

## Working paper 3

# Industrial Development of Kyrgyzstan: Investment and Financing

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# Industrial Development of Kyrgyzstan: Investment and Financing

## 1. Overview of investment climate

Improving investment environments and creation of attractive conditions for foreign direct investment (FDI) have been policy priorities for several developing and transition economies. FDI inflows are especially important for industrial development as they are often connected with the transfer of more advanced technology and know-how and best management practices. FDI can also stimulate market development and provide opportunities to establish new businesses or enter new foreign markets.

In regard to the creation of a favorable investment climate, Kyrgyzstan faces several challenges, including low property rights protection, a weak judicial system, poor infrastructure or limited size of domestic markets. This notwithstanding, during the last decade Kyrgyzstan has made a number of improvements to the legal framework on investment, including through concluding relevant international agreements. Kyrgyzstan participates in 35 bilateral investment treaties (10 of which have been signed but are not yet in force). These agreements provide a definition of investment and they list assets considered as investment. Bilateral investment treaties contain also provisions aimed to promote and to protect investment, including investment into Kyrgyz industry. Apart from bilateral investment treaties, Kyrgyzstan is also a party to 9 multilateral treaties with investment provisions and to 20 investment related instruments – intergovernmental agreements, guidelines, principals and resolutions.

The volume of total **fixed capital investment** almost tripled over the 2011 to 2016 period (Table 1). This can be explained by a doubling in internal investment, whereas external investment grew 4.6 times (the FDI component of external investment grew 4.7 times). Foreign credits for infrastructural projects played a significant role, including the transmission line “Datka-Kemin” and the reconstruction of Bishkek combined heat and power plant. Increased domestic savings contributed to a positive dynamic of internal investment.

*Table 1. Volumes of fixed investment in the Kyrgyz Republic in the period 2011-2016 (in percentage to the year 2016). Source: (National Statistical Committee of the Kyrgyz Republic, 2018).*

Indicator name	2011	2012	2013	2014	2015	2016
<b>Total</b>	<b>36</b>	<b>54</b>	<b>61</b>	<b>80</b>	<b>94</b>	<b>100</b>
<b>Internal investment</b>	<b>48</b>	<b>65</b>	<b>70</b>	<b>87</b>	<b>99</b>	<b>100</b>
Investment from State budget	47	29	26	30	46	100
Investment from local budget	46	47	64	64	86	100
Resources of enterprises and organizations	60	96	96	118	122	100
Bank credits	39	104	90	131	154	100
Resources of population and charity support of residents of the Kyrgyz Republic	38	47	59	77	95	100

<b>External investment</b>	<b>21</b>	<b>40</b>	<b>50</b>	<b>70</b>	<b>87</b>	<b>100</b>
Foreign credits	20	43	30	73	83	100
Foreign direct investment	21	29	118	70	111	100
Foreign grants and humanitarian aid	31	43	39	46	59	100

From 2005 to 2017 total **FDI** to Kyrgyzstan amounted to 9.3 billion US dollars. The period characterized by heightened volatility as a result of the global financial crisis in 2009, political instability in the Kyrgyz Republic (2010), the quantitative easing in the United States, the appreciation in the US dollar exchange rate, and significant fluctuations in commodity prices.

Manufacturing industry, mostly primary processing of natural and raw resources, saw the highest volume of inflows in the amount of 3.4 billion US dollars or 37%. Geological prospecting received 2 billion US dollars or 22%. Financial sector is the third ranked investment recipient with 1.74 billion US dollars or 19%. These sectors are followed by wholesale and retail trade and repair of motor vehicles and motorcycles (6%), exploration of mineral resources (5%), energy, gas and steam supply as well as air conditioning (4%), construction (3%), other sectors (4%) and agriculture (0.1%).

In 2015 FDI reached its maximum annual amount of 1.57 billion US dollars mainly due to large financial inflows into following main sectors:

- Geological exploration with the overall financing volume of 262 million US dollars or 17%, from which the biggest part was invested by the Kazakhmys Corporation LLC,
- Manufacturing industry, through the Kumtor Gold Company and several cement plants, received financing of 565 million US dollars or 36% of the entire investment,
- Energy sector, mainly from PJSC Gazprom, attracted 137 million US dollars or 9% of the entire investment,
- Construction sector, such as the Bishkek Park, attracted 107 million US dollars or 7% of the entire investment,
- Financial sector attracted 412 million US dollars or 26% of the entire investment, mainly, from the US and Netherlands

The largest share of FDI goes to the extraction and mining industries, followed by processing of raw materials. By contrast, the share of investment targeting manufacturing remains low.

From a regional perspective, the largest share of investment concentrates in two regions only, namely Bishkek city (4 billion of US dollars or 43%) and Chui region (2 billion US dollars or 21%). This can be explained by such factors as migration of population to these regions, which started in 1990s, and the growing level of concentration of industrial production in the capital and around it (National Statistical Committee of the Kyrgyz Republic). Concentration of business and investment in Bishkek and Chui regions is in detriment of other regions that contribute significantly to migration. For instance, Issyk-Kul region received 16% of total investment and Jalal-Abad region received 13% due to its significant mineral deposits. Other regions, such as Talas region (3% of investment), Batken region (1.6% of investment), Osh region (1.1% of investment), Naryn region (0.5% of investment) attracted relatively small amounts of investment during the 2005-2017 period.

Main investor countries during the period 1995 – 2016 are Canada (2 billion US dollars, concentrated in mining); China (2 billion US dollars into manufacturing industry and geological prospecting); Russia (1.25 billion US dollars into manufacturing industry, electric power, water and gas supply, trade and repair of motor vehicles, financial sector); and Kazakhstan (1.2 billion US dollars into trade, financial sector, geological prospecting).

Compared to Russia and Kazakhstan, Kyrgyzstan attracts average levels of FDI only (as percentage of GDP). It should be also of cause considered that economy of Kyrgyzstan is much smaller than economy of Russia and Kazakhstan. The volumes of FDI were also more or less stable during the last decade. Exceptions are years with much higher volumes of FDI, like the year 2015, which can be explain by a few large-scale deals (Table 2).

