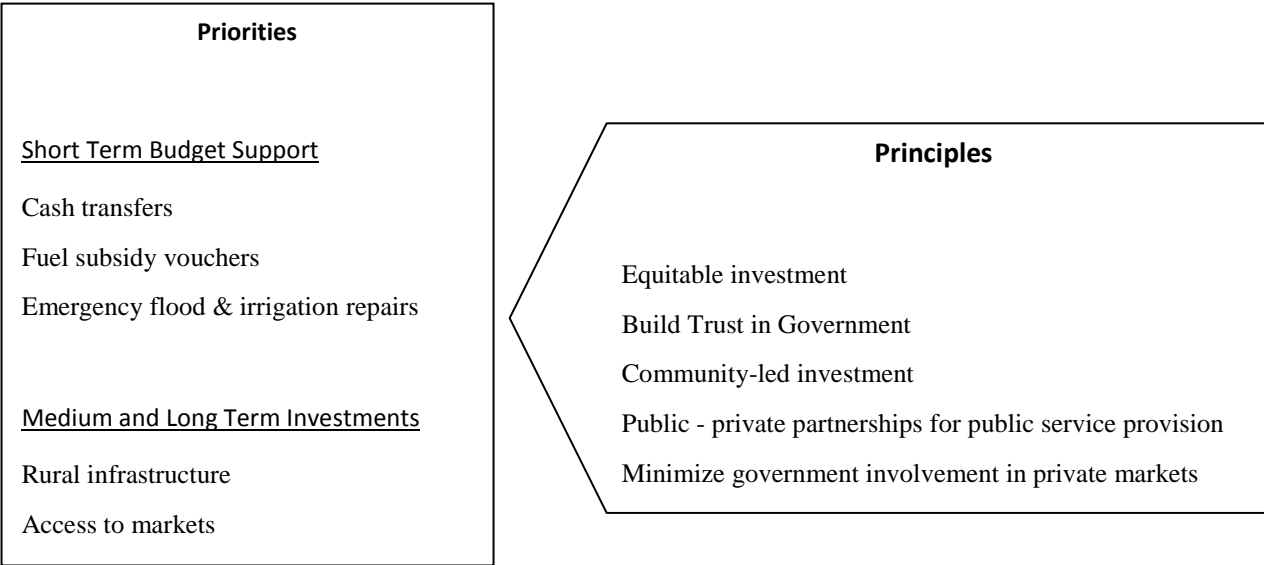
In the short-term, the shock to farm incomes and food security resulting from the crisis may be mainly addressed through cash transfers. The private sector is sufficiently developed to be able to import and distribute the necessary input, materials and food products if demand exists. Over the last 8 years, food imports have grown to meet domestic demand for food, demonstrating that food insecurity is essentially a problem of low incomes not low availability of food. As part of the effort to rebuild trust in government, the government should as far as possible not participate in private markets – cash provision is far preferable to input and output distribution by government as long as managed transparently.

In the medium and long-term, the response to the crisis should be a renewed program of investment in rural communities to improve equitable access to natural resources for both communities, to increase agricultural productivity and stimulate trade between the two communities. This should include investments to improve in rural infrastructure, access to markets and agricultural productivity.

To re-establish trust in government and build peaceful communities, these investments should be based on principles of: a) equitable investment – this means ensuring a fair geographical distribution of investments, so that benefits are distributed fairly across ethnic groups; and b) community or private sector led investment – this means designing and implementing investments through community based organizations (such as local investment committees, water user associations and pasture user unions) and managing public infrastructure and services through transparent public-private partnerships where possible.

These principles and priorities summarized in Figure 2 are described in detail below, all complement the proposed reconciliation, reconstruction and peace building measures described in this report.

Figure 2: Priorities and Principles for Medium and Long Term Investment



Short term response (To December 31st 2010)

Cash Transfers: Farmers have suffered severe price and production shocks this year, agricultural GDP is expected estimated in this assessment to decline by 19% as a result of the crisis and many more rural inhabitants will become food insecure this year. Bearing in mind the principles for building trust in government described above, the appropriate short term response in the next six months is a program of targeted cash transfers financing from budget support. Mechanisms for short term cash transfers are described elsewhere in the report.

Fuel Vouchers: The Ministry of Agriculture has requested budgetary support to fund a program of fuel vouchers. Under normal circumstances, the provision of cash transfers would serve the same purpose as fuel vouchers and would provide greater flexibility for households in deciding on how to cope with the crisis. However, the government already has arrangements in place to provide 23,000 MT of fuel for agriculture (20,000 MT of which will be provided by the Russian government) at a subsidized price of 31 KGS per liter¹⁰³. The government estimates that total fuel requirement for the summer harvest and autumn planting is 50,200 MT. While under normal circumstances there is not a strong argument for government importation and subsidization of fuel, under current circumstances a government subsidy is appropriate. This is because: a) fuel prices have risen dramatically in a short period in the middle of the growing season and farmers have had no opportunity to change production decisions in response the price increase. Secondly, given the current tensions in rural areas, it would be unwise to subsidize only part of the fuel on the market for the agricultural sector – disputes regarding the allocation of fuel and subsidies are likely to ignite further tensions and may do more harm than good. Funding a 3 KGS per liter subsidy for the remaining 26,800 MT of diesel would require a budget allocation of US\$1.8 million.

Emergency irrigation and flood channel response: The State Committee for Water Resources/ Ministry of Emergency Situations require funds immediately to excavate and repair the flood control channels, following the mud slides in the South and to de-silt irrigation and drainage canals. These works are urgent to avoid further flood damage to agricultural land and property. Table 4 describes the total cost of works which is approximately US\$430,000. The majority of the works require mechanical cleaning but a proportion of the works could be done manually under a food for work operation.

¹⁰³ In June, Government (Gos material Reserve) purchased 3000 MT from GasProm in Kyrgyzstan at 34 KGS per liter including taxes which could not be exempt as the fuel had to be purchased quickly in an emergency situation. Any future consignments of fuel would be purchased directly from Russia at 31 KGS per liter and no import duties other than a 0.15% customs charge would be paid – fuel would be sold to farmers at cost at 31 KGS per liter. Retail prices to farmers currently range from 32 to 40 KGS per liter depending on location. There are not currently any budget allocations for further fuel purchase by Gos material reserve.

Table 4. Estimated Costs of Emergency Cleaning of Irrigation and Mud Flow Channels

Province	District	AWC (if any)	Canal	Cost of Works	
				Vol.of work (m ³)	Cost (KGS)
Osh	Alay		Kungey, Savai		340,500.00
	Aravan		Mazar-Aryk, Naiman Golovnoy and others		360,900.00
	Kara-Kuldja		Ylai-Talaa, Sary-Kamysh and others		2,000,000.00
	Kara-Suu		Savay, Taldyk, Laglan and others		3,440,000.00
	Nookat		Hodja, Kugei, Saparbaeva-1 and others		5,750,000.00
	Uzgen		Jany,Mogol, Kara-Diykan, Mirza, Kozu-Uulu andothers		1,590,000.00
	KaraSuu	Murza-Ajy	Kayirma-2	3,200.00	384,000.00
	KaraSuu		Ak-Sai	600.00	72,000.00
	KaraSuu	Voruh-Ali	C-3	18.00	384,000.00
	KaraSuu	Ak-Suu			138,820.00
	KaraSuu	Sultan-Naz	Ak-Dobo	3,300.00	396,000.00
	Subtotal				7,118.00

Table 4. continued

Province	District	AWC (if any)	Canal	Cost of Works	
				Vol.of work (m ³)	Cost (KGS)
Djalal-Abad	Suzak		Oktyabrskiy-Ob'edinyaushiy, Ache-Sai		1,270,000.00
		Unusov A	Blagoveshenskiy	800.00	96,000.00
			P1	310.00	37,200.00
			Mamairam	680.00	81,600.00
			Kommunism-1	430.00	51,600.00
		Murok-Suu	Bazarchy	1,020.00	122,400.00
			Kal-1	440.00	52,800.00
		Shabnam	CDS	1,190.00	142,800.00
		Tushum-Suu	Kotur-Kaman	630.00	78,000.00
			Voroshilov	340.00	40,800.00
	Tash-Bulak	Tash-Bulak	900.00	108,000.00	
	Ala-Buka	Sary-Talaa Suu	Teshik	2,300.00	345,000.00
			Chanach-Sai		1,500,000.00
	Bazar-Korgon		Jany-Jogorku-Akman, Eski Jogorku-Akman		292,600.00
		Karacha-Suu	Eski Hogorku Akman	30.00	3,600.00
		Kashka-Suu	Too-Tilek	360.00	43,200.00
			PK-58	200.00	24,000.00
			KDK	200.00	24,000.00
			Ala-Talaa	450.00	54,000.00
		Tamchy-Bulak	Kara-Jygach	160.00	19,200.00
Temirgen-Kol			100.00	12,000.00	
Nichke-Kolot	100.00		12,000.00		
Subtotal			10,640.00	4,410,800.00	
Total			17,758.00	19,267,020.00	

Source: State Committee for Water Resources

Medium term (January 1st 2011 to June 30th 2012) and Long term Response (June 2012 onwards)

The medium term and long term response should aim to build rural infrastructure, improve access to markets and improve agricultural productivity.

Improve Rural Infrastructure. There is intense land pressure in Southern Kyrgyzstan and increasing the provision of irrigation water is one way to reduce that pressure and associated ethnic tensions. Eighty percent of cultivated land is irrigated and generates an even higher proportion of crop output. Access to irrigation is a potential trigger for ethnic conflict. Water

flows back and forth across ethnic and national boundaries, allowing one ethnic group to restrict the access of other. Rehabilitation can spark conflict but if implemented sensitively, will improve the productivity of the land of all ethnic groups.

There has been substantial investment in the development of water user associations to manage on farm systems and a network of water- user support units exists under the Committee for Water Resources to support their development. Although there has been substantial investment in irrigation and drainage over the last fifteen years, many systems have yet to be rehabilitated. Designs are already prepared for some systems awaiting funding. The State Committee for Water Resources estimates that a further 63 Water User Associations, serving 78,000 ha, require rehabilitation at an estimated cost of US\$17 million (Table 5). This can be implemented through the provision of additional financing to an existing on farm-irrigation project. Irrigation and drainage rehabilitation should be an important part of the long term recovery effort. The medium term program includes a budget of \$12.50 million to undertake rehabilitate irrigation and drainage on about 30,000 ha.

Table 5 List of Farm Irrigation and Drainage Systems in Southern Kyrgyzstan Requiring Rehabilitation

№	Name oblast	Name rayon	Village government	Name of WUA	Irrigated area, ha
1	Batken	Batken	Tort-Gul	Bavash	856
2	Batken	Batken	Samarkandek	Tort-Gul tolkunu	1,376
3	Batken	Batken	Batken	Bazar-Bashy-Batken	1,506
4	Batken	Kadamjai	Alga	Alga-Jarkoton	715
5	Batken	Kadamjai	Birlik	Gauyan	2,458
6	Batken	Kadamjai	Maidan	Isa-Marijam	560
7	Batken	Kadamjai	Uch-Korgon	Uch-Korgon-Isfairam	2,194
8	Batken	Kadamjai	Markaz	Kojo-Kaiyr	2,200
9	Batken	Kadamjai	Kyrgyzkyshtak	Tillasuu (Mital-Musan)	1,839
10	Batken	Leilek	Jany-Jer	Yrysmat	2,793
11	Batken	Leilek	Toguz-Bulak	Sarkentsuu	1,172
12	Batken	Leilek	Katran	Kyrk-Bulak	1,072
13	Batken	Leilek	Ak-Suu	Omursuu	550
14	Batken	Kyzyl Kiya	Ak-Bulak	Ak-Bulak Dyikan	700
15	Jalalabad	Ala Buka	T.Baltagulova	Sulaiman-Suu	2,046
16	Jalalabad	Ala Buka	Oruktu	Arashan-Bulak	1,007
17	Jalalabad	Bazar Korgon	Seidikum	Almaz-Suu	1,805
18	Jalalabad	Bazar Korgon	Akman	Kashka-Suu	1,642
19	Jalalabad	Bazar Korgon	Beshik-Jon	Karacha-Suu	343
20	Jalalabad	Bazar Korgon	Seidikum	Toichubek Chek	1,000
21	Jalalabad	Nooken	Sakaldy	Taimonku	1,317
22	Jalalabad	Nooken	Shaidan	Aikol-Suu	802

23	Jalalabad	Nooken	Town Tash Kumyr	Ak-Shar-Suu	1,067
24	Jalalabad	Nooken	Sakaldy	Sakaldy-Suu	972
25	Jalalabad	Nooken	Sakaldy	Suyumbai-Suu	1,149
26	Jalalabad	Suzak	Kara-Darya	Altyn-Suu	1,900
27	Jalalabad	Suzak	Bagysh	Dostuk-Bagysh-Suu	3,668
28	Jalalabad	Toktogul	Nichke-Sai	Chabar-Kashka-Suu	1,360
29	Jalalabad	Toktogul	Torkent	Torken-Suu	1,350
30	Jalalabad	Toguz Toro	Atai	Kaba	357
31	Jalalabad	Chatkal	Kanysh-Kiya	Suu Kanysh-Kiya	2,005
32	Osh	Alai	Jany-Alai	Kaldar	250
33	Osh	Aravan	Kerme-Too	Isan	2,162
34	Osh	Aravan	Tuya mojun	Kur-Tash	800
35	Osh	Aravan	Tuya mojun	Tal-Bulak	1,150
36	Osh	Aravan	Tuya mojun	Asantai	1,700
37	Osh	Aravan	Tuya mojun	AJM	401
38	Osh	Aravan	Tuya mojun	KMZ	431
39	Osh	Kara-Suu	Sarai	Mongu-Suu	2,100
40	Osh	Kara-Suu	Kashkar-Kyshtak	Jar-Ooz	485
41	Osh	Kara-Suu	Joosh	Sultan-Naz	1,997
42	Osh	Kara-Suu	Joosh	Joosh-Kanal	520
43	Osh	Kara-Suu	Joosh	Kyzyl-Koshchu	520
44	Osh	Kara-Suu	Joosh	Konurat-Yug	901
45	Osh	Kara-Suu	Joosh	Sarai-Suu	280
46	Osh	Kara-Suu	Jany-Aryk	Jany-Turmush	2,298
47	Osh	Kara-Suu	Katta-Taldyk	Eshme	154
48	Osh	Kara-Suu	Sary-Kolot	Ene-Sai	1,002
49	Osh	Kara-Suu	Sarai	Kydyrsha-Suu	858
50	Osh	Kara Kulja	Kara-Kulja	Shadai	1,257
51	Osh	Nookat	Kyrgyz-Ata	Kyzyr-Ata	1,479
52	Osh	Nookat	Jany-Nookat	Tegirmech	909
53	Osh	Nookat	Kenesh	Shankol-Sai	1,521
54	Osh	Nookat	Bel-Kairagach	Murok	1,028
55	Osh	Nookat	Yntymak, Kulatov	Hodja-Aryk (Abshyr-Ata)	1,832
56	Osh	Nookat	Zulpuev	Kyzyl-Boston	1,056
57	Osh	Nookat	Jany-Nookat	Kyzyl-Teyit	356
58	Osh	Nookat	On-Eki-Bel	Moltur-Suu	1,200
59	Osh	Uzgen	Kurshab	Kurshab-Arzybek	1,516

60	Osh	Uzgen	Tort-Kol	Nur-Bulak-Bashat	1,417
61	Osh	Uzgen	Jazy	Jashoo	1,206
62	Osh	Uzgen	Ak-Jar	Jany	580
63	Osh	Chon Alai	Kashka-Suu	Chekendeli	1,200
Total Area (ha)					78,347
Cost per hectare (\$US)					220
Total cost (\$US)					17,236,340

Source: State Committee for Water Resources

Improve Access to Markets. There are strong agricultural trading links between Kyrgyz and Uzbek communities. Producers feel exploited by buyers when they are limited in their choice of buyer, when they face high costs to access markets and lack the flexibility to store and sell produce at the most opportune time. Poorly maintained farm to market roads, a shortage of suitable storage facilities for root crops, fruit and vegetables, and poor infrastructure at raion and oblast markets, all increase the physical degradation of produce, increase marketing costs and reduce competition between traders. An assessment of rehabilitation needs, ownership and management arrangement for farm to market roads, market places and storage facilities should be undertaken with a view to preparing an investment project to improve to address these issues. This potential investment would need to be financed under a new loan project at an approximate cost of US\$30 million including \$15 million in the medium term program.

Improve Agricultural Productivity. The proposed investments in improved access to markets should be complemented by measures to improve farm productivity and to link farmers to markets. This requires measures to improve the provision of seed, rehabilitate orchards, rehabilitate minor field irrigation infrastructure, implement land conservation measures, and improve crop and animal husbandry. It also requires business advice to assist farmers to find buyers, establish formal or informal marketing groups, establish agreements with buyers and adapt their production systems to buyers' requirements. The needs of each community will be different and such investments would be implemented through a grant program for community based agricultural micro-projects. Grants would allow the communities to procure support packages from advisory services and suppliers of materials to implement their micro project. There is substantial capacity in Southern Kyrgyzstan in providing this type support. Previous projects have established both the community based organizations to implement micro projects and the independent advisory services to provide the necessary technical services. All AO in Kyrgyzstan have prior experience of micro project management. This potential investment would need to be financed under a new loan project at an approximate cost of US\$15 million including US\$7.50 million under the medium term program.

Kyrgyzstan's 9 million hectares of pasture are one of its most important natural resources but a cause of ethnic conflict particularly in border areas. The government adopted a new pasture law in 2009, which places responsibility for pasture management in the hands of local communities. This provides an important mechanism to ensure equitable access to pastures and can potentially contribute to substantially reduced conflicts over pasture use. The government has also adopted an improved approach to veterinary services provision, through the establishment of services contracts with private vets. It is also working to establish internationally recognized animal disease control strategies, which will be implemented in cooperation with the Pasture User

Unions. These measures are currently financed until July 2013. Further funding of about US\$ 8.0 million will be required thereafter to invest further in pasture improvement and animal disease control. In combination, these medium and long term investments provide an important foundation for long term peace building in rural communities. The proposed short, medium and long term measures are summarized in Table 6.

Table 6 Summary of Short, Medium and Long Term Financing Needs for the Agricultural Sector

	Response		Source of Funding	Budget(US\$)
Short Term (To Dec 31st)	Fuel vouchers	26,800 MT diesel. Subsidy of 3 KGS / litre.	Budget Support	1,800,000
	Emergency de-silting irrigation and cleaning mud flow channels after flooding	Mechanical and manual cleaning	Budget Support	430,000
Medium/Term (Jan 1st 2011 – Jun 30th 2012)	Invest in Rural Infrastructure	Irrigation and drainage rehabilitation in three Southern Oblasts	Additional financing WB on farm irrigation project II	12,500,000
	Investment in Improved Access to Markets	Assessment and investment in farm to market roads Assessment and investment in storage and distribution facilities.	New investment loan A	15,000,000
	Invest in Improved Agricultural Productivity	Community based agricultural micro-projects. · Advisory and marketing services · Land and soil improvement · Community seed funds · Savings and Loan Groups · Orchard rehabilitation	New investment loan A	7,500,000
Long Term (From July 1st 2012 onwards)	Rural Infrastructure II	As above	Additional financing WB on farm irrigation project (OIP II) cont.	4,500,000
	Access to Markets II	As above	New investment loan A cont.	15,000,000
	Agricultural Productivity II	Community based agricultural micro-projects	New investment Loan A cont.	7,500,000
	Animal Health and Pasture Management	Pasture management and improvement. Further investments in veterinary services	Additional financing for Agricultural Investments Services Project	8,000,000
Total				72,230,000
Short Term				2,230,000
Medium Term				35,000,000
Long Term				35,000,000

ANNEX XIII: PUBLIC FINANCIAL MANAGEMENT (PFM) AND FIDUCIARY ISSUES

The management of external aid for recovery should build on the progress achieved by the Kyrgyz Republic and donor organizations in aid harmonization. Kyrgyzstan is the first country in the Central Asia region that participates in international initiatives for aid harmonization and effectiveness in line with principles of the Rome and the Paris Declarations on Aid Effectiveness.

This section describes the overall fiduciary environment (public financial management, fiduciary and safeguards arrangements), potential financing options for the recovery efforts as well as the principles and mechanisms which will guide the implementation and monitoring of external aid provided for the recovery program.

Background

A decade long reform effort on the PFM system¹⁰⁴ has resulted in a gradual formation of a professional technical team in the MOF and Central Treasury and establishment of a reasonably strong aggregate fiscal discipline in budget execution. This has entailed a process of fiscal consolidation and bringing extra-budgetary funds into the budget, introduction of cash flow forecasting and implementing a balanced budget, and elements of accountability in the use of public funds, considerable improvement in reporting, as a result of the introducing of new budget classification and a unified chart of accounts.

The remaining weaknesses of the PFM system are related to the shortcomings in strategic planning. They result in: (i) inconsistent outcomes of budget policy with a huge variation in the quality of public service provision across the country; (ii) frequent re-allocation of resources within the originally approved budget and hence low predictability of funds for spending units; (iii) weak links between the sector strategies, the Medium Term Budget Framework (MTBF), and the annual budget; (iv) a lack of transparency, with poor public access to key budget information and (v) poor system of internal checks and balances with the exception of selective spending entities. The internal audit system is at an early stage and cannot provide credible assurance of the legality, effectiveness, and efficiency of the use of public funds.

PFM reform program is on-going and is aiming to address the above shortcomings. It is being supported by a US\$5 million Multi Donor Trust Fund (MDTF), financed by jointly by EU, DFID, SECO and SIDA and administered by the WB. The MDTF is also designed to provide assistance to the MoF and line ministries to help in building the PFM capacity of the respective civil servants. US\$4.5 million remains undisbursed and available to support reforms and basic capacity building.

Impact of recent events on the PFM system and its institutional setup

The robustness of the PFM system was tested. The PFM system was weakened and fragmented by the previous Government's attempt to monopolize key PFM functions under the Central Agency for Development, Investment and Innovation (CADII). CADII was established under the President's administration in October of 2009 and was led by former President's son. This

¹⁰⁴ Assessment of PFM reform progress is made possible by comparing two consecutive Public Expenditure and Financial Accountability assessments (PEFA) conducted in 2005 and 2009.

agency took over public investment budget and management of State Owned Enterprises (SOEs) and privatization. It was responsible for supporting large national projects in the energy sector, agriculture, and construction of social housing, and de facto for strategic budget policy. The MOF has been able to recover from the above setback with the reintegration of functions and technical staff to the Ministry of Finance.

The provisional government abolished CADII together with KDF in April 2010. All functions previously transferred from to CADII were devolved back to the MOF. The MOF will have a complete oversight of capital and recurrent expenditures. The MOF currently is conducting competitive recruitment of civil servants to staff the MOF unit responsible for the Public Investment Program.

Second, the Public Financial Management system proved to be sound against the disruptions caused by the April and June events and ensured functioning of essential budget organizations.

The institutional capacity of the MOF and Treasury has been maintained at the pre-crisis level. In the aftermath of the political events of April 2010, MOF and Central Treasury (CT) undertook the following actions and policy measures:

- (i) Treasury information was backed-up in a timely manner at the central data processing centre prior to violence against the treasury premises. Measures to protect budget execution records in locations near heightened ethnic and political tension were also taken. As a result information on the budget execution has been protected in spite of the physical damage incurred by local treasury divisions.
- (ii) The MOF and the Central Treasury continued to adhere to strict overall aggregate budget discipline in budget execution, with the exception of June when expenditure pressures became unmanageable and undermined the concept of balanced budget – main achievement of the PFM reform in KR.
- (iii) The staff turnover has been minimal at the central level and was noted only at sub-national level, where new heads of local governments were elected.
- (iv) Considerable funds were confiscated from bank safe deposit boxes owned by people presumably related to the previous political regime. The Chamber of Accounts is now working to identify the sources and ownership of these funds.

The provisional government also renationalized three State Owned Enterprises (SOEs) and suspended further privatization plans. The three renationalized SOEs, privatized by the previous regime, are: Kyrgyztelecom and the two electricity distribution enterprises-Vostok Electro and Servo Electro. The termination of the purchase and sales agreements for the electricity enterprises occurred voluntarily after irregularities in the privatization procedures were reported. New privatization is postponed until a new Parliament is elected and until the Government revises the current rules and procedures.

Public procurement

Public procurement has gone through some reform through revisions introduced in the Public Procurement Law to bring it in line with international standards; introducing principles and stages of an efficient procurement process, and defining the mandate and authority of the State Procurement Agency. However, this agency which was established as an independent public procurement oversight body, was abolished in October 2009 as a part of the government reorganization which took place under previous government. Instead, a new Department on Public Procurement Methodology has been established under MOF while the procurement supervision function was not assigned to any organization. In addition, the National Procurement Training Center has been taken over by a private ownership and the range of procurement training has been gradually decreasing.

As such, budget entities have become solely responsible for the procurement process, with no regular oversight from other government bodies. Random external audits are conducted by the Chamber of Accounts once every two years. This decision seriously undermines a system of checks and balances in public procurement and creates a responsibility gap for assuring the quality of public procurement, especially given that the public sector internal audit is weak. This heightens corruption risks in procurement.

MOF procurement unit intends to start publishing contract award information to bring more transparency to the procurement system. However, the process for redressing tender violations remains unclear. Given that public procurement carries a risk of high corruption, appropriate oversight and transparency will need to be established as a priority. The MOF recognizes this priority, but its capacity and current legal basis are the main constraints for immediate improvements. The MOF public procurement unit includes only five staff, whose major responsibility concerns methodology of public procurement. Recently, the unit began to request the minutes of tender commission meetings in an attempt to check accuracy of the tender process; however, the unit's capacity clearly is not sufficient to do this promptly and with acceptable quality. The unit also drafted a new public procurement law that is intended to re-establish appropriate procurement oversight. The process of approving the draft law will take quite some time. Even once approved, there will be a need for extensive capacity and institution building.

The treasury is developing a database of contracts, but there is an institutional gap in monitoring the adherence to the procurement rules. The Chamber of Accounts reviews procurement process only during the regular assessment of budget organizations once every two years. The Government had noted that the supervision function in procurement had been reportedly a source of administrative corruption. The provisional government will need to establish the procurement oversight function to foster credible state institutions and to develop mechanism of dispute resolution and handling of complaints to reduce corruption in procurement.

External audit

The impact of the April on external audit is twofold. The first aspect is related to opening access to the enterprises shielded by the former President from public and audit scrutiny. The second one is temporarily suspension of the Audit Council because of a lack of quorum of seven Audit Council Members. Expectations are that the provisional government will take a decision on nominating a replacement for the supervisory member of the Audit Council (including two members of parliament, and others). Making the Audit Council fully operational is an urgent requirement to legitimate decisions by the Chamber of Accounts – the Supreme Audit Institution.

The Chamber of Accounts is actively involved in auditing SOEs special funds and organizations. The newly appointed Acting Chairman guides the effort of the Chamber of Accounts to search for irregularities in accounting for public funds. Such audit will allow possibility of collection and transfer of funds to the state budget. The results of the audit are to be referred to the President for decision-taking.

Impact of recent events on the budget

Revised budget for 2010. Routine in-year budget amendments are the mechanism for meeting new institutional, political, and economic realities. Before the April events, MOF considered the need to amend the Republican Budget to reflect both projected revenue declines and the need for additional expenditure on salaries and social benefits incorporated the approved 2010 budget. The plan was to amend the budget in May. However, April and June events caused considerable individual losses (including life, health, and property), public and community infrastructure damage.

The fiscal impact of the April and June events is, therefore, large and is expected to widen. Additional expenditure pressure on the budget arise from the need to mitigate the economic and social impact of recent events by rehabilitating the affected region, providing social assistance, compensating the losses incurred by affected population, and exercising effective public safety and security and build the peace in the Region. A commission chaired by the Ministry of Economic Regulation was established to estimate the cost of damage and amount of compensation required. The total additional spending needs are estimated in the range of KGS14 billion. The Joint Economic Assessment has estimated the associated additional financing needs in 2010 to be around US\$ 335 million.

The revenue base of the budget has also been negatively affected by recent economic and political events. Revenue collection has deteriorated and is expected to continue the downward trend over the coming months. Total revenues and grants are estimated to decline by KGS 4 billion thus increasing the budget deficit up to an estimated KGS28.2 billion (or by 15.9 billion more that originally approved for 2010).

The table 1 presents the 2010 budget projection against the approved budget to reflect the impact of the crisis.

Table 1. Summary 2010 State Budget in KGS (millions)

Budget item	2010 Budget Law	Projection of the 2010 budget reflecting the impact of the crisis as of July 2010	Difference
Total revenue and grants	61,576	57,608	-3,968
Total revenue	54,067	50,201	-3,866
Tax revenue	42,123	37,674	-4,449
Non-tax revenue	11,384	11,959	575
Capital revenue	559	568	9
Total grants	7,509	7,407	-102
Programmatic grants	2,462	2,397	-65
PIP grants	5,047	5,010	-37
Total expenditure (incl. net lending)	73,867	85,839	11,972
Total expenditure	74,595	81,769	7,174
Current expenditure	56,951	60,654	3,703
Salaries and Soc. Fund contrib.	19,609	21,102	1,493
Transfers and subsidies	7,975	9,002	1,027
Transfers to Social Fund	4,999	5,487	488
Interest	2,043	2,367	324
Purchases of other goods & services	22,324	22,696	372
Capital Expenditure	17,644	21,114	3,470
Capital exp. from domestic resources	4,353	8,532	4,179
Capital exp. externally financed	13,291	12,582	-709
Net lending	-728	4,070	4,798
Budget deficit	-12,300	-28,230	-15,930

Source: Ministry of Finance

The provisional government plans to approve the Additional Budget with a provision for implementation by MOF. Expectations are that following the formation of a new parliament, planned for October 2010, the Additional Budget would be included in the draft law on the amendment of the 2010 Budget Law, thus retroactively approving the measures taken during the interim period. The provisional government plans to publish the draft Additional Budget on the internet prior to its approval.

Government fiscal response to recent events

In order to avoid fiscal imbalances from the anticipated revenue shortfall the Treasury delayed financing of unprotected expenses for 14 days in April so that protected budget items (mainly wages and social payments) could be financed at 100 percent. Payments against unprotected expenditures have been resumed in the second half of April since the provisional government received a Russian grant in the amount of US\$20 million to cover its fiscal gap. Budget came under renewed expenditure pressure in June due to special circumstances caused by June events in the South. This put into jeopardy the established practice of balance budget. The authorities have been able to temporarily contain spending pressures in July through resuming tight control on spending and resisting to additional spending pressures. While the Treasury monitors closely revenue receipts and predicts weekly cash flows, the budget execution continues to be done on ad hoc basis to take into account emerging needs and the appropriate government decrees requesting additional financing. Thus, predictability of funds (aside from protected items) for spending units remains problematic.

Budget preparation for 2011

Recent political events have also impacted the preparation process of the 2011 budget. Given the immediate concern of the interim government to develop an Additional Budget, the budget process for 2011 has not begun. Before the April events, the MOF had developed a medium-term budget forecast for 2011-13 as a basis for budget preparation. However, fiscal uncertainty stemming from the April crisis suggests that the fiscal framework can no longer be considered reliable or serve as a basis for the 2011-13 MTBF. This year the MOF plans to develop a 2011 annual budget only. The MOF is determined to adhere to the budget preparation calendar prescribed in the Budget Code. However, the timeline for formation of a new parliament (after the October 10 elections) is likely to delay the deadline for approval of the 2011 Budget Law.

The MOF has taken a decision to use the 2010 parameters (revised after the April events) for determining expenditure ceilings for 2011. The rationale for such a proposal is that growth will likely be limited and revenue collections remain stagnant. The MOF has issued budget preparation guidelines along with sector expenditure ceilings for budget organizations, thus beginning the process of budget preparation requests.

Main Risks and Recommendations for their mitigation

Major risks arise from the remaining weaknesses in checks and balances, transparency and accountability and underdeveloped results orientation of the budget. Need for additional resources, erosion of the revenue base and the extraordinary amount of Donors' funds that will be mobilized for the mitigation of the impact of recent developments put additional stress on the PFM system.

The Public Financial Management System during 2010 will likely experience stress related to increased uncertainty of revenues; additional pressure from expenditures related to compensation for damage suffered by citizens and affecting infrastructure during the April and June events; implementation of additional social benefits approved at the end of 2009; and expenditures related to the Referendum and general elections. The last month's events also undermined some businesses and trade operations that will continue to impact revenue collection. Pressure to raise salaries for security personnel will also create additional stress. The 2011 budget will likely be prepared based on the current expenditure framework, given short-term revenue and policy uncertainties, and will probably undergo further corrections to reflect the current economic realities.

To mitigate above risks it is imperative to (i) preserve the independence of the technical team in the area of PFM, (ii) develop and clearly articulate temporary solutions for coping with extraordinary circumstances and new pressures put on the budget. This will entail establishing, empowering and supporting the technical team from the MOF and the Treasury and requesting them to develop the tools and techniques to effectively cope with additional expenditure management needs and to reduce the political pressure on the budget process. A technical team of experts from the MOF and the Treasury needs to be established immediately to present their assessment of the situation and problem at hand and develop solutions for coping with the situation. The work of this team needs to be supported by key Donors as required and results of the work need to be reviewed and endorsed by the provisional government and clearly articulated to the public. Particular attention should be paid and a mechanism of rigorous control, reporting and monitoring should be elaborated and put in place for the use of expenditure mobilized for mitigating impact of June events since they cannot be effectively integrated in the budget.

The climate for more basic PFM reforms seems promising and could lead to a decrease in fiduciary risk. The previous Government had taken some actions that resulted in worsening transparency and accountability in government activities. In recent speeches the President and the Minister of Finance have announced their intention to improve transparency and accountability in government operations. The call for a more transparent government is supported by a vocal civil society, which now has benefitting from improved freedom of the press after the April events. Clearly articulated and concrete set of actions by the provisional government in area of financial and social accountability and in use of public resources will directly contribute to generating public trust.

While the normative and methodological basis for introduction of internal audit has been established, much needs to be done to develop reliable internal control systems. Today 12 units out of a planned 14 in ministries and central agencies have been established. But auditor capacity needs improvement and the importance attached to their work by managers is insufficient. The MOF, as a lead organization, is planning some activities aimed at improving capacity and further developing systems of internal control for the public administration in general.

Staff turnover may present additional risks for local self-government during budget preparation and execution. The MOF will need to consider measures to compensate for the capacity gap through training and other measures.

ANNEX XIV: MEMBERS OF THE JEA REPORT TEAM

The report was prepared by a team led by the Asian Development Bank (Ramesh Subramaniam), the International Monetary Fund (Nadeem Ilahi), and the World Bank (Afsaneh Sedghi). The core team managing the report consisted, in addition, of representatives from EBRD (Kenji Nakazawa), the European Commission (Rafael Aguirre Unceta), and UN (Neal Walker).

The JEA team is most grateful for management guidance and support to Motoo Konishi, Roger Robinson (WB), Lan Wu (ADB) and David Owen (IMF).

Sector teams

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