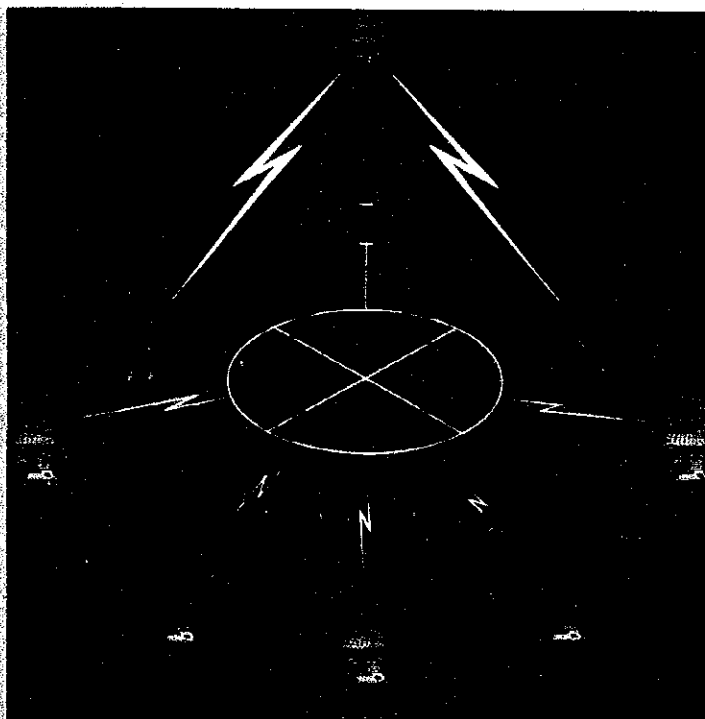


**STUDY ON IMPROVEMENT
OF
PAYMENT SYSTEM
IN
THE KYRGYZ REPUBLIC
(MAIN REPORT)**



FEBRUARY, 1995

**UNICO INTERNATIONAL CORPORATION
SAKURA INSTITUTE OF RESEARCH**

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JAPAN INTERNATIONAL COOPERATION AGENCY (JICA)
NATIONAL BANK OF KYRGYZSTAN

STUDY ON
IMPROVEMENT
OF
PAYMENT SYSTEM
IN
THE KYRGYZ REPUBLIC
(MAIN REPORT)

FEBRUARY 1995

UNICO INTERNATIONAL CORPORATION
SAKURA INSTITUTE OF RESEARCH

国際協力事業団

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Preface

In response to a request from the Government of the Kyrgyz Republic, the Government of Japan decided to conduct a Study on Improvement of Payment System in the Kyrgyz Republic and entrusted the study to the Japan International Cooperation Agency (JICA).

JICA sent to Kyrgyz a study team headed by Mr. Nobuo Aihara, UNICO International Corporation, and composed of members of UNICO International Corporation and SAKURA Institute of Research three times between January 1994 and November 1994.

The team held discussions with the officials concerned of the Government of Kyrgyz, and conducted field surveys at the study area. After the team returned to Japan, further studies were made and the present report was prepared.

I hope that this report will contribute to the promotion of the program and the enhancement of friendly relations between our two countries.

I wish to express my sincere appreciation to the officials concerned of the Government of the Kyrgyz Republic for their close cooperation extended to the team.

February 1995



Kimio Fujita
President

Japan International Cooperation Agency

February 1995

Mr. Kimio Fujita
President
Japan International Cooperation Agency
Tokyo, Japan

Dear Mr. Kimio Fujita

Letter of Transmittal

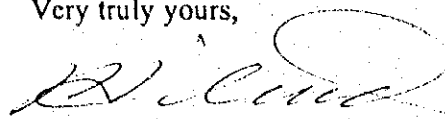
We are pleased to submit to you the study report on Improvement of Payment System in the Kyrgyz Republic.

The report presents the development strategies for improvement of financial and payment system in the Kyrgyz Republic upon our scrutinized analysis on its present status. With regard to the payment system, in particular, the report contains the preliminary design for the construction of payment system with computerized network throughout the country as well as plan of installation, maintenance and management of the projected system. Proposals for realization of the project together with its overall evaluation are also presented.

In view of the urgency of the improvement of payment system in the Kyrgyz Republic and of its resultant extensive contribution to socio-economic development of Kyrgyz as a whole, we recommend that the esteemed government of the Kyrgyz Republic implement this Project as a top priority.

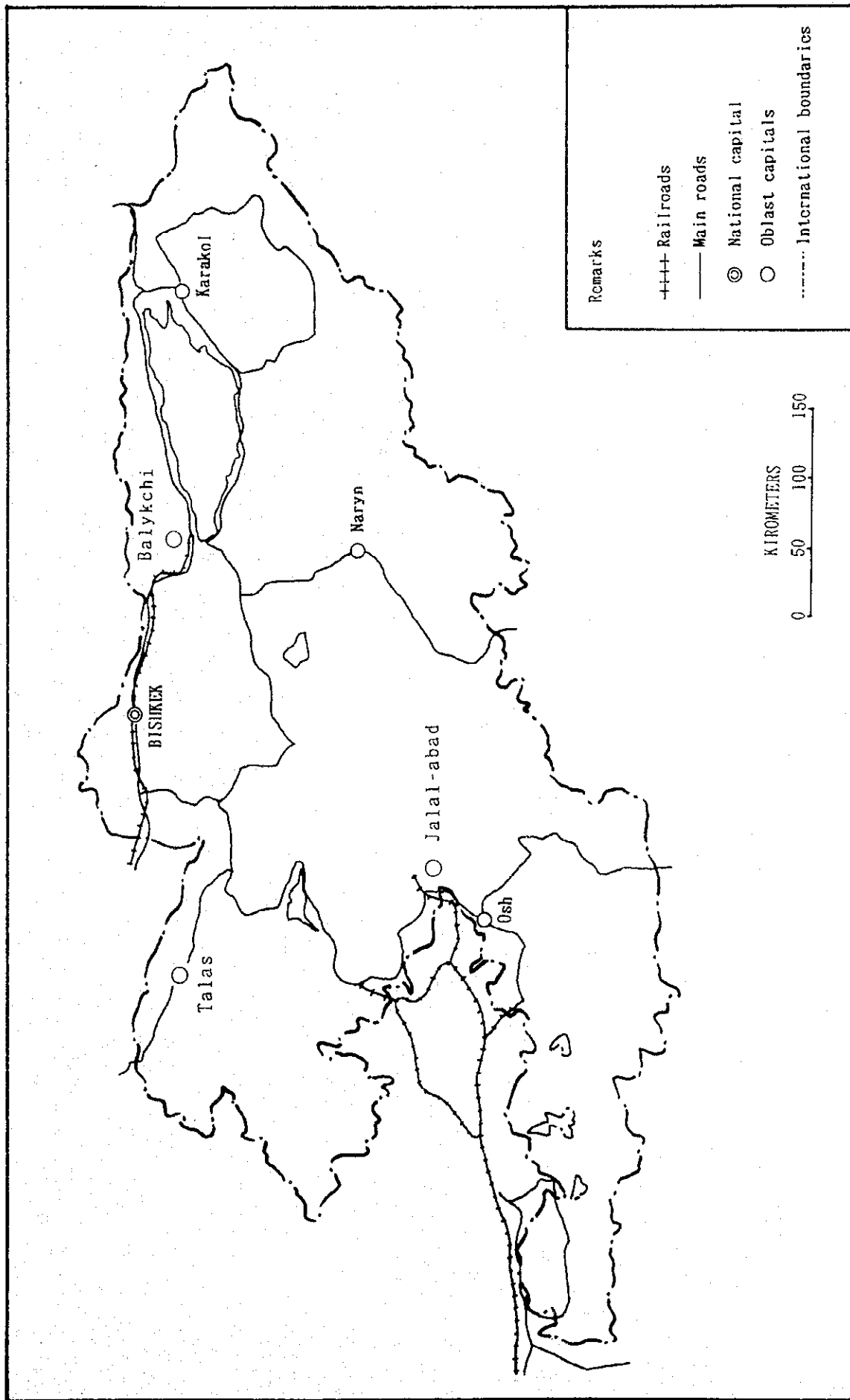
We wish to take this opportunity to express our sincere gratitude to your Agency, the Ministry of Foreign Affairs. We also wish to express our deep gratitude to the National Bank of Kyrgyzstan and other authorities concerned of the Government of the Kyrgyz Republic for the close cooperation and assistance extended to us during our investigations and study.