*Table 2. FDI inflows as percentage of GDP: comparison with countries of the region. Source: (UNCTAD, 2018).*

	2008	2009	2010	2011	2012	2013	2014	2015	2016	On average
Georgia	12	6	7	7	6	6	11	11	12	9
Kazakhstan	11	12	8	7	6	4	4	2	7	7
Kyrgyzstan	7	4	9	11	4	9	3	17	8	8
Moldova	12	4	4	4	3	3	3	3	2	4
Russia	5	2	2	2	1	2	1	1	3	2
Tajikistan	16	3	3	4	3	2	4	7	6	5
Uzbekistan	2	3	4	4	1	1	1	0,1	0,1	2

**Public investment** in Kyrgyzstan includes credits from international financial organizations and foreign states provided mainly under the guarantee of the Government of the Kyrgyz Republic. In the period 1991 to 2018 financing was received from the China Exim Bank, the International Monetary Fund, The World Bank, the Asian Development Bank and other financial institutions. According to the National Statistical Committee of the Kyrgyz Republic, in 2016 foreign credits in fixed capital amounted to 594 million US dollars and grants – to 82 million US dollars.

One of the projects in infrastructure sector, which received finance from the China Exim Bank and the Asian Development Bank, is Bishkek-Naryn-Torugart road – one of the main transport routes of the Kyrgyz Republic and the part of "Europe-East Asia" CAREC Transport Corridor. The loan of the Chine Exim Bank amounted to 200 million US dollars and the Asian Development Bank gave 83 million US dollars in credit and 44 million – as a grant.

Another Kyrgyz development partner is The World Bank, which funds projects to help Kyrgyzstan to foster more inclusive economic growth and to build a more resilient economy. According to the World Bank Country Snapshot (World Bank, 2018), there are 21 projects, including introduction of automated weigh-in-motion systems along major international corridors to address vehicle overloading, prevent damage to roads, and improve traffic safety; installation of more accurate electricity meters with more than 200 thousand people

benefiting from a more reliable electricity supply; building capacity of local self-governments to work with their communities to plan and implement local development programs (Village Investment Projects). Half of the bank's lending are grants and another part are highly concessional credits with no interest. According to the (IMF, 2018), the World Bank has approved 1.5 billion US dollars for the International Development Association (IDA) funded projects and Recipient Executed Trust Funds (RETF) for Kyrgyzstan since it joined the World Bank in 1992. Over 1992–2000, the Kyrgyz portfolio had a significant focus on budget support; however, there has been a gradual shift toward investment projects. Fifty-two IDA investment operations for about 1.18 billion US dollars have been completed and closed, and eleven IDA investment operations for 228.5 million US dollars are ongoing.

The credits through financial-credit institutions are mostly lending to enterprises, which are provided by commercial banks, noncommercial financial institutions, various state funds and agencies. The Russian-Kyrgyz Development Fund is one example. Also starting from 2013 Kyrgyz Government subsidizes interest rates of commercial banks through different state projects.

Budget credits of the Ministry of Finance are another source of financing. Starting from 1998 the Ministry of Finance of the Kyrgyz Republic allocated budget credits to business through its State Agency on the Management of budget credits. These credits also included re-crediting of the foreign credits. Such budget credits usually go directly to support large-scale enterprises in the sectors of energy, transport and industrial sectors, as well as companies in the agriculture sector. Enterprises also have an opportunity to re-credit their credits with low interest rates via commercial banks. The overall budget loan portfolio (arrears of enterprises) of the Ministry of Finance from 1993 is around 1.7 billion US dollars (according to the current exchange rate).

The biggest share of these credits goes to the enterprises in energy (83% of all credits), where 11 enterprises de facto received 1.49 billion US dollars. The share of other sectors is much lower. For instance, transport and telecommunication got 6.2% of all credits where 36 enterprises received jointly 89 million US dollars. Here the main recipients of state loans were "National Electrical Grid of Kyrgyzstan", "Electrical Stations" and "Severelectro".

The banking sector got 4% of all credits where 14 enterprises received 80.5 million US dollars. Here the main recipients were "Aiy Bank", "Kyrgyz Investment and Credit Bank", as well as the "State Mortgage Company".

The construction sector received 2.4% where 8 enterprises benefited from 51.5 million US dollars. The machinery sector attracted 1.9% where 9 enterprises received jointly 35.4 million US dollars. Food industry received 1.1% with 4 enterprises sharing 24.7 million US dollars. Public health received 0.4% where 8 enterprises were supported with 8 million US dollars. Light industry received 0.3% for 10 enterprises sharing 6 million US dollars. Coal mining received 0.07% with 10 enterprises benefited from 1.47 million US dollars financing. 5.5 million US dollars were distributed to 7 other enterprises, which were not falling into any of previously mentioned categories.

One example of joint financing initiatives is the **Russian-Kyrgyz Development Fund** created in 2014 with the goal to support integration of the Kyrgyz economy into the EAEU. The Russian Federation invested 500 million US dollars into the fund during the period 2014-2016. The fund provides direct loans to businesses as well as the loans through financial-credit institutions. The credit conditions of the fund became even more favorable during the last three years. For instance, the credit periods were increased from 5 to 15 years, depending of the sector of economy, which requires financing. The interest rates for direct credits in US

dollars were reduced from 7% to 4% per year. The interest rates for small and medium-sized enterprises, provided through partner-banks in US dollars, decreased to 5% per year in dollar currency and to 10% per year in local currency. The cost of funding from micro-financial organizations in national currency decreased to 14% per year. The threshold for small and medium-sized enterprises decreased from 3 million US dollars to 1 million US dollars. The possibility for credit restructuring of up to 30% from the entire amount of the credit was created.

According to the data from the beginning of the year 2018, the fund approved portfolio included 33 direct financing investment projects with the overall total amount of 145 million US dollars. These projects cover various sectors of economy including agriculture, textile, processing, construction, power industry, communication and IT, as well as mining, metallurgy, transport and logistics, trade and public health. These investment projects are implemented in different Kyrgyz regions, including Chui, Naryn and Issyk-Kul regions as well as Jalal-Abad and Bishkek.

Some specific examples of investment projects include textile, agro-processing, transport and logistics, mining and metallurgy. In the textile sector the fund supported the construction of the textile factory and the establishment of new textile enterprise, "Textile Trans", in Chui region. The aim of the project was to increase competitiveness of the Kyrgyz clothing manufacturing and improving its position in international trade through reduction of the cost of production and materials such as knitted fabrics. The overall investment volumes of the project were 9.78 million US dollars, from which 7.54 million US dollars were provided by the fund.

Another example in the agro-processing industry is the enterprise "PROD IMPEX LLC". The enterprise is specializing on the production of canned fruits and vegetables. The aim of the project was to develop agricultural sector in the Kyrgyz region by purchasing crops from families of private farmers in the Issyk-Kul and Osh regions as well as in the surroundings of Bishkek. The planning was that the project would provide income to 437 local families by the year 2020 in three regions of the country. Another aim of the project was to ensure growth of exports to EAEU. The total investment volumes of the project were 5.53 million US dollars, from which 3.91 million US dollars were provided by the fund.

The renovation of the Manas airport is a well-known project in the area of transportation and logistics. The renovation of the Manas international airport, which included the extension of the runway, the arrangements of electricity supply in accordance with the requirements of ICAO, the extension of the airport terminal, the equipment of the aerodrome with a light system of high intensity in accordance with the requirements of the category I of ICAO. The aim was to create conditions for aircrafts to take off and to land any time of the day and night and under any weather conditions. The total value of the project was 38.3 million US dollars, from which 12.4 million US dollars were financed by the fund.

An example from the mining and metallurgy sector includes construction of the metallurgical silicon production factory in Jalal-Abad region with the overall capacity production of 5.000 tons per year. The aim of the project was to develop semiconductor industry and to increase inflows into the local budget thus contributing to social security and development of the region. In the project will be successful, the fund expects that the FDI inflows will make up to 5 million US dollars. The entire factory should have the capacity of 4 ovens with the overall production capacity of 20.000 tons. The total financing volumes of the project is 4.45 million US dollars, from which 2.15 million were financed by the fund.



The abovementioned successful examples of investment illustrate that the fund contributes significantly to the real sector of Kyrgyz economy. These activities comply with objectives of sustainable industrial development of Kyrgyzstan and help the country, i.e., to increase domestic products competitiveness, adapt to the EAEU membership conditions, achieve modernization and development of the economy through replacement of physically and morally obsolete fixed assets and introduction of innovations, attract preferential financial resources to the economy. However, the opportunity to receive direct credits from the fund was used only by a limited number of entrepreneurs. The business perceives requirements of the fund as difficult to meet, therefore the number of requests from a broader number of entrepreneurs remains limited.

The fund also provides financing to small and medium enterprises through commercial banks and has an entire network of partner-banks, which currently includes 13 commercial banks. According to the status of January 2018, the fund under its SME financing program through commercial banks and microfinance sector of the Kyrgyz Republic approved 789 projects for a total of 116 million US dollars. Here, however, some concerns of entrepreneurs about the program for small and medium enterprises also have to be addressed, such as the strict credit requirements or the verification of the loan purposes.

In general activities of the fund have positive effects on the Kyrgyz financial markets. The activities of the bank contribute to the reduction of interest rates for credits taken in the US dollars, as well as in national currency. According to the data from the fund itself, the revenues from the credit recipients of the fund increased by 102 million US dollars or by 24%. The fiscal transfer increased by 7.8 million US dollars or 21%. The volumes of export-oriented credits reached 192 million US dollars. The modern equipment was acquired for the amount of 109 million US dollars.

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## 2. Drivers and instruments for investment

The Kyrgyz leadership realizes importance of investment and is ready to undertake necessary steps. In a statement at the session of the Parliament of the Kyrgyz Republic on 27 June 2018, President of Kyrgyzstan H.E. Sooronbay Jeenbekov, stressed the need to protect business, to improve investment climate and to support investors. He identified reducing corruption, reform to the judicial system, introduction of information technologies and electronic government services as drivers of investment.

The state investment policy in Kyrgyzstan and its implementation is regulated by the investment legislation of the Kyrgyz Republic and is based on the Constitution of the Kyrgyz Republic. It also comprises Civil code, Tax code, Customs code, Land code, as well as the Law "On Public-Private Partnerships in the Kyrgyz Republic" adopted on 22 February 2012 №7; Law "On Free Economic Zones (FEZ) in the Kyrgyz Republic" adopted on 11 January 2014 №6; Law "On joint stock companies" adopted on 27 March 2003 №64; Law "On mining" adapted on 3 February 1999 №18; Law "On Licensing and Permitting System in the Kyrgyz Republic" adopted on 19 October 2013 №195.

While abovementioned legal acts regulate investment activities directly or indirectly, the main national instrument on foreign direct investment is the Law "On Investments in the Kyrgyz Republic" adopted 27 March 2003 №66. According to Article 1 of this Law, the term "investments" is defined as tangible and intangible assets invested in any economic actor in the form of: money; movable and immovable property; property rights (mortgages, liens, pledges and others); stocks and other forms of participation in a legal

entity; bonds and other debt instruments; non-property rights (including intellectual property rights, such as goodwill, copyrights, patents, trademarks, industrial designs, technological processes, trade names and know-how); any right to carry out activities based on a license or other permit issued by government bodies of the Kyrgyz Republic; concessions based on the legislation of the Kyrgyz Republic, including concessions to explore, develop or exploit natural resources of the Kyrgyz Republic; profits or revenues received from investment and re-investment in the territory of the Kyrgyz Republic; other forms of investment not prohibited by Kyrgyz laws. The Law "On Investments in the Kyrgyz Republic" also guarantees equal treatment to foreign and domestic investors. Foreign investors also enjoy protection under international treaties of the Kyrgyz Republic and its obligations that follow from the provisions of these agreements. As compared to protection measures enshrined in the national legislation – subject to possible change on the national level, protection measures arising from international agreements are usually considered by investors as more stable and reliable. Nevertheless, despite existence of regulations, it is still difficult to enforce them.

The most important drivers for investment during the last years were stabilization of political situation, strengthening of state institutions and adoption of the National Sustainable Development Strategy for the Kyrgyz Republic for the period of 2013-2017 (Decree of the President of the Kyrgyz Republic from 21 January 2013 №11). Statistical data indicate a steady growth of fixed investment in the country over the last years. The major drivers for any potential investor in Kyrgyzstan according to the survey conducted by IIASA are political stability, assured investment security, absolute respect for property rights and high level of the rule of law for investing financial resources into Kyrgyz economy. There are also specific instruments to promote investment, which we are describing below.

During the roundtable workshops in the regions of Kyrgyzstan following drivers for private investment were identified:

- Drivers in governance and legislative framework include simplification and streamlining of administrative rules and procedures (such as registration of property, licensing, number of controlling procedures), as well as development and implementation of legislation on protection of rights of private investors, including predictability of state policy and reduction of political risks and further development of legislation on land property and rights, assessment of necessary time for land registration, facilitation of transformation of land for industrial purposes. Assessment of existing procedures for permitting rights on mining and rent of land, including assessment of necessary time for all permitting procedures,
- Financial and economic drivers include creation of investment packages and facilitation of business associations as well as facilitation of financing on attractive conditions, namely, with the lower interest rates and a longer repayment period, including availability of credits in national currency with low interest rates and long repayment period. Other economic drivers are introduction of the system of state orders, procurement and tenders for products of local enterprises.

Several participants during the roundtable workshops recommended private public partnerships schemes for facilitation of private investment. *Funding through **Public private partnerships*** (PPP) is according to the Article 14 of the Law "On Public-Private Partnerships in the Kyrgyz Republic" where the Government guarantees protection of private investments into the PPP projects, as well as non-interference into the business of private partner, except cases regulated by PPP agreements, protection of private property from nationalization as well as other financial rights and guarantees. The aim of PPP is to help channel private investment into infrastructure projects and to reduce the burden on the state budget.

Several ministries are involved in the design and implementation of PPP projects. For instance, the Ministry of Economy is responsible for defining PPP policies and legislation, it also supports relevant ministries with implementation of PPP. The Ministry of Finance is responsible for management of financial risks. There are also other ministries and agencies, which contribute to preparation, monitoring and evaluation of implementation of PPP projects.

Currently 15 projects are in the phase of implementation in Kyrgyzstan with total investment exceeding 165 million US dollars. Sectors covered include public health, sport, tourism, urban development, transport and customs, and education. There is already one project in the phase of implementation. This is the provision of services of hemodialysis in the cities of Bishkek, Osh and Jalal-Abad. Another project is at the phase of call for tender for private partner. This is the reconstruction of hotel and trade center "Issyk-Kul" State Company. Three projects in the approval phase by institutions such as the Ministry of Economy and the Ministry of Finance include installation of computer tomography in medical institutions of the Kyrgyz Republic, reconstruction of mountain base for skiing "Nooruz" and the introduction of electronic payment system in the public transportation.

Creation of **Free Economic Zones** (FEZ) in Kyrgyzstan started in 1991 and currently there are five FEZ (Table 3). Jointly FEZ gross production in 2016 amounted to 1,2% of Kyrgyz GDP, most of it came from Bishkek.

*Table 3. Free Economic Zones in Kyrgyzstan.*

Status of FEZ	Name
Currently existing	Naryn (established in 1991), Karakol (Issyk-Kul region, established in 1993) Bishkek (established in 1996), Maymak (in Talas region, established in 1997), Leylek (Batken region, established in 2011),
Effective	Bishkek and Naryn
Underperforming because of the lack of investors' interest	Leylek, Maymak and Karakol

FEZ try to stimulate investment mainly through taxes decrease or exemption (Table 4). However, according to the FEZ Directions of the Kyrgyz Republic, FEZ residents pay the equivalent to 0.5%-2% of total sales.

*Table 4. Taxes within and outside FEZ. Source: (CAREC, 2018).*

Taxes	Within FEZ (%)	Outside FEZ (%)
Import	0	7
Export duties	0	12
VAT	0	12
Profit	0	10
Property	0	0.8%

The efficiency of FEZ for industrial development is, however, questionable. For instance, the volumes of exports from FEZ to foreign markets declined by 39% in 2016 in comparison to 2010. The share of imports to

FEZ exceeds the share of export, from which the share of re-export and export to internal market is considerable. Product share exported by FEZ residents constitutes only 5.3% from the total volume of export, whereas the export share of high technologies park amounts to 80% from the gross production.

Recommendations regarding FEZ were also collected during the roundtable workshops in the regions. There are expectations that FEZ will stimulate investment, will help to reduce costs of production and the costs of doing business. However, FEZ mainly seem as a vehicle to promote investment, their role in economic development of the regions is not yet fully recognized. There was also a request for successful examples and best practices from other countries, which showed that FEZ could provide diversification and industrial growth, can contribute to urbanization and regional integration. Feasibility studies of such best practices and assessment of conditions for their implementation in Kyrgyzstan is required.

**High Technology Parks** (HTP) is another tool to promote investment. The main aim of HTP is to export goods and services at the amount of not less than 80% of total revenues. The main activities of HTP are software development, export of information technologies and provision of services from interactive service centers. The first HTP was created in 2013 and benefited from low tax regime and regulatory advantages for information technologies companies and specialists. This HTP included 3 registered residents and employed 55 people. The number of registered residents and employees of HTP is constantly growing (8 residents and 106 employees in 2014, 13 residents and 111 employees in 2015, 27 residents and 250 employees in 2016). The volumes of production of HTP are also growing (1 million US dollars in 2015, 3 million US dollars in 2016 and almost 8 million US dollars in 2017). The volumes of export in 2017 amounted to 5.4 million US dollars. Kazakhstan is the major importer of HTP goods and services (40%), followed by USA (32%), Japan (8%) and Russia (3%).

In 2014 the Government of the Kyrgyz Republic initiated creation of **industrial parks** in the country. The Ministry of Economy of the Kyrgyz Republic was charged to prepare the draft law "On Industrial parks (industrial zones)". In order to elaborate the draft text, a working group, comprising representatives of relevant ministries, agencies and business community, was established. The first draft of the law was not supported by the Ministry of Finance and the Social Fund of the Kyrgyz Republic since its adoption would have impact on tax revenues receipts and on the volume of social contributions. A draft law "On **special economic zones**" (SEZ), elaborated by the Ministry of Economy of the Kyrgyz Republic and the Investment Promotion and Protection Agency of the Kyrgyz Republic, is currently in the consultation phase.

Several land plots were proposed for the creation of industrial parks, including 80 ha in Chui region close to Tokmok city; 40,75 ha in Voенno-Antonovka village 13 km from Bishkek; and 200 ha in At-Bashinsky district of Naryn region for construction of industrial-logistics park. Furthermore, local authorities propose to create industrial zones in Osh and Jalal-Abad regions, as well as 11 logistics centers in all regions of the country. Creation of techno parks on the basis of existing universities was also initiated. During the tender procedure about 50 universities applied for participation, three of them were selected in 2018 and received 2 million soms each (29 thousand US dollars according to the current exchange rate).

Among main shortfalls of special economic zones (SEZ) and reasons of their weak performance are: a) Share of SEZ in Kyrgyz GDP and in number of jobs created in the country is very low; b) Strategy of each SEZ development is missing; c) Improvement of SEZ activities is not reflected in any strategic document initiated by the Government; d) State monitoring and evaluation of SEZ activities is missing; e) SEZ were mainly created for regional development, especially in border territories, while investment attractiveness and export

potential were not taken into consideration during the process of selection of each SEZ location. Currently three SEZ (“Maymak”, “Leylek” and “Karakol”) are de-facto non-operational due to the lack of necessary infrastructure, separation from other territories, missing clustering of SEZ with local raw materials producers and lack of financial resources.

These results show that Kyrgyzstan was experimenting with SEZ to attract investment and to create positive dynamics for manufacturing firms but the strategy was underperforming based on the shortfalls mentioned above. The short-term recommendation here is to undertake assessment and evaluation of SEZ to learn and to introduce any changes needed in the strategy. This could be done in light of the new industrialization strategy or national development plans for the country.

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### 3. Barriers for investment

National Sustainable Development Strategy for the Kyrgyz Republic for the period 2013-2017 acknowledged shortcomings in the doing business and investment environment in Kyrgyzstan, a situation reflected in several international ratings (Table 5).

*Table 5. Ranking of Kyrgyzstan in major international economic ratings.*

Rating	Place
World Economic Forum and Global Enabling Trade Report (2012)	111 <sup>th</sup> out of 132
Global Competitiveness Report for 2011-2012	126 <sup>th</sup> place out of 187
World Bank’s Doing Business 2018 report	77 <sup>th</sup> place out of 190

Review of existing databases on investment shows differing evaluations regarding the quality and the ability to implement legislative frameworks for investment in Kyrgyzstan (UNIDO, 2018). The weaknesses in legislative frameworks contribute to factors that jeopardize investment in Kyrgyzstan. Investors may be forced to resort to litigation – a fact that tarnishes the country’s image and has detrimental effects on investment climate. In this section we speak about barriers, which were identified by IIASA survey with Kyrgyz stakeholders, by the UNIDO diagnostic studies and by previous studies conducted by international organizations.

Following barriers for investment into industrial projects in Kyrgyzstan were identified during interviews and survey with stakeholders in Kyrgyzstan, conducted in spring – summer 2018 by IIASA. Following barriers were identified:

- political barriers (political instability, dependency of goods exports on political decisions of neighboring countries). The survey showed that these are the most important barriers

- custom's barriers, administrative barriers (investors expect that functioning of enterprises into which they invest would not be endangered or their returns cut by bureaucratic procedures or state interference),
- sectoral barriers (incl. fragmented production chains), fiscal barriers, technological barriers, market barriers (rather small internal market, lack of affordable long credits),
- price barriers.

Furthermore, during the survey Kyrgyz experts were asked to estimate influence of main barriers on investment in three focus sectors: energy and green economy, textile, and agro-food processing industry. In energy sector the major barriers are political, price and technological barriers, followed by administrative barriers. In textile sector the major barriers are market, price, technological and customs barriers. In agro-food the major barriers are market, administrative, political and technological barriers. These results show that technological barriers are important for all three sectors, also administrative and political barriers are playing an important role.

### **Governance and social factors**

Among factors, which have the highest influence on investment the survey allowed evaluation of international, political and social factors. International factors: level of attracted foreign direct investment has the highest influence on improvement of Kyrgyz investment climate in the next 5 years, followed by such factors as competitiveness on the world market, state credit rating and level of achieved integration processes. Political factors: political stability has the highest influence on investment climate, followed by the level of democracy processes, interethnic relations, form of governance, number of international organizations in the country, administrative and territorial structure as well as the number of political parties. Social factors: level of migration and development of social infrastructure have the highest impact, followed by welfare level of people and level of social tension.

The UNIDO diagnostic report identified the following governance barriers: lack of strategic and long-term vision of local authorities on informing the public about feasibility and advantages of small hydropower plants in local areas.

Speaking about governance barriers a joint study on the business climate in the Kyrgyz Republic, which was conducted by the World Bank and EBRD in 2013, concluded that corruption was the second-worst obstacle to doing business in the country, out of 16 systemic issues. The International Finance Corporation (IFC) in the project "Improvement of the Investment Climate" identified that 20% of foreign investors admit to paying unofficial payments and that political instability remains among the top risks for Kyrgyzstan, despite minor improvements since 2010.

The International Law Development Organization identified the unstable political environment and the distrust in country's justice system as the major barrier for investment. For example, in the end of 2017 some political disputes with Kazakhstan took place. As a result, Kazakhstan strengthened boarder with Kyrgyzstan and unilaterally restricted trade with this country. Because of these measures many Kyrgyz exporters, in particular those engaged in trading perishable agriculture products, suffered considerable losses. Subsequent negotiations with Kazakhstan helped to resolve the situation, nevertheless, in accordance with the Road map signed by the two countries, Kazakh requirements concerning cargo transportation became stricter. In 2017

research of the Chamber of Commerce and Industry of the Kyrgyz Republic among main reasons of low volumes of foreign investment in Kyrgyzstan named corruption, risk of expropriation without fair compensation, unstable legal framework, and breach of contractual obligations. The World Bank’s survey results highlighted a low level of trust within the domestic business community in the justice system of Kyrgyzstan; firms avoid settling commercial disputes via the country’s courts.

**Economic and financial factors**

Further on, the survey provided data on economic factors, which will have influence on improvement of the Kyrgyz investment climate during the next five years (Figure 1).

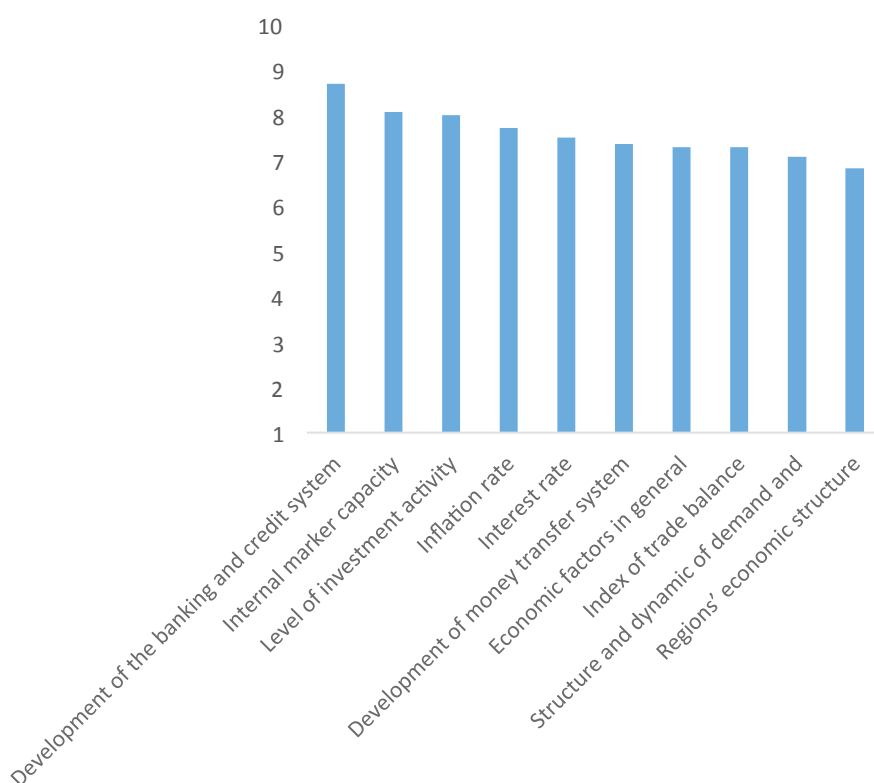


Figure 1. Influence of Economic factors on improvement of Kyrgyz investment attraction in the next 5 years, ranked from 1 (lowest) to 10 (highest) according to the survey of Kyrgyz experts carried out by IIASA.

Development of the banking and credit system, as well as the internal market capacity and the level of investment have the highest impact on investment climate. Financial institutions, including commercial banks and non-commercial institutions, are the main source of credit for various sectors of the economy. Average interest rates from commercial banks declined during the last decade from 22% in 2012 to 15% in 2018. According to the data of the National Bank of the Kyrgyz Republic for the first half of 2017, the overall credit portfolio of financial credit institutions amounted to 1.65 billion US dollars or 24% of GDP. According to the National Statistical Committee of the Kyrgyz Republic, in 2017 the commercial banks allocated 1.58 billion US dollars of credits, from which wholesale and retail trade received more than 452 million US dollars and agricultural holdings received more than 306 million US dollars.

Table 6. Distribution of commercial credits among major economic sectors

Sector	Percentage of allocated commercial credits in 2017
Wholesale and retail trade, including repair of motor vehicles and motorcycles	28
Agriculture, forestry and fishing	20
Consumer credit	10
Hypothec	10
Industry	10
Construction	7
Social services	3
Transport	2
Purveying and processing as well as telecommunication	1
Other	9

These data show weak credit attractiveness of the industrial sector and a stronger consumer-oriented nature of economic development, expressed in strong financing of wholesale and retail trade.

Starting from 2013 the Government of the Kyrgyz Republic began to **subsidize interest rates** for projects in the agricultural sector. During the period of 2013-2017 the volumes of such subsidies exceeded 29 million US dollars. The support from the Government helped commercial banks to provide 334 million US dollars of credits to 67 agricultural and food-processing holdings with the annual interest rates of 11%. On 13 October 2017 Government of the Kyrgyz Republic adopted Decree № 669 on the Project of "Funding of businesses of the Kyrgyz Republic for improvement of quality and safety of products through introduction of international quality standards, including system of management of food safety, based on HACCP (Hazard Analysis Critical Control Point)". The amount of credits under this project will exceed 5.8 million US dollars. The state mechanisms of subsidizing interest rates allow a significant decrease of interest rates from commercial banks and also provide access to concessional lending for a significant number of private enterprises.

The IIASA survey identified that the following financial factors have the highest impacts on investment: existing tax system, level of balance of payments and profitability of regional projects, as well as the level of balanced regional budgets and finances of the business. The UNIDO diagnostic report identified following barriers: lack of government guarantees for returns of investment, both local and foreign investments, and constantly "jumping" exchange rates.

The 2017 Moody's Investment Service affirmed the Kyrgyz Republic's local and foreign currency issuer ratings at B2 and maintained the outlook at stable. The following parameters were highlighted:

- Kyrgyz Government's debt levels will remain relatively high (58.9% of GDP at the end of 2016), although the fiscal deficit and debt levels are likely to ease in coming years. A large and stable revenue base and the largely concessional nature of government debt will continue to keep servicing costs low;
- Kyrgyz economy's shock absorption capacity will remain low due to its small size, a lack of operational scale in a number of sectors, and low incomes;



- Kyrgyz institutional strength will continue to develop, including through ongoing reform in partnership with the International Monetary Fund (IMF).

The sovereign's 'Medium' susceptibility to event risks, given in particular the highly dollarized banking sector and volatile political system. One of the sources of event risks was – external payments position, which weakened by persistently very large current account deficits, only partly funded by foreign direct investments. International investment position of Kyrgyzstan has deteriorated markedly to -79% of GDP, pointing to increased reliance on debt financing. This risk was mitigated by very low external debt service payments. The rating stated however that Kyrgyzstan has prospects for high economic growth and donor-funded infrastructure investment.

Following factors might have negative effect on future ratings: withdrawal of donor support, which would add to the government's borrowing costs; large financing needs due to fiscal deficits combined with a substantial deterioration in debt structure; economically destabilizing political and social tensions.

As for recommendations, the report reiterated fiscal consolidation efforts that lead to a significant reduction in the government's debt burden and necessity of growth-enhancing structural reforms, especially if they are combined with continued evidence of domestic political stability. Indebtedness is indeed a challenge if one thinks of funding sources for industrialization. If credit worthiness is affected, then overall investment attractiveness in manufacturing will suffer, even more so if no interesting and credible rates of return on investment are provided. So, recommendation could be to engage with national level authorities to analyze possible solutions to financing requirements for industrialization. So, this issue becomes more of a risk and any strategy on industrial development should suggest preventive measures to be analyzed and introduced accordingly.

### **Production factors**

The IIASA survey identified following production factors, which can become barriers for investment into industrial projects. These are the following factors: commodity, labor, industrial and innovative factors and infrastructure. Among the commodity factors the most important ones are availability of natural resources, the level of their depletion and distribution among the regions. The labor factors include availability of highly skilled professionals and the existing system of remuneration for work and labor protection. The industrial factors include regulations for land use (such as rent and property) and deterioration of main assets. Innovative factors are existing regulation for protection of property rights, the overall level of innovation in the country, the level of science and technology advancement and the intellectual and educational level of population. The infrastructural factors include the availability of infrastructure such as transport, telecommunications and energy as well as the development of logistics chains and geographic position of the regions.

The UNIDO Diagnostic report identified the following production factors as barriers for investment: a) lack of strict rules in Kyrgyz legislation on land allocation and reliability of the use of water, land and excessive bureaucracy in land acquisition; b) lack of strategic and long-term vision of local authorities on informing the public about feasibility and advantages of small hydropower plants in local areas; and c) lack of guarantees from distribution companies on timely payment for electricity.

Speaking about innovation as a production factor, according to the [Global Innovation Index 2018](#), prepared by Cornell University, INSEAD, and the World Intellectual Property Organization (WIPO), the Kyrgyz Republic

is ranked 94<sup>th</sup>. This is a slightly change to compare with previous report in 2017, when Kyrgyzstan was ranked 95<sup>th</sup>, so the country moved up one score. At this, authors of the report underline that in the last years Kyrgyzstan improved its rank considerably. One of the main problems of innovation is that Kyrgyz research institutes are at a low end since early 90s, with salaries still being at one of the lowest levels in the country. The document, among others, mention expenditure on education, FDI net inflows in knowledge absorption, and FDI net outflow in knowledge diffusion, as strengths; and citable documents H index, ICTs & business model creation, ICTs & organizational model creation and QS university ranking, – as weaknesses. Another international ranking – World Economic Forum’s Global Competitiveness Report 2017-2018 placed Kyrgyzstan at a very low, 130<sup>th</sup>, place out of 137 in FDI and technology transfer criteria (extent to which foreign direct investment bring new technology in Kyrgyzstan).

Speaking about infrastructure as a production factor, according to data from the World Economic Forum’s Global Competitiveness Report 2017-2018 Kyrgyzstan is at 112<sup>th</sup> place out of 137 in Quality of overall infrastructure ranking, 122<sup>nd</sup> out of 137 in Road quality ranking, 102<sup>nd</sup> out of 137 in Quality of electricity supply ranking. Automobile roads in Kyrgyzstan are intensively used, however railroad network stays unbranched and the railroad connecting southern and northern regions of the country is missing. Another major obstacle in infrastructure development are the difficulties of business to get connection to electric grid, rolling blackouts and growing indebtedness of energy companies.

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## 4. Socially and environmentally sustainable investment

IIASA survey conducted with Kyrgyz stakeholders identified that ecological factors and the need to protect environment are perceived as important factors by the Kyrgyz stakeholders. Industrial activities are providing pressure on water reserves, soil and air. During the last years the volumes of polluting substances from industry increased by 21%. Also, the volumes of industrial waste and products of industrial activity are increasing. To add to this, that there are almost no measures for processing of waste. Especially mining industry, which frequently is being located in fragile ecosystems of mountains, significantly influences the environment.

The draft of the Program of the Government up to 2040 names the waste reduction as one of the strategic priorities. The waste reduction should include a decrease of the volumes of produced waste, processing of waste and secondary usage of materials. It is planned to implement measures to close and to clean up reserves of radioactive waste, which was located on the territory of Kyrgyzstan during the previous century, and on the waste from metallurgic and mining industries. Also measures of needed to decrease the number of solid household waste, which are growing with every year. According to the report of PAGE for 2017, packaging makes around 40%-50% of the solid waste. One of the solutions would be also to stop using one-time disposable plastic products.

Several measures to protect environment are planned in Kyrgyzstan. These measures include new improvements to legislation, development of a national policy on climate change, strengthening of international cooperation on environmental problems to meet obligations under global environmental conventions, new programs which aim to enhance conservation of biodiversity, sustainable use of natural resources and increased level of awareness about climate change mitigation as well as involvement of civil

society in development and implementation of policies and legislation. Also, legislation is currently under development of protecting Kyrgyzstan from impacts of natural hazards as well as to decrease its environmental vulnerability.

To facilitate sustainable industrial development of Kyrgyzstan, it is important that investment, which is going into the country, does not only contribute to economic growth but also satisfies criteria of environmental and social sustainability. Participatory governance, which includes close interaction and continuous consultations on environmental sustainability and resource efficiency with stakeholders at national, regional and local levels, can contribute to social and environmentally sustainable character of investment. Also measures of participatory governance, such as environmental impact assessment and social impact assessment, can reduce potentials for social tensions and protests against planned and existing infrastructure projects. Consultations can also help to prevent events like the protests of April 2018, when inhabitants of local communities protested against the Ji El Makmal Development gold recovery company in Jalal-Abad region and burned down several pieces of machinery and equipment.

Specialized agreements with investors are another effective instrument, which can help to ensure social and environmentally sustainable investment. The Strategic Agreement on Environmental Protection and Development of Investments for the Kumtor Project is a good example. The agreement was signed in September 2017 by the Government of Kyrgyzstan and Centerra Gold Inc. It laid down conditions how the implementation of the Kumtor project can be connected with the implementation of environment protection measures. According to this agreement, the Centerra Gold Inc. took new obligations on expanded financial support for implementation of measures on environment protection, primarily, for the water area of the Issyk-Kul lake.

**Strategic Agreement on Environmental Protection and Development of Investments for the Kumtor Project**

In January 2018 the Kyrgyz Government created the Public Nature Development Fund, which should finance measures for improvement of environmental situation in Kyrgyzstan. The contribution from the Kumtor project will go into this fund. For instance, according to the strategic agreement, the Centerra Gold company should provide a one-time payment in the amount of 50 million US dollars as well as annual payments in the amount of 2.7 million US dollars starting from the year 2017 and until the end of the Kumtor mine operation. The Centerra Gold company will also make a one-time payment of 3 million US dollars to the Cancer Care Support Fund, which is administered by the government. The payments which will be made into the Public Nature Development Fund should be used exclusively for implementation of measures of environmental protection and conservation of natural resources as well as on capacity building measures for environmental specialists, support of ecological and natural well-being and assistance to sustainable development of Kyrgyz natural resources.

Further priorities of the Kyrgyz Government policy are on expansion of the scale of social partnership and ensuring output and procedural justice during the implementation and planning of infrastructure projects. This also includes an increased level of transparency and possibility for engagement into decision-making

processes. Such standardized agreements should provide not only possibilities for implementation of environmental protection measures but also provide certainty to investors. For example, agreements which are subject of renegotiation can lead to situation when requirements for compensation payments are growing or changing, thus, creating uncertainty for investors. Such uncertainty resulted in a dispute with the Canada's Centerra Gold and filing for international arbitration when agreement was changed and requirements for compensation payments increased.

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## 5. Key messages

Key messages and conclusions of this chapter are based on several sets of data such as review of existing in Kyrgyzstan regulations and cases, several rounds of questionnaires and surveys as well as interviews with Kyrgyz stakeholders as well as interviews with international experts.

### 1. Improve certainty to investors and decrease investors risks

The unstable political environment worries foreign investors for many reasons, but the most primary concern comes from distrust in the country's justice system. The International Development Law Organization, an intergovernmental group in Rome, has stated that the "Kyrgyz judiciary is not favorably viewed by the public and, at the same time, the public is not well-informed about the functions and duties of the courts." The World Bank's survey results also highlighted a low level of trust within the domestic business community in the justice system of Kyrgyzstan; firms avoid settling commercial disputes via the country's courts. Such worries then translate into risk aversion towards investment into industrial projects. Given high levels of intransparency and recurrent political instability, Kyrgyzstan has been drawn to international arbitration to settle investment disputes with foreign investors. Foreign investors and companies prefer to settle commercial disputes via institutions for international arbitration, such as ICSID or UNCITRAL. Therefore, one of the major barriers for investment into industrial development is not the lack of regulation but poor **implementation of these regulations**, which are influenced by the above – mentioned governance risks. The recommendation here is to review the reasons for such underperformance and if they lay in missing capacities, low understanding of implementation problems or the lack of budget. Another recommendation is to ensure continuity of the state investment policy and mitigation of the risk of expropriation without a fair compensation. The measures on protection of investors should include enhancement of property rights protections, including protection of minority investors, further development of legislation framework as well as its implementation.

According to interviews with Kyrgyz stakeholders, conducted by IIASA, one of the measures to facilitate private investment and to improve conditions for doing business is the e-governance reform. The measures for this reform should be reflected in the legal framework. For instance, the current Law "On State and municipal services" foresees amendments, which take into account **digital transformation of public and municipal services**, also referred to as "digital service government". Other measure is the Government decree on interagency electronic interaction, provision of services and enhancement of efficiency of government bodies through a wider use of information and communication technologies. It also includes automation of public services such as public services portal, possibility to provide documents in electronic forms for registration of legal entities. There are also plans for introduction of single electronic database of the notary documents and the preparation of the draft law on electronic commerce.

Another key message is to prepare **investment packages** to guarantee certainty for internal investment and FDI. The plans are to prepare at least several substantial investment proposals for manufacturing cluster by 2020. The necessary regulatory frameworks for these plans are currently under development. For instance, the Government decree on formalization of the necessity to create attractive investment conditions for manufacturing clusters in the regional development programs is currently under development.

The introduction of "**single window**" should also facilitate investment and create favorable conditions for interaction between government bodies and investors. The Government decree on the provision of public services to investors following the principle of the "Single window" should be prepared during the year 2019. According to this principle investors should have an opportunity to obtain the entire spectrum of consultative, legal and administrative services for investment from a single government body.

## **2. Continue with deployment of instruments, which facilitate investment into industrial projects**

Government of Kyrgyzstan is currently considering several instruments such as Free Economic Zones, High Technology Parks, Private Public Partnerships and Special Economic Zones. Further assessment of efficiency of these instruments and feasibility of their deployment is needed. Also, further assessment is needed about the ability of these kinds of policy instruments to drive industrial development. Such assessment should be based on a critical review of existing experience. So the short-term recommendation is to provide evaluation of these policy instruments to inform medium-term interventions and required changes in existing policy frameworks and investment requirements in capabilities to benefit from such interventions.

## **3. Address economic and financial barriers and improve accessibility of finance**

The recommendation is to continue with further development of the banking and credit system, including providing financial instruments of support to reduce interest rates for investment and to increase the period of their repayment, which can help to increase credit attractiveness of the industrial sector. Another recommendation is to soften credit requirements and the conditions for verification of loan purposes used by development funds. Also, further efforts are needed to reduce government debt burden and to attract private capital into financing of industrial projects.

Further recommendations are about improvement of macroeconomic stability and prosperity, which include stabilization of the exchange rates dynamics, the decrease of susceptibility to event risks, the limitation of the national debt and burden and the systematic undertaking of the fiscal consolidated efforts. The macroeconomic stability will also require growth-enhancing reforms combined with a banking sector stability policy.

## **4. Increase quality of production factors as a necessary condition for investment into industrial projects.**

For social and labor factors, this will require special educational programs, such as vocational training, specialized training, courses on main languages of international communication, etc., to increase competencies and skills of workers in different industrial sectors.

For innovation factors, the measures on improvement of investment climate should be combined with creation of conditions for innovative industries, development of innovation within the country and facilitation of innovative technologies and know-how transfer.

There is an urgent need to address the infrastructural factors, which are needed for industrial development. This would include providing reliable and secure electricity access and facilitation of access to electricity grids, further deployment of transport and telecommunications infrastructure, which is necessary for industrial development.

Also, the question of commodity factors should be addressed, which would require an assessment of available commodity factors for industrial development in the regions as well as implementation of measures to avoid their depletion. Further recommendations are to improve legislation and planning for usage of such resources as water and land and facilitation of usage of such resources for industrial activities with coordinated implementation of measures for their sustainable use and protection. The implementation of social and environmental impact assessments should reduce negative impacts on environment and human health and guarantee socially sustainable character of investment.

Implementation of **social impact assessment** (SIA) and **environmental impact assessment** (EIA), as it is existing nowadays in several countries, can help to guarantee environmentally and socially friendly character of investment. Internationally, the SIA is defined as a study that seeks to understand the changes that a project or policy can produce in the social sphere and the potential negative and positive impacts associated with them, as well as the process of managing the social issues associated with the intervention. This includes all the effects that an intervention has at the social level (life forms, work, recreation, relations between people, and organization) and cultural level (values, beliefs, and norms that drive the way people perceive themselves and their community). Its objective is to inform governmental actors, companies, social actors, and communities about the sociocultural effects that a policy or project will have in a specific context, to avoid or mitigate its adverse social aspects and amplify potential positive impacts. As the social aspects of economic development have received more attention by social and political actors, the SIA has been adopted by different international agencies and national governments, promoting its theoretical and practical advancement.

Large-scale industrial infrastructure projects such as mining affect local communities and their livelihoods, therefore, an EIA is required for infrastructure projects that are likely to have considerable negative impacts on the environment. EIA allows for participation of all stakeholders and inhabitants of affected communities as participation is at its core and everybody can comment on the outcomes of EIA. It is actually one of the main aims of EIA to encourage the participation of different parties in the planning phase before project implementation takes place. The purpose of EIA is to reduce or prevent negative environmental impacts of the projects while involving knowledge of all interested stakeholders and people on the ground. The EIA is not a decision-making procedure, but an evaluating and planning procedure, which can inform policy and what is regarded as a "considerable impact" depends on the nature of the project and is case-specific. The EIA reports have to be approved before the environmental permits are given to the project.

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