Very truly yours,



NOBUO AIHARA, Leader

Study Team on Improvement of Payment System
in the Kyrgyz Republic



KYRGYZSTAN

Abbreviations(1)

A/C	Account
ACS	All Chigin Cash Service
ADB	Asian Development Bank
ASCII	American Standard Code for Information Interchange
ATM	Automatic Teller Machine
BA	Banker's Acceptance
BANCS	Bank Cash Service
BOJ	Bank of Japan
BS	Balance Sheet
CB	Convertible Bond
CC	Computer Center
CD	Cash Dispenser
CF	Cash Flow
CH	Clearing House
CHAPS	Clearing House Automated Payment System
CHIPS	Clearing House Inter-Bank Payment System
CIBN	Cooperative Inter-Bank Network
CIF	Cost, Insurance and Freight
CIS	Commonwealth of Independent States
CPM	Critical Path Method
CPU	Central Processing Unit
Cr	Creditor
DAC	Development Assistance Committee
DBMS	Data Base Management System
DCF	Discounted Cash Flow
DM	Data Management
DOS	Disk Operating System
Dr	Debtor
DT	Data Terminal
EB	Electronic Banking
EBRD	European Bank for Reconstruction and Development
EDP	Electronic Data Processing
EFT	Electronic Funds Transfer
EGR	Economic Growth Rate
EIRR	Economic Internal Rate of Return
FB	Firm Banking
FDD	Floppy Disk Drive
FLOAT FUND	FUND to be kept by banks during the period of transfer
FOREX	Foreign Exchange
FSU	Former Soviet Union
FY	Fiscal Year
G/L	General Ledger
GAB	General Agreement to Borrow
GB	Giga Byte
GDP	Gross Domestic Product
GNP	Gross National Product
Goskominvest	State Commission on Foreign Investment and Economic Assistance
Goskomstat	State Committee on Statistics
GUI	Graphic User Interface
H/W	Hardware
HB	Home Banking
HD	Hard Disk
HDD	Hard Disk Drive
HDLCL	High-Level Data Link Control
I/O	Input-Output
IBF	International Banking Facility
IBRD	International Bank for Reconstruction and Development (World Bank)
IDA	International Development Association

Abbreviations(2)

IFC	International Finance Corporation
IMF	International Monetary Fund
IRR	Internal Rate of Return
ISB	Inter-State Bank
JICA	Japan International Cooperation Agency
KB	Kilo Byte
LAN	Local Area Network
LIBOR	London Inter Bank Offered Rate
M/M	Minutes of Meeting
MB	Mega Byte
Mb	Broad Money
MOC	Ministry of Communication
MOF	Ministry of Finance
Mq	Quasi-Money
MS-DOS	Microsoft Disk Operating System
MSB	Mutual Savings Bank
MT	Magnetic Tape
NBK	National Bank of kyrgyzstan
NN	Network Node
PC	Personal Computer
PI	Payment Instruction
PL	Product Liability
POS	Point of Sales
RCC	Regional Clearing Center
RCH	Regional Clearing House
RKC	Regional Cash Center
ROA	Return of Asset
ROE	Return of Equity
RP	Rashotonaya Parata
S/W	Scope of Work
S/W	Software
SB	Savings Bank
SE	Systems Engineer
SPF	State Property Fund
SWIFT	Society for Worldwide Interbank Financial Telecommunications
T/R	Terms of Reference
TB	Treasury Bill
TIBOR	Tokyo Inter-Bank Offered Rate
TP	Transaction Processing
TRX	Transaction
TT	Telegraphic Transfer
UA	User Agent
USAID	United States Agency for International Development
VAT	Value Added Tax
Vm	Velocity of Money
Vmb	Velocity of Broad Money
WB	World Bank
WEU	Western European Union
WS	Work Specification

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Chapter 1 Introduction

Chapter 1 Introduction

JICA Study Team commenced their research work for the Study on Improvement of Payment System in the Kyrgyz Republic at the end of November, 1993, in accordance with the Scope of Work signed on August 3, 1993 at Bishkek between National Bank of Kyrgyzstan (NBK) and Japan International Cooperation Agency (JICA).

The Team has conducted the First Field Survey from January 6, until March 6 and the Second Field Survey from June 26 to August 25, and the Third Field Survey from November 6, 1994 for the period of 15 days. Progress Report, Interim Report and Draft Final Report have been lodged with NBK and JICA by the Study Team in February, August and November 1994 respectively. Between the periods of these Field Surveys, the Team has continued their analytical study work in Japan.

This Report represents the Final Report for the Study on Improvement of Payment System in the Kyrgyz Republic, the Major Components of which are summarized as follows:

- (1) The present situation of the macro economy, the financial system and the payment system in Kyrgyz are reviewed and its main problems and policy issues are subsequently taken up and analyzed respectively.
- (2) The social and economic framework which would be built up in the target year of 2000 is designed.
- (3) On the basis of the results of the above analysis, the future volumes of the payment transactions up to the years of 2000 are forecasted according to the diversification of types and means of transactions.
- (4) Coincidentally, the development strategies of the financial system in the Kyrgyz Republic are formulated together with the forecast of the financial framework which is expected to be built up in the year of 2000.
- (5) Finally, the computer network payment system to be developed up to the year of 2000 is formulated, together with

- Formulation of plans and implementation programs for the development strategy for the payment system using a computer network
- Preliminary design of the proposed hardware, software and network of computer plan
- Plan for introduction, operation and maintenance, etc.
- Preliminary cost estimation
- Economic & financial analysis on the Study
- Overall evaluation and proposition as mentioned above

Three Seminars were held during the period of three Field Surveys by having lectures on "Financial and Payment System and Introductory Process of Systems Development in Major Countries", "The Present Conditions and Future Image of the Financial and Payment System in Kyrgyz", and "Realization of the Payment System Improvement Program". Upon the Third Field Survey, personal computer-based demonstration on payment system was presented during the Seminar.

The Study Team would like to take this opportunity to express their hearty gratitude for the most cordial assistance and cooperation extended to the Team by NBK, governmental institutions, commercial banks, enterprises and all the persons concerned, in particulars, to the member of the counterparts of NBK who worked jointly at all times with the Study Team in this Study Work.

Chapter 2 Background and Objectives of the Study

Chapter 2 Background and Objectives of the Study

2-1 Background of the Study

Kyrgyz is presently exerting their uttermost efforts to promote structural reform of the economy in order to effect a smooth transition from the central planning used during the Soviet Union era to a market economy, invigorating economic activities in the course of that process. The improvement of the environment to enable adoption of a market economy system is the most pressing task for Kyrgyz at present.

It is understood that since attaining independence, the government of the Kyrgyz Republic, by such means as establishment of the central bank, proclamation of the Banking Law and introducing a national currency, is seeking to invigorate and reconstruct the national economy by shifting to a market economy regime, and strongly wishes to both build a modern financial system and improve the efficiency of the payment system through computerized network system.

In this country at the present time, the insufficient provision of financial system is a major obstacle to invigorate the national economy and has caused a negative effect on economic activity resulting in the economic stagnation in this country.

No doubt, the financial system constitutes the most essential so-called software infrastructure in the free market economy system.

In particular, the retarded development of the payment system had lengthened the duration of time needed to transfer money and accomplish payments, and because emphasis is placed on payment in cash, the turnover (velocity) of funds is low, and the problem of hindrance to money flow to production, distribution and the consumer market has arisen. It is believed that by building a efficient, high-productivity bank payment system, it will be possible to facilitate the supply of capital to areas where it is needed through improving the flow of funds, in addition to contributing to more effective control of money supply.

It is not too much to say that the success in the shift to the market economy and subsequent vitalization of the Kyrgyz national economy should inevitably rely upon the improvement of the Financial System including Bank Payment System.

Under the circumstances, in response to the official request of the Kyrgyz Republic, Japan International Cooperation Agency (JICA) nominated UNICO International Corporation (UNICO) and Sakura Institute of Research (SIR) to undertake "The Study on Improvement of Payment System in the Kyrgyz Republic" (the Study), the objectives and scope of which are defined in the Scope of Work attached in the annex. UNICO and SIR have hereby formed a Study Team (the Team) comprising experts who have wide and deep experience in the financial system as well as the payment system including the most advanced electronic banking system.

2-2 The Overall Objectives of the Study

The overall objectives of the Study are:

- firstly to formulate a development strategy to establish a more modern and efficient financial system by the year 2000,
- secondly to formulate the subsequent improvement plan of the payment system by use of a computer network system and,
- thirdly to accomplish a transfer of the technology to the Kyrgyz counterparts throughout our joint Study Work and seminars to be organized in Bishkek three times in total.

2-3 Methodology of Carrying Out the Study

1. Current macroeconomic situation in Kyrgyz were studied. In addition, the Study Team established the contours of the social economic situation in Kyrgyz in the year 2000. These contours will be derived from approximations of Kyrgyz's population, industrial structure, GDP, balance of payments structure, the number, size and managerial methods of its corporations, its employment situation, etc., in the year 2000. Based on this predicted social economic situation, the number of financial transactions and payments in the year 2000 were estimated for each type of transaction. At the same time, the computer payment system which is the most appropriate for Kyrgyz will be established.
2. In collecting local data, the Study Team did not stop with not only collecting official statistics, but also visited relevant ministries and agencies - primarily NBK, also the Ministry of Finance, the Ministry of Industry, Goskomstat,

Goskominvest, etc. – as well as all the commercial banks and various local corporations, and had them all fill out questionnaires.

3. Three seminars that included study and training regarding payment systems were held. In so doing, the Study Team were able to survey the opinions of people involved with local financial and payment systems. In addition, the Team conducted technical transfers by means of a demo model of a payment system that used personal computers.

4. The study was undertaken by the following approaches:

- (1) Work in Japan

- 1) Analysis of existing materials and collection of related information
- 2) Preparation for the first workshop

- (2) First Field Study

- 1) Obtaining an understanding of the social & culture aspects of the background
- 2) Obtaining an understanding of present conditions of the economy, industry & trade
- 3) Obtaining an understanding of regional characteristics & relation of region
- 4) Survey of present conditions of the financial system
- 5) Analysis of results of efforts at development of the financial system
- 6) Review of development strategy for the financial system
- 7) Holding of the first workshop

- (3) First Phase of Analytic Work in Japan

- 1) Determination of key problems of the financial system
- 2) Analysis of constraints & priorities in development of the financial system
- 3) Forecast of the number & scale of financial transactions & settlements
- 4) Drafting of a scenario for development strategy for a bank payment system
- 5) Preparation for the First Seminar

(4) Second Field Study

- 1) Formulation of the socio-economic framework
- 2) Formulation of development strategy for the financial system
- 3) Formulation of the framework for the financial system
- 4) Formulation of development strategy & planning for the bank payment system
- 5) Holding of the First Seminar

(5) Second Phase of Analytic Work in Japan

- 1) Formulation of development strategy & implementation program for the financial system
- 2) Formulation of the basic program for improvement of the payment system
- 3) Formulation of plans & implementation programs for the development strategy for the financial system, and development strategy for a payment system using a computer network
- 4) Preparation for the Second Seminar

(6) Third Field Study

- 1) Explanation of & discussion on the draft final report
- 2) Holding of the Second Seminar

(7) Third Phase of Analytic Work in Japan

- 1) Preparation of the Final Report

Chapter 3 The Social and Economic Situation of the Kyrgyz Republic

Chapter 3 The Social and Economic Situation of the Kyrgyz Republic

3-1 Purposes of This Chapter

This chapter does not aim to present an overall introduction to the social and economic situation of the Kyrgyz Republic. We have limited the scope of our concerns to those matters directly related to the aims of the present survey. Firstly we have focused on showing why the development of payment systems is necessary for the economy of the Kyrgyz Republic. In a later chapter we have carried out economic evaluations of benefits on the basis of existing statistical data assuming a specific payment system. In this chapter we will consider the utility of the payment system development by a general economic analysis. Secondly, it is necessary to study basic information for the purpose of selecting the actual design of the payment system. Designing the payment system involves not only considering the basic social and economic conditions, but since a payment system is part of the financial system it is also necessary to give sufficient consideration to the overall organization of existing financial systems. Of course the financial system is itself considerably influenced by the social and economic context. Thirdly, it is necessary to gather the basic data needed for drawing up forecasts of the social and economic framework for the target year of 2000. Such a framework will provide the statistical data needed for evaluating and selecting the specific design of the payment system project. Finally, it is important to study whether the necessary social and economic foundations for developing a payment system are available or not. One example to be treated in this last area is the question of political stability.

3-2 Social Situation

3-2-1 National Territory and Natural Conditions

The Kyrgyz Republic lies to the west side of the Tianshan mountain range in Central Asia, and formerly one of the main Silk Roads linking China to Uzbekistan passed here. Total national surface area is 190,000 sq. km. representing about half of the national area of Japan. More than 94% of national territory is located above 1,000 meters altitude while 49% is over 3,000 meters altitude. In addition to Lake Issyk-kul which is more than 9 times the surface size of Lake Biwa in Japan, there are plentiful

river resources suited to generation of hydroelectric power. The climate is continental type with low rainfall and high temperatures in both summer and winter. Agricultural production is very closely linked to the amount of rainfall.

3-2-2 Political Situation

Since the area has served as a crossroads since early times there is a long history and experience of cultural and economic exchange and interaction. While Islamic culture has a strong influence, the proximity to China has meant that the Kyrgyz Republic is also one of the countries in Central Asia which shows strong Asiatic cultural influences. Traditionally being a nomad and pastoral culture, the nation was integrated as a socialist republic of the USSR after the Russian Revolution. With national independence from the Soviet Union in August, 1991 the country also abandoned its former socialist regime. In 1993 a new constitution was established which guaranteed the political liberties of freedom of thought and expression and economic liberties of occupational choice and free enterprise. The Constitution establishes and guarantees the separation of the three branches of government under a Presidential system. The Constitutional Amendment of October, 1994 reorganized Parliament as a two house system composed of a permanent Legislative House with 35 members and a non-permanent House of Representatives made up of 70 members. In addition to appointing the Prime Minister with the approval of Parliament the President is responsible for overall coordination of the government. The President is empowered to issue Presidential decrees as distinct from governmental laws. Such decrees may or may not be ratified as laws. In October, 1991 President Akayev, currently in office, was elected as President for a term of 5 years. President Akayev enjoys an extremely high level of national support which is thought to be largely due to his commitment to actively furthering a policy of the transition to a free market economy. Governmental organization consists of a President's Office and Prime Minister's Office which preside over 14 Ministries and 10 State Committees. The governmental bodies concerned with economic affairs are the Ministry of Finance, the State Committee on Foreign Investment and Economic Assistance (SCFIEA) and the State Committee on Economy (SCE). The Ministry of Finance is responsible for works connected with national budgeting, while financial policies including bank supervision are delegated to the central banking authority that is the National Bank of Kyrgyzstan. The SCFIEA consists of the heads of five Ministries including the Ministry of Finance, the head of the SCE and the NBK. The SCFIEA has its own independent staff and is responsible

for all liaison activities for channeling overseas assistance.

3-2-3 National Characteristics

The total population of the Republic is 4.47 million of which 56% are Kyrgyzs followed by Russians who account for 18% of total population, and Uzbeks with 13% of the total (refer to Table 3-1). The following outlines the main points of national character.

Firstly, in comparison with other national populations the age structure of the Kyrgyz population shows a higher ratio of younger age groups (up to 16) while the ratio of elderly is comparatively low (cf. Table 3-2). The second noticeable particularity is the quite high level of education. Compulsory education as in Japan is for a period of nine years (under the Soviet system this was 10 years) beginning at the age of 6. After compulsory education students decide on a course of secondary education for a further two years in the light of their decisions about future careers (so that compulsory education could be said to be for 11 years if these last two years are included). 93% of the population benefits from compulsory education while 13% of the student population proceed on to university. The literacy rate in 1989 was at the very high level of 99.7%. (cf. Table 3-3).

The third national characteristic is the existence of a strong tradition of mercantile and entrepreneurial spirit fostered and promoted as a result of the role of this area as a trading crossroads on the Silk Roads since the Tang period. The recent flourishing of small-medium size businesses and the dynamism of bazaars are signs of the revival of this traditional spirit of entrepreneurship in the context of the ongoing shift to a market economy.

In view of the above national characteristics we conclude that there is sufficient expertise and readiness to permit the introduction of free market mechanisms and technologies and that the Kyrgyz nation will be able to adapt to a free market economy.

3-2-4 Relations between the Center and Local Regions.

The autonomy of local government is clearly stipulated in the Constitution and local government is presided over by State Governors who are appointed by the President of the Republic with the agreement of the Prime Minister and Parliament. Therefore in comparison with countries of a federalist nature the independence of regions is limited. Looking at population distribution we see that 30% of overall population is concentrated in Chui region and the capital city of Bishkek (cf. Table 3-

4). Population statistics for the main cities are 5.97 million population in the capital Bishkek, 2.19 million in Osh, 720,000 in Jalal-abad, 620,000 in Karakol, etc.

There is a large disparity between the level of industrial production achieved in the center and that in the provincial regions. Bishkek and the Chui Region (the center) account for 58.2% of overall industrial output value while the Talas and Naryn regions together accounted for less than 1% of total value. A similar disparity in production values can be seen also in the case of agriculture production with the central region accounting for 26.5% of total output while the combined output of the Talas and Naryn regions accounted for less than 10% of total output value (please refer to Table 3-5).

Local tax revenue accounts for some 5 to 6% of the total national tax revenue. Part of the national revenue accruing from collection of company tax, income tax and commodity tax is allocated to the provincial governments in the form of regional assistance.

3-3 Current Economic Situation

3-3-1 Institutional Reforms for a Transition to a Market Economy

In order to make the transition from a socialist economy to a free market economy the Kyrgyz Republic has actively engaged in a program of institutional reforms and this republic is one of the most energetic of the Former Soviet Union countries pursuing such policies. Guarantees for basic economic freedoms such as freedom to undertake business enterprises, freedom to choose occupations, freedom of moving domicile, etc. have an enormous influence on the economic activity of a nation. In addition to such guarantees institutional reforms are also vital in the following four areas. It should also be noted that the introduction of the Som and banking system reforms are obviously also important reform measures but since these are two of the major themes of the present report we have considered these at length in subsequent chapters.

(1) Price Liberalization

It is essential for the smooth working of a free market economy that prices be free to fluctuate in response to the forces of demand and supply since this ensures the effective working of price mechanisms. The Kyrgyz Republic has furthered a policy of price liberalization since 1988 although about prices of 90% of all products were set by the government at the time of Independence. Measures for significant price liberalization were introduced in two stages in January, 1992 and

in December, 1993. At present, with the exception of the price of public utilities such as electricity and gas, etc. price regulations have been completely abolished. In this way while a policy of price liberalization has been pursued, the fact that large state enterprises continued to be run on a monopolistic system meant that price mechanisms were not completely effective and this was a major cause of hyperinflation. To counter this situation the Anti-Inflation Law was passed in 1993 to promote price competition.

(2) Privatization

A free market economy rests on the principle of the self management principle so that economic development results from enterprise and endeavor. The principle of self management means that while private sector firms are free to act the managers and personnel of such firms are held totally responsible for the results of their actions. When applied the principle encourages management and staff of a company to exert themselves to seeing that their methods of management, production and sales will keep the firm from bankruptcy. Firms are encouraged to supply better and lower cost products to satisfy the market.

In order for such a principle to be operative it is necessary for ownership to be transferred from the state to the private sector. The Kyrgyz Republic has undertaken an active policy of privatization since Independence. In February, 1992 the State Property Fund (SPF) was set up, and at the same time a Privatization Act was passed and an active program of privatization undertaken. At the present date of January 1st, 1994 the ratio of privatization (in fixed property terms) is calculated to have reached a 33.15% level (refer to Table 3-6). An earlier implementation of privatization than originally planned has subsequently been announced and according to this it is hoped to achieve an 80% level of privatization for the agricultural sector by 1996 with 100% privatization planned for the year 2000 in this sector. The same program plans for an 80 to 85% level of privatization in non agricultural sectors of the economy by 1996/7.

During the initial phase of privatization the majority of shares tend to remain in the hands of management and personnel. Following April, 1994 the SPF began the distribution of vouchers to the general public. Privatization coupons have been allocated to the public on request and in May, 1994 some 70% of the public had obtained these (the deadline for acquisition being set for October 1st). Share auctions have been arranged thirteen times for a total of 85 firms of middle to large size up to the present month of July, 1994.

In April, 1994 the Enterprise Reform and Resolution Agency was established and 29 state enterprises running at a loss were selected for restructuring under the PESAC project. This project is a two to three year program funded with aid from the IBRD which will distinguish those parts of national firms which are profit making from those parts which are making a loss, and then will proceed to liquidate the unprofitable parts and sell off the profit making parts to the private sector.

(3) Foreign Trade Liberalization

Since prior to Independence under the former Soviet System the Kyrgyz Republic was part of a unified socialist economic federation there had previously been no foreign trade restrictions applying to trade with neighboring FSU areas. Since Independence the Kyrgyz Republic has adopted a policy of foreign trade liberalization. As of February, 1994 export and import licenses were abolished with the exception of a few special commodities. Import duties are set at a standard rate of 10% while export duties are 9%. Moreover since the Republic has land borders with surrounding countries which are not sufficiently supervised by customs control the import duties cannot always be levied and exacted.

The republic welcomes foreign investment and there are no maximum limits to foreign capital equity (so that 100% foreign ownership for firms is accepted). There are preferential investment policies to favor foreign affiliates (firms of more than 51% foreign capital) and corporation tax is not levied for a certain period (for example for the first five years in the case of manufacturing firms) while customs duties are also waived. Further, Free Economic Zones, where firms are exempt from taxes have been set up in Naryn and Karakol. As regards capital transactions the NBK request banks to provide information about the purpose of the capital funds use but no regulations are imposed.

(4) Legal System Reforms

There have been 43 laws passed relating to economic topics alone since Independence. Many of these laws are of fundamental importance to the creation of a free market economy and relate to areas such as Civil Law, Banking Law, Bankruptcy Law, etc. However, Commercial Law has still to be regulated and there are other important areas such as Accounting Law, Bills and Checks Law, etc. which have yet to be stipulated. Further, there are cases such as Bankruptcy

Law where the legal principles and details of the Law have been established but for which the framework for application has still to be set up.

3-3-2 Economic Difficulties

(1) Industrial Structure

The main industrial sectors are agriculture (including livestock farming) and manufacturing which together account for about 70 to 80% of the total NMP (cf. Table 3-7). However, in view of the fact that more than 50% of the manufacturing sector is in fact related to processing of agricultural products (light industry, food processing industry, etc.) it is clear that agriculture is the central industry. In terms of NMP statistics the above areas are followed in importance by construction, transport and communications, but the share these account for is small. The service industries tended to receive little attention under the previous planned economy and so have not developed to any great extent.

The main characteristic of agriculture in the Kyrgyz Republic is the dominant share accounted for by livestock agriculture (this was 63.6% in 1992). Since Independence however the government has adopted a policy of promoting self sufficiency in food. As a result of this policy the importance of livestock farming fell from 63.6% in 1992 to a level of 42.1% in the following year of 1993, while over the same period the share of agricultural products rose from 36.4% to 57.9%. The main products are grain crops, maize, vegetables, cotton, tobacco, etc. Because of the geographical and natural conditions which it enjoys the Kyrgyz Economy has traditionally been primarily agricultural. Industrialization was the result of development carried out under the Soviet regime. The share of specific industrial sectors in 1993 was 28.0% for light manufacturing, 23.1% for food processing, 16.4% for fuel energies, 15.1% for machine and metal working industries (including non ferrous industries). For details please refer to Table 3-8.

(2) Real Economic Decline

Economic activity experienced a turndown from around the time of Independence. Looking at the evolution of the economy in terms of real GDP, an annual increase (varying in size from one year to another) was sustained up to 1990. After 1991 this changed to a minus (of -4.2% in 1991, -16.4% in 1992 and -16.4% in 1993). By 1993 the real GDP had shrunk to a level representing two thirds of its peak level registered in 1990. Moreover the GDP for 1994 is expected to decrease by

23% over the level recorded for the previous year thus representing half of the peak time level.

Looking at performance by specific industrial sector we find that large decreases were registered by both agricultural (including livestock production) and manufacturing sectors which accounted for more than 80% of the total Net Material Product. However, relatively speaking the drop in production has been smaller in the agricultural sectors as compared to the manufacturing sector (cf. Table 3-7).

However the credibility of the above statistics must be regarded with some caution, since statistics under the Soviet regime often included output which was not always useful and there was a tendency towards overestimating actual GDP results, while the recent flourishing of an underground economy for the purposes of tax evasion and the hyper inflation tends to distort statistics somewhat.

Real GDP

	Growth rate	Level of GDP
1990	+3.2%	100.0
1991	-4.2	95.8
1992	-16.4	80.1
1993	-16.4	67.1
1994	-23.0	51.7

(3) Inflation, Wages and Unemployment

Inflation

Prices evolved in a stable manner up to 1990 but severe inflation was experienced around the time of Independence. Prices were 359 times higher in December, 1994 relative to their level in December, 1991 (cf. Table 3-9). The reasons for this extremely high level of inflation include; a) the surfacing of potential inflation which had been restrained and accumulated under the Socialist regime and which was released with price liberalization, b) the rapid price increase of energy costs and of imported fuels in particular, c) the turndown in production and confusion in distribution systems resulting in a decreased supply of commodities, d) the effect of the over supply of Ruble currency prior to the introduction of an independent national currency.

However both the Kyrgyz government and the NBK reacted rapidly by giving top

priority to austerity measures and a program of financial restraint to calm inflation. In May, 1993 a new national currency was introduced which interrupted the influence of the ruble and in 1994 inflation came increasingly under control. By March, 1994 monthly inflation figures were down to single digit figures and inflation figures have shown a downward trend since.

Wages

As a result of the two wage increase measures taken in 1994 (40% in January, 30% in May) the average nominal wage in May had reached the 195.5 Som level (the minimum wage being 58 Som). This represented a 50.4% increase over the level of wages at the beginning of the same year while real wages have dropped by 30% over the last 4 years. In May, 1993 a Stand By Agreement was signed with the IMF which stipulated that fiscal debt was to be restrained to 7% of GDP and that monthly inflation figures would be brought down to single digit figures during 1993. These agreement conditions obliged the government to resist increasing the wages and minimum wage levels for government employees.

Unemployment

Unemployment increased with the worsening of the economic situation and the drop in company operating rates so that the official rate of unemployment announced by government figures in 1993 was 6.3% (actual figures are asserted to have been considerably higher). The present government is pursuing a policy of privatization which will involve privatization of national enterprises currently employing surplus labor so that unemployment is expected to proceed to higher levels in the future.

(4) Fiscal Deficits

Up to 1991 public expenditure regularly exceeded public revenue and the difference (revenue shortfall) was made up for from financial subsidies received from the central government in Moscow. However such assistance from Moscow was obviously discontinued after Independence (although the Russian Federation arranged loans in 1992). Consequently a considerable fiscal deficit resulted as of 1992 (cf. Table 3-10).

Since the collapse of the Soviet Union in 1992 the government of the Kyrgyz Republic has adopted a number of austerity measures to curb public expenditure (principally involving the reduction of capital expenditure by cutting various

public subsidies and assistance, etc.). However the level of public revenue fell drastically (actual revenue in terms of the percentage of GDP fell from 29.7% in 1990 to 16.9% in 1992). Fiscal deficit reached the considerable level of 12.7% of GDP in 1992. Public revenue did not increase in 1993 either (representing only 15.4% of GDP) but thanks to the working of expenditure restraint the fiscal deficit was reduced to 6.0% of GDP (cf. Table 3-10).

The difficulty encountered in increasing public revenue is partly caused by the worsening profit situation for firms in the depressed economic context but is also explained by the reluctance of the general public to meet tax obligations, the frequency of tax evasion and the flourishing of an underground economy to avoid high corporation tax obligations.

(5) Decline in Foreign Trade

Foreign trade imports and exports calculated in real terms have dropped considerably. Although there are no statistics available for real imports and exports, the figures showing the ratio of imports and exports to nominal GDP show a drop from an average of 87.3% achieved in the years 1988-1991, to 76.2% in 1992 and to 51.5% in 1993 (cf. Table 3-11). Since GDP is falling in real terms the drop in exports and imports in real terms must be considerable.

While a trade deficit existed under the Soviet Regime this was made up for by a transfer payment from the central Soviet government so that previously the current account showed a surplus. But since 1992 the transfer payment was considerably reduced and the current account went considerably into the red (cf. Table 3-12).

With regard to 1994 while there was a considerable fall in the level of imports the increased export of electricity meant that the fall in exports was smaller than the fall in imports and this resulted in a surplus in the balance of trade. Since the increasing of electricity export was possible simply because of the reduced domestic consumption of electricity resulting from reduced economic activity the surplus in trade balance is expected to be of temporary nature.

The greater part of trade conducted by the Kyrgyz Republic is with former Soviet Union countries. This has remained unchanged following Independence but there has been a reduction in the volume of trade with these countries, and an increase in the volume of trade carried out with non-FSU countries. It is worth noting that imports and exports with China in particular have grown in importance (cf. Table 3-13).

Looking at specific commodities traded we find that among exports the most important sectors are machine metal works, light industry products, and food industry products. Among imports, the most important items are petroleum products and natural gas which together account for more than half of total imports (cf. Table 3-14).

3-3-3 Causes of Economic Difficulties

The root cause for the economic difficulties which the Kyrgyz Republic faces is taken to be the negative effect of the former socialist economic system. However the recent severe economic situation is seen as a result of the initial shocks of the collapse of the previous socialist system and of Independence. Moreover development of the free market system to take the place of the moribund socialist economic system remains incomplete and insufficient. In particular, financial systems which are essential infrastructures of a free market economy are still underdeveloped at present and this hinders the effective working of a free market system. The difficulties faced by the country are the result of the complex interaction of the above factors (cf. Fig. 3-1).

(1) Initial Shocks

The economy of the Kyrgyz Republic has suffered a series of shocks disrupting its stability. Two shocks in particular have had a very strong adverse effect on the economy and produced a wide range of economic difficulties for the following reasons. Firstly, Independence from the Soviet Union had an adverse shock effect on the economy through the following channels. Subsidies allocated from Moscow which accounted for about 40% of the national budget were stopped. Secondly, the supply of oil and gas provided by the Soviet Union at prices considerably below international standard was stopped. Thirdly, a halt was called on all strategic projects which had formerly been carried out by the Soviet Union. Such strategic industries were not confined only to military industries but had included a number of public commodity industries such as the textile and food processing industries.

The second big shock created by the collapse of the Soviet Union was the disruption of the interdependent relations which had existed between the FSU countries. Under the economic system of the Soviet Union production had been coordinated as a single system. Member Soviet countries had been allocated roles in an overall system of the division of labor and so each member relied on the

import of raw materials and parts from another member country, and other members were also relied on for carrying out sales too. Under this system the payment of sales and their distribution was coordinated by the central government, and the Kyrgyz Republic had been fully integrated into this coordinated network. This explains why trade of the Kyrgyz Republic was highly dependent on other FSU countries. Such coordination came to a complete stop with the collapse of the socialist economic system and Independence. In particular, payment systems and distribution networks were disrupted. As a result trade with both non-FSU countries and with FSU countries was upset and the securing of raw materials and sales of finished products were rendered difficult. Various institutional reforms were carried out with the aim of developing a new multilateral system based on market mechanisms but as yet this has not yet come into effect.

Even if we confine our analysis to the national economy of the Kyrgyz Republic alone it is still clear that the collapse of the socialist economic system has had a huge effect. Under the previous system economic management was carried out by GOSPLAN which was an integral part of government organization. Under this system all businesses and firms were nationalized and production levels or prices were set by government order and not in accordance with free managerial decisions. In exchange the supply of required capital and raw materials was assured by the government. If profits resulted from company activities this was taken by the state while any losses were compensated for from state funds. Therefore bankruptcy did not exist and negotiations between firms were settled by the government.

The system of a planned economy was abandoned with reforms for a transition to a free market economy and GOSPLAN was abolished. Company ownership was transferred from the state to private individuals and price determination was freed from state control. The liberalization of business management meant that setting up businesses was allowed. However privatization and abolition of state control alone are not sufficient to ensure the effective working of a free market economy. It is necessary to create and provide the basic infrastructures which support such a free market economy. Since these infrastructure systems are underdeveloped in the Kyrgyz Republic it was inevitable that the economy of the Kyrgyz Republic would face economic difficulties after the initial shocks mentioned above.

(2) Under-Development of the Financial System

A major cause of the economic difficulties faced by the Kyrgyz Republic is the

insufficient development of such basic systems as the financial system, legal system, accounting system, and governmental administration. In the following we will examine the adverse effect of the insufficient development of the financial system on the economic situation in line with the aims set out for this present study. Financial systems constitute the most basic and important of all infrastructures in a free market economy, and this is a major factor contributing to the present economic difficulties encountered by the Kyrgyz Republic.

1) Functions of the Financial System

The financial system refers to a part of an economic system consisted of the central bank and commercial banks which provide financial services to financial markets such as the money market or capital market. The financial system contributes to the development of a free market economy via a variety of channels, which can be classified into those relating to micro-economic functions and those relating to macro-economic functions.

Micro-economic functions consist of three functions all of which are essential in a free market economy to ensure the working of the principle of self management. Provision of financial services is especially vital in a free market economy because this consists not only of large size companies but also small or middle sized firms, and private businesses, etc.

The first micro-economic function is intermediation. This means that the systems acts as an intermediary network between economic agents enjoying surplus funds and economic agents suffering from a shortage of funds. Since each individual firm is run on the self management principle and is itself responsible for acquiring necessary capital under the free market system this function is essential.

The second micro-economic function is for payments and settlements. This involves transfers of funds in bank deposits using the payment systems such as a computer network. Since bankruptcy is a risk involved in a free market economy it is extremely important to ensure that promised payments are received. Such functions are also important for confirming whether payments have actually been made or not and for determining whether bankruptcy has occurred or not. Reliable and effective payment systems are essential for the development of financial systems. The third micro-economic function is monitoring. This is a derivative function of the other

two functions, and involves checking on the management of firms to which bank funds have been loaned and giving advice. Another aspect of this function is to permit shareholders to check up on share issuing firms. Since firms are not obliged to be managed in line with state commands they should be monitored by banks and shareholders to ensure that company management is acceptable and disciplined. This function also contributes to the smooth working of the liquidation process carried out by banks acting as creditors in cooperation with courts when firms go bankrupt.

Macro-economic functions of the financial system include firstly the function of optimum allocation of funds. In a mature financial market, capital is allocated to economic agents most needing it through the working of the price mechanism (that is the fluctuation in interest rates which correspond to the price of funds). The second function is macro-economic adjustment. This depends on the ease with which the central bank can carry out monetary policy. In a well developed financial system even if a policy of credit restriction is implemented to restrain inflation this will not have any great adverse effect on real sectors of the industrial economy.

2) Present Situation in the Kyrgyz Republic

As stated previously, financial systems are not particularly necessary under a socialist economy where the state supplies necessary capital, there are no bankruptcies and under which the principle of self management does not apply. In the Kyrgyz Republic financial systems did not develop under the socialist regime as we have seen in a later section. As a result the financial systems of the Kyrgyz Republic are considerably less developed than those of East Asian countries, and this insufficient development results in a number of problems for the economy.

Firstly, there is the problem of the shortage of capital funds available. As can be seen in the following case studies (conducted by interview) while Company A declared that it was unable to obtain a loan, Company B asserted that the banks are only interested in dealing with private individuals or small private companies. Further the Kyrgyz Association of Manufacturers issued an appeal to the President in July of 1994 in which they included the request that favorable financial conditions be given for capital funding of running costs (cf. Figure 3-2). It would seem from the

above that capital funds are not always allocated to firms which are a vital part of the economy.

This situation is partly the result of the shortage of capital on the nation as a whole but is worsened by the insufficient development of the financial systems which makes it impossible for these to act as intermediary for fund transfers between households and companies. Since the recent household saving rate is around 30% which is considerably higher than the equivalent figure in the advanced economies it would seem that a large amount of cash is kept at home and is not placed in bank deposits (cf. Table 3-15). Moreover the tight monetary policy being implemented by the NBK with the aim of restraining inflation places a considerable burden on the real sector of the economy given the under-developed state of financial systems and is seen as a major cause of capital shortage.

Secondly, there is the problem of payment and settlement. This is discussed in detail in a later section, but our conclusion is that payment systems are insufficiently developed in the Kyrgyz Republic. As a result all of the companies questioned in the case studies below complained about payment and settlement problems of some kind. In particular, since collection of payment is not certain there are even firms (A and B) which prefer to settle by cash. Further, in the appeal paper issued by the Kyrgyz Association of the Manufacturers the issue of payment and settlement problems is raised in such sections as, "the establishment of a reliable system which will ensure that payments and settlements in the republic are carried out without delay in the commercial banks", and "the problems involved in payments and settlements carried out between Kyrgyz Republic companies or between these and companies of CIS member nations should be remedied at the government level." It remains unclear to what extent the payment delay which occurs in inter-enterprise arrears is due to the insufficiencies of the payment system itself or due to the procrastination of the payer.

Thirdly, the following case studies show that there is absolutely no awareness of the importance and need for monitoring function of financial systems. Bankers do not seem to build up sufficient trust among clients, and so they do not carry out such basic functions as forwarding capital funds to appropriate companies, nurturing industries, and when necessary ensuring the smooth liquidation of businesses. Yet the function of monitoring is essential for ensuring the operation of the principle of self

management in the free market economy. Since financial systems do not provide this function coordination of national businesses is neither carried out by the state nor by bankers and the present situation can only be described as one of economic anarchy.

SUMMARY OF CASE STUDIES

	Company A (Electronics Related Manufacturer)	Company B (Pastry and Con- fectionary Manufacturer)
Company Profile		
1) Managerial Structure	<ul style="list-style-type: none"> -Joint Stock Co. (founded in 1970 and privatized in Autumn of 1993). -Government holdings 25%. -Capital invested from Russia and the USA. 	<ul style="list-style-type: none"> -Joint Stock Co. (founded in 1936 and privatized in June, 1993). -Government Holdings 35% and Kazakh sister company 15%.
2) Number of Employees	-1,700 personnel (50% less than the previous year).	-670 personnel.
3) Products	-Large computers, Measuring devices relating to energy sectors, Machine tools, Ceramic products, etc.	-Chocolate, Candy, Spaghetti, etc.
4) Sales Destinations	-60% of output sold on domestic markets, 90% of exports go to CIS destinations and 10% to Bulgaria and Israel.	-Domestic outlets (mostly small businesses)
5) Raw Material Inlets	-90% supplied domestically and the rest (Ex. Radio Components) from Kazakhstan, Uzbekistan and Russia.	<ul style="list-style-type: none"> -Flour from China, CIS and Poland. -Sugar from domestic sources at present.
Summary of Remarks		
1) Managerial Situation and Conditions	<ul style="list-style-type: none"> -In process of shifting from military to private sector. -The present situation is difficult but future prospects are good thanks to technological expertise the company possesses. -Payment of wages is 2 to 3 months behind schedule. -Printing Circuit Board Dept. is being developed with capital from World Bank and IDA. 	<ul style="list-style-type: none"> -A barter agreement for products against raw materials has been signed with China. -Now planning to introduce new technology and equipment from Germany. -Payment of wages to employees has been stopped for the time being.
2) Financial and Monetary Problems	<ul style="list-style-type: none"> -Not available loans, too short terms and high interest rates because of capital shortage of banks. -Payment for intake of raw materials and for sales are all carried out as cash payments. 	<ul style="list-style-type: none"> - Complaints against banks; 1) deposits cannot be withdrawn, 2) interest rates continue to rise, 3) banks focus attention on private individuals and private businesses. - Sales carried out on the principle of cash payments. - Unpaid sales to be collected;

3.5 Mil. Som

- | | | |
|-----------|---|---|
| 3) Others | <ul style="list-style-type: none"> -The present economic depression is the fault of banks. -Poor sales result in the building up of massive stockpiles. | <ul style="list-style-type: none"> -Recent (August) factory operating rates are about the same as operating rates last year for the same period. |
|-----------|---|---|

Company Profile		Company C (Machinery Manufacturer)	Company D (Glass Manufacturer)
1) Managerial Structure		<ul style="list-style-type: none"> -Joint Stock Co. (founded in 1974 and privatized in Jan., 1993). -Government holdings 49%. 	<ul style="list-style-type: none"> -Public Enterprise (Employees oppose privatization).
2) Number of Employees		<ul style="list-style-type: none"> -2,500 personnel. 	<ul style="list-style-type: none"> -630 personnel.
3) Products		<ul style="list-style-type: none"> -Radiators, Tractors, variety of machines, etc. 	<ul style="list-style-type: none"> -Glass products and Porcelain.
4) Sales Destinations		<ul style="list-style-type: none"> -Domestic 3%, non-CIS 25% and the remaining 72% to CIS. 	<ul style="list-style-type: none"> -Domestic 75% and CIS 25%.
5) Raw Material Inlets		<ul style="list-style-type: none"> -90% of Iron/Steel sheets come from Russia, Kazakhstan and Ukraine, while local supplies only account for 3%. 	<ul style="list-style-type: none"> -100% imported (Sand, Soda Ash, Natural Gas, etc.). Note: In order to use domestic sand it is necessary to change the production equipment.
Summary of Remarks			
1) Managerial Situation and Conditions		<ul style="list-style-type: none"> -Two projects have been submitted to Ministry of Industry (for new type of car radiator and bicycle). 	<ul style="list-style-type: none"> -Listed as a Liquidation Industry (Since being the only company of its sort, the continued existence of our (this) company is important. It is most unfortunate that the company must be liquidated according to governmental command).
2) Financial and Monetary Problems		<ul style="list-style-type: none"> -Funds transfers take too much time and great losses result because of inflation. -Inter-CIS payments are impossible (80% of delivered goods remain unpaid and outstanding invoices of Russian clients amount to Rubles equivalent to 201.4 Mil. Som). 	<ul style="list-style-type: none"> -Top priority should be given to regularizing Inter-CIS settlements. -4 Mil. Som of credit sales remain unpaid for. -Gas bills amounting to 2 Mil. Som unpaid.
3) Others		<ul style="list-style-type: none"> -The government provides little support. 	<ul style="list-style-type: none"> -The government has no policy for nurturing industry. -The civil service and government administration require thorough reform.

3) Sharp Fall of Effective Demand

The initial shock on the supply side of the economy caused by the sudden rise in the price of electricity, the difficulty of importing raw materials and

economic turmoil also had an adverse effect on demand and economic difficulties became critical. Effective demand in the Kyrgyz Republic dropped rapidly and in business cycle terms a situation of great depression resulted. Effective demand refers to demand which effectively influences the macro-economy and is not just a question of general wishful thinking. Personal consumption is the most important component of effective demand (Table 3-16). The level of nominal personal consumption for 1993 was 6.8 times higher than the level of the previous year, but over the same period CPI rose 13.1 times, which means the personal consumption is about half in real terms. This is not only the result of the fall in real wages mentioned earlier but is also the result of a fall in the propensity to consumption caused by fears and uncertainty about future socioeconomic trends. Whereas the household saving ratio was around the 7% mark around 1990 this has risen to 30% recently (cf. Table 3-15). Because of the inadequacy of the tax revenue collected government consumption has been on the decrease. The disruption of the cross border payment system and of the inter FSU trade links has caused a fall in the effective demand from these countries. The current situation does not allow capital investment to take place. Change of stocks has taken place and there is a considerable accumulation but stocks remain unsold. The multiplier effect has magnified the impact of the fall in the various kinds of effective demand and there has been a rapid contraction of the national economy. According to the analysis found in Keynes or among American Keynesians this situation is comparable to the great depression which occurred in Europe and America prior to World War II (multiplier-accelerator theory).

3-4 Possibility of Economic Recovery and Development

3-4-1 Possible Scenario for Economic Recovery and Development

The national economy faces considerable difficulties but it is not possible to predict how long this unfavorable situation will continue when trying to forecast the economic prospects of the Kyrgyz Republic. We can expect the situation to pass the worst phase in the near future after which the economy will enter into a period of recovery followed by a dynamic period of development surpassing anything seen during the period of the socialist economy sometime towards the 21st century. Such an optimistic scenario obviously depends on the assumption that the development of financial systems

described in the present report will be realized (cf. Figure 3-3 and 3-4).

The following outlines the details of both a short term and long term scenario for the recovery and development of the economy.

(1) Short Term Scenario

When predicting the economic situation in the Kyrgyz Republic for the coming one to two years it is considered preferable to focus on business cyclical factors such as the drop in effective demand discussed in a previous section. The business cycle is expected to show a shift from the recession cycle to a recovery cycle in the near future.

Firstly, effective demand will not continue to fall indefinitely but once demand has dropped to a certain level there will be a change back towards an increase in effective demand. Obviously, it is necessary for people to consume to live and so personal consumption cannot drop below this minimum level and after a certain point a further drop in consumption becomes impossible. It is judged that this point has been reached. Given the relative importance of agriculture in the Kyrgyz economy and the fact that income from agriculture is relatively stable the consumption of farmers, etc. should work against further decreases in effective demand. Once a given effective demand starts to show an increase this will bring the multiplier effect into play with the full range of effective demands and the process of recovery will be intensified by the multiplier-accelerator effect. The second reason for predicting a shift to recovery is the likelihood of there being sufficient momentum from overseas assistance and the export sales of new gold mines to provide the initial push to bring about a recovery process of the business cycle. Thirdly, thanks to the monetary stability a favorable economic framework for designing future economic programs is being established. Monetary stability, of course, will not only have good short term effects but will also produce favorable long term effects.

(2) Long Term Scenario

After the process of economic recovery begins as a result of the short term cyclical reasons explained above we expect economic development to take place in the long term for the following structural reasons. As in Czechoslovakia and other East European countries the development in this country is expected to proceed along the lines of a "two track economy". The two track economy refers to a situation where the economy consists of a small enterprise sector and of a

large enterprise sector whose development proceeds at different speeds while the two sectors continue to interrelate. The small enterprise sector includes cooperatives and private individual businesses and in addition to manufacturing industry the sector covers a large range of service industries which can only develop in a free market economy, such as tourism, financial industries, distribution industries, etc. The large enterprise sector is made up of state enterprises and the agricultural sector as well as large enterprises proper. In the early phases the small enterprise sector shows an active development for reasons clarified hereafter, while the large enterprise sector tends to be inactive and stagnant because of the negative heritage remaining from the period of the socialist economy. Labor forces increasingly shift from the inactive large enterprise sector over to the active small enterprise sector. Subsequently the newly privatized large enterprises begin to push through managerial reforms in line with the principles of a free market economy and so become increasingly active and dynamic so that further, new development can be expected to result. In line with the above and in view of the fact that the Kyrgyz Republic is considered to have a strong economic potential we anticipate the realization of this potential will result from institutional reforms in the direction of a free market economy. In particular, since financial systems are a basic infrastructure of the free market economy the development of these will permit the sufficient functioning of a market mechanism and this will promote the development of the small enterprises which adapt more quickly to the environment of a free market economy followed by large enterprises which have adopted the principle of self management. The factors contributing to the short term recovery of the economy as analyzed in the previous section will also contribute to long term economic development.

In view of the high educational level of the Kyrgyz Republic it is anticipated that the amount of time needed for achieving significant development will be relatively short. Since the social capacity for accommodating borrowed technology is judged to be high the republic should be able to reach the technological levels prevailing in the industrialized countries within a short space of time. It is highly likely that the so called "compressed process" of technology transfer will apply. It is also probable that once economic development takes off the republic will enjoy a high growth rate similar to those occurring in the emerging economies of Asia. The Kyrgyz Republic borders China and shares many of the traditions of Asian culture.

The following sections explain in detail the reasons supporting the above

scenarios.

3-4-2 Potential of the Economy of the Kyrgyz Republic

The main reason why the Kyrgyz economy was unable to realize economic development to date despite its strong potential in many fields is due to the fact that this potential was not adequately realized under the socialist economic system. The following factors are seen to be particularly important aspects of this overall potential;

(1) Excellent Workforce

As already mentioned the educational level in the Kyrgyz Republic is very high while there is also a tradition of entrepreneurship and of the merchant spirit which will facilitate the reception of the free market economy. The large ratio of young in the population structure will also be an advantage to smooth adoption to the new systems. In this way aspects of the national character and of population structure provide a significant potential power for realizing economic development. Since Independence sections of the Russian population previously residing in the Kyrgyz Republic have unfortunately left the country and this has had an adverse effect on the republic's economy. It is reported that between 1991 and 1993 some 163,000 Russians emigrated and so the government decided in July, 1994 to encourage Russian speakers to stay in the republic and a Presidential decree was issued which contained measures for achieving this. This Presidential decree included eight topics including a declaration to the effect that Russian as well as the Kyrgyz language is to be considered a national language and a section restraining extreme nationalism. It is expected that these measures will succeed in reducing the exodus of Russian nationals. If the Kyrgyz economy shows signs of recovery it should also be possible to get some of the emigrants to return to the Kyrgyz Republic.

(2) Natural Resources

In addition to plentiful river ways suitable for the generation of hydroelectric power the Kyrgyz Republic is rich in mineral resources coming from the mineral storehouse of the Tianshan mountain range. Beginning with natural energy resources such as coal, oil and natural gas the Kyrgyz Republic has verified deposits of gold, antimony, mercury and other non ferrous metals. These resources will provide a powerful support to the recovery of the mining industry.

The international markets for mining products are well established and it will be easy to sell at international prices and so gain foreign currency. Further, the development of the mining industry will help develop other industries such as the transportation industry, the energy industry, and the machine industry. Since the international market for gold is strongly placed and firmly established and gold has traditionally served as an international currency this product will enjoy a special position. Formerly only one gold mine was operated in the Kyrgyz Republic. However, using technology introduced from the advanced industrialized nations it has been possible to start production in two gold mines. These two gold mines are expected to produce between 17 and 20 tons of gold (the equivalent of \$200 million US \$ at international prices being the same as the gross import value of the Kyrgyz Republic for 1993). Since this gold can be used as international currency it will be sold to the NBK and used for payments of foreign currency. Gold production will contribute to government revenue in the form of payments of the natural resources development fee and so will help reduce the fiscal deficit of the Kyrgyz Republic.

(3) Tourism Resources

The Kyrgyz Republic enjoys picturesque natural scenery and a wealth of cultural and historic sights from the Silk Roads period and is often described as the Switzerland of Central Asia. Picturesque beauties include the majestic mountains of the Tianshan range snow-capped even in summer and the grandeur of Lake Issyk-kul, nine times the size of Japan's Lake Biwa. The rolling hills of the countryside are also well suited to skiing grounds or golf courses. Above all the national traditions of warm hospitality will ensure that tourists visiting the country take away a positive impression. The policy of liberalization of foreign trade currently adopted will also be an important support to the development of tourism in the Kyrgyz Republic.

If these tourism resources can be effectively employed to attract tourists from overseas this will not only contribute to the acquisition of foreign currency but will promote the development of hotels and other service industries, while the production of souvenirs for tourists could be used to help support manufacturing through production of traditional handicraft items, etc. The tourist industry tends to consist of a large number of middle to small or personal enterprises and so tends to be inconspicuous. Since service industries generally tend to remain undeveloped under a socialist economy the tourist industry has not been actively

developed to date. However, in a free market economy this is a very important sector. As the transition to a market economy proceeds in the Kyrgyz Republic we can expect the appearance of sufficient numbers of entrepreneurs capable of effectively developing the tourist resources available. There is a good chance that the tourist industry will therefore take the leading role among the businesses in the small enterprises sector of the two track economy.

(4) **Advantages of Being a Small Country**

The population of the Kyrgyz Republic is less than 4.5 million. Though there are disadvantages attached to being a small country there are also numerous advantages. Despite their small size countries such as Switzerland, Singapore or Hong Kong have achieved a remarkable success in economic development, thanks to a variety of factors.

Firstly, the small size of the economy means that even a small scale positive impact will be sufficient to set the economy on the road to recovery and development. For example, if an annual revenue of \$200 million US \$ can be gained from the exports gold quarrying as indicated in the previous section this will cover the annual gross import cost of the Kyrgyz Republic. Also in the case of foreign aid a comparatively small outlay on the donor's part will have a great impact on the receiving economy.

Secondly, the small size of the nation makes it easier to achieve a consensus of national opinion. This is especially important with issues like the shift to a free market economy involving a new national direction. This acts as a definite advantage when constructing new systems. Thus for example with the setting up of new payment systems which is the main topic of the present report it is vital to have the agreement of both the Central Bank and the Commercial Banks. Since the number of persons concerned is small it is relatively easy to gain their cooperation and agreement.

Finally, one of the disadvantages of being a small country is the small size of the domestic market available. However, it is possible to overcome this disadvantage in large part through foreign trade liberalization and the government of the Kyrgyz Republic is pursuing such a policy.

3-4-3 Effects of the Free Market Economy

The introduction of the free market economy will help realize many of the potential

strengths of the Kyrgyz Republic which have been examined above and so this can be expected to contribute to the economic development of the country. Of course, a necessary prerequisite to the effective working of the free market economic system is the development of the infrastructures such as financial systems supporting this (cf. Figure 3-4). The following classifies the actual benefits expected to result from the development of a free market system under three main headings.

(1) The Diffusion of Free Enterprise and Self Management

The greatest benefits arising from the introduction of the free market system are the diffusion of free enterprise and self management. Given freedom of enterprise businesses it will be possible to establish businesses at any time and anywhere where profits are expected to accrue. If there is a shortage of goods and services in a context of liberalized prices it will be possible to make profits by providing these. In the Kyrgyz Republic restrictive regulations on prices and enterprises have already been done away with. In this context there has been a rapid revival of merchant spirit and entrepreneurship among the national population. The operation of market mechanisms should assure the supply of goods and services which are in short supply in the economy. The recent emergence and development of small enterprises, examined in detail hereafter, is one concrete sign of this effect.

Another important benefit of the free market economy is the principle of self management, which is basic to this system. This principle means that the actions of enterprises are not determined by government commands but by the freely taken decisions of managers. Businesses which are unable to make a profit cannot expect to rely on the government but must decide on and implement counter measures by themselves. Those enterprises which are unsuccessful in meeting these challenges will face bankruptcy. Bankruptcy results in the liquidation of a business, the loss of employment for managers and staff and a loss of capital lent by shareholders and lenders. Bankruptcy constitutes a severe disciplinary penalty in a free market economy which ensures the effective working of the system. In the Kyrgyz Republic Bankruptcy Law has already been established and this will be enforced. Once Bankruptcy Law is applied to actual situations the principle of self management will be clarified. However, Bankruptcy Law only applies to the private sector. It is therefore expected that the management of private enterprises will be rendered effective before the management of state enterprises to which these principles will not apply.

However the state enterprises will be gradually obliged to come into line with the private sector enterprises and extreme cases of inefficient management will become increasingly unacceptable. However this difference in respective situation is a major cause giving rise to the two track economy previously mentioned.

(2) Emergence of Small Enterprise

Since freedom of enterprise and freedom of occupation did not exist under the former socialist economy it was not easy for individuals to set up in business. However, since Independence this has become possible and has resulted in the rapid emergence of small enterprises. According to statistics of companies registered with the government (cf. Table 3-17) there were 176 small enterprises in 1993 which achieved a turnover of 334.6 million Som and employed 65,300 personnel. This means that the average number of staff employed in one enterprise was 12.6 personnel. A wide range of sectors ranging from agriculture to manufacturing was represented. Of course at present these small companies do not represent an economic force which could compensate for the current poor performance of large industry. However, in the future the number of small enterprises is expected to grow in all economic sectors of the domestic economy and these are expected to play a vital role in the future economic development. They will come to constitute one half of the two track economy with large industries as the other half. In all free market economies small enterprises are seen to play an important role. For example, about 80% of Japan's labor force work in companies which employ less than 300 operative personnel. This results from the need to respond flexibly to small demand patterns (called "niches") in domestic and overseas markets in order to gain profits in a context of free price mechanisms and free trade. In the Kyrgyz Republic price liberalization and trade liberalization have already been implemented and with the exception of development of financial systems the main conditions needed for development of small enterprises are available. In addition to the fact that many industries of the Kyrgyz Republic such as light manufacturing and food processing industries are suited by nature to small enterprise organization, the industries with most potential for future development such as tourism are also suited to small enterprise organization. If financial systems are developed it would be possible to provide services such as the supply of capital funding and effective settlement systems which are vital to small enterprises.

(3) Development of Distribution Networks

Since the socialist economic system tends to give most emphasis to the productive sectors there is a tendency to overlook the importance of the commercial sectors which have the role of connecting consumption and production. Consequently the commercial sector has not been developed in the Kyrgyz Republic. In the free market economy the commerce sector in the form of distribution networks tends to develop together with the productive sector in response to market needs. Distribution networks not only cover a range of purely commercial sectors from wholesale businesses down to retail businesses but also encompasses transportation services and warehouse businesses as well. It is necessary for the public sector to provide public goods such as transportation infrastructures in the form of roads and railways. However, if the principle of free enterprise is recognized for the greater part of the distribution networks then the private sector can be expected to spontaneously undertake to supply these as business undertakings. In the Kyrgyz Republic it is expected that there will be an increase in the number of entries into this field of business in the future and that distribution networks will be developed as a consequence. Distribution networks are both a business undertaking and an infrastructure of the free market economy at the same time. So with the development of distribution networks and their use by other industries a positive feedback mechanism will come into play which will provide an important driving force for economic development in the Kyrgyz Republic.

3-4-4 Benefits from Introduction of Foreign Capital and from Foreign Assistance

It is extremely important for economic development of the Kyrgyz Republic to make the best use of foreign direct investments and foreign aid. The foreign trade liberalization policy of the present government has a very favorable reputation with international financial institutions and this has resulted in a large flow of foreign investments and aid into the Kyrgyz Republic. This inflow of foreign capital is expected to contribute significantly to economic development of the Kyrgyz Republic.

(1) Foreign Direct Investment

According to Table 3-18 showing the cases of foreign investments there were

339 cases of investments from Independence to June, 1994 amounting to 91,000 thousand Som, with the number and value of investments increasing annually. Looking at the sectors concerned we see that the investment was concentrated in the miscellaneous manufacturing and commercial sectors. Investing countries included of course the FSU countries (33 cases of investments from Russia) and there were 100 cases of investment from China with which the Kyrgyz Republic has increasingly close economic ties in recent years. Many investments originate from the members of minority ethnic groups previously residing in the Kyrgyz Republic as a result of the enforced policies of ethnic redistribution which had existed under the Soviet regime. Repatriated nationals of such minority ethnic groups have invested from their mother countries back to Kyrgyz after repatriation (thus there are 25 cases of investment from German nationals, 6 from Koreans, and 7 from Israelis). In addition to 54 investments coming from neighboring non CIS countries (Turkey, Afghanistan, Iran, etc.) there were 35 cases of investment coming from the USA and 10 from Great Britain. According to SCFIEA responsible for collecting these statistics the figures do not show how many investments were actually made and resulted in actual business undertakings.

(2) Foreign Aid

Foreign aid takes the form of capital assistance or technical assistance. Technical assistance is obviously an important contribution to economic development of the Kyrgyz Republic but the following remarks are limited to the issue of capital assistance. The total amount of foreign capital assistance provided to date by foreign sources (excluding grant aids) was for 470 million US\$ (12 different arrangements) and as of July 1st, 1994 disbursement on loans was of the order of 332.7 million US \$. In addition to the foregoing an additional 291.1 million US \$ was scheduled to be arranged during 1994 in 8 arrangements (cf. Figure 3-5). 5 of these additional loans accounting for 176.2 million US \$ were arranged with three former FSU countries (Russia, Kazakhstan and Uzbekistan), and three of these five arrangements were inter governmental agreements for rescheduling unpaid balances (amounting to 156.6 million US \$) providing for reimbursement terms of 6 to 8 quarterly payments at an interest rate of LIBOR plus 1.0 to 3.7%. The above aid took the form of loans to be repaid in the future. The balance outstanding on loans made at the present date of July 1st, 1994 was 332.7 million US \$ being the same as the sum amount already borrowed with repayments

scheduled to begin in the middle of 1994 (cf. Figure 3-5).

At the end of December, 1993 the net balance of the public credit-debt was 12.361 million rubles (with the largest credit being 10.967 million Rubles to Tajikistan and 25.316 million Rubles to Turkmenistan.

However since Kyrgyz has signed a zero option agreement with Russia (by which it is proposed that Russia will accept to meet all loan obligations to non communist nations dating from the period of the Soviet Union in exchange for accepting the transfer of all overseas assets to Russia), at the time of Independence there were no outstanding credit obligations with non FSU countries and the Kyrgyz Republic started off after Independence with virtually no foreign currency reserves.

3-4-5 Beneficial Effects of Monetary Stability

As mentioned in the previous section, the Kyrgyz Republic has achieved monetary stability through the introduction of its own national currency, the Som, and through implementation of a tight monetary policy. This stability will serve as an important foundation for national economic development. Thanks to monetary stability inflation has been brought under control and the foreign exchange rate of the Som against the dollar has been stabilized. In May, 1993 when the Som was introduced the exchange rate was 4.0 Som per US\$. In late 1993 the Som had been devalued to an exchange rate of 12.5 Som per dollar but from the beginning of 1994 the Som began to gain against the dollar and stabilized at a level of 10 Som per US\$. The evaluation of the Som is all the more marked if we compare this with currencies of other FSU countries such as the Russian ruble, Kazakh Tenge, etc. which have dropped considerably in value against the dollar. When a national currency gains in value this makes exporting more difficult in the short term while at the same time imports increase. The increased value of the Som against the Russian ruble acts a protective block against the adverse influence of Russian inflation. Moreover the upward valuation of national currency has improved the terms of trade for the Kyrgyz Republic. The improved terms of trade mean that it is possible to trade a given unit of exports for a larger value of imports than could formerly be obtained. This situation will obviously have a favorable effect on long term national economic development. Moreover this increases the level of confidence accorded by the advanced nations and so has a favorable influence on direct investment and foreign aid.

3-5 Tasks to Economic Recovery and Development

While the economy of the Kyrgyz Republic faces a number of difficulties at present, the above analysis leads us to expect economic recovery and development will occur in the near future.

The process of economic recovery and development will make use of the benefits produced by the transition to a free market economy. It is therefore essential to develop financial systems and other basic infrastructures of the free market economy in order to ensure the efficient working of the free market system. The development of such basic infrastructures is vital to the economy of the Kyrgyz Republic. The following indicates other areas which are important for achieving economic recovery and development.

(1) Improvements in Government Administration

It goes without saying that governmental functions are essential even in a free market economy. However the role of government in the free market economy is not to issue commands to the private sector but to ensure the provision of public goods and services such as roads or police and to establish laws and rules. However, in over reaction against the excessive intervention of the state under the socialist regime there seems now to be a widespread feeling among the general public that no governmental action is needed at all in a free market economy. One manifestation of this mood is the absence of moral culpability about evasion of taxes. Further, the wages of government officials have failed to keep up with the rate of inflation and it is increasingly difficult to recruit good personnel for the public sector. The basic policies of the government are decided by the Presidential Office and Parliament, but once these policies have been drawn up and passed it is the government officials who will see that they are implemented and enforced. Unless such implementation is carried out by reliable government officials enjoying the respect of the general public the credibility of the government will suffer. Improvements need to be made in government organization and the promotion system for government officials to ensure that officials who can be trusted and relied upon by the general public are employed, and that government officials are promoted to high positions on merit. Such reforms are essential to the economic development of the Kyrgyz Republic.

(2) Resolution of the Inter-enterprise Arrears Issue

The issue of inter-enterprise arrears poses a big problem to the economy. The

system of inter-enterprise arrears has resulted from the delayed development of payment systems and the short supply of capital. Going back further the system stems from the very nature of the socialist economic system which permitted business activities to take place without a clear logic of settlement. This issue can be seen as part of the negative heritage left behind after the collapse of the socialist system. If nothing is done about this then the large enterprise track of the two track economy will continue to lag behind the small enterprise track. Moreover the situation will have a negative effect on the soundness of the overall banking system. If payment systems are improved the problem will be clarified but not resolved. Resolution of the problem itself will require a clear political decision and prompt action needs to be taken in this direction.

(3) Nurture of Qualified Personnel and the Accumulation of Expertise

The nurture of qualified personnel who can actively contribute to the economic development of the country is very important for long term national economic development. To this end, greater emphasis needs to be given to business education in the overall framework of national education. Secondly, in order to train excellent entrepreneurs seminar programs for school graduates should be set up and opportunities for overseas study be provided. Thirdly, it is necessary to train competent bankers capable of monitoring and advising businesses. As already explained in a previous section businesses will need to be monitored and advised as part of the fundamental functions relating to a financial system.

Chapter 4 Current State of the Financial System in the Kyrgyz Republic and Major Issues

Chapter 4 Current State of the Financial System in the Kyrgyz Republic and Major Issues

4-1 Historical Background of Financial Structure and Major Issues

Under the former Soviet Union's financial system, Gosbank was only one central bank. The Kyrgyz Republic did not have its own central bank, and Gosbank operated its branch office. Gosbank was solely responsible for currency issue and monetary policy in the Soviet Union. In addition, it also assumed the function of credit allocation to all the industries (Figure 4-1). In addition, Stroibank was established as a channel of fund allocation to construction and related companies, while sber cassa served to absorb savings from citizens. Fund supply to enterprises was provided with no interest, and it was not restricted much by budget, partly causing inefficient enterprise management.

Under Perestroika started in 1987, Gosbank's function to supply funds to enterprises was transferred to government-owned special banks that were newly established to serve the agricultural sector and other industry sectors. As a result, Stroibank, while continuously serving the construction sector, started to assume the function of credit allocation to industries in the Soviet Union. At this stage, Gosbank officially assumed the central bank function only, and specialized banks supplied funds to industries, thus giving birth to the banking system of dual structure.

In Kyrgyz, commercial banks were established in September 1989 and the central bank in December 1990, to create the original form of the current financial system. Then through the collapse of the Soviet Union and the independence of the Kyrgyz Republic in August 1991, the Law on the National Bank of Kyrgyzstan and the Law on the Banks and Banking Activities were enacted in December 1992, marking the establishment of the current two-tier banking system.

It should be noted, however, that the system is only two years old and has not reached the state of smooth operation. To promote sound growth of the banking system, government programs and measures to help the effective functioning of the system should be planned and implemented, and a supplemental system designed for economic and industrial development should be added to the core financial system consisting of the central bank and commercial banks.

4-2 Current State of the Financial Management System and Major Issues

4-2-1 Outline of Financial Management Organization

The financial management organization of the Kyrgyz Republic consists of NBK that serves as the central bank and Ministry of Finance. NBK takes leadership in monetary policy and administration (Figure 4-2).

Notably, NBK is empowered to act independently from the government and is authorized to make a final decision on monetary policy, as mandated under the Law on the National Bank of Kyrgyzstan.

NBK has power and authority to grant licenses and permits related to banking operations and to supervise activities of banks. On the other hand, insurance companies are under supervision of National Insurance Supervision Committee which belongs to the government. At present, commercial banks and insurance companies are in dispute related to nonpayment of credit insurance premiums, but there seems to be little communication between the two supervising organizations.

NBK is vigorously reforming its organization under assistance and advice of IMF and other organizations and is steadily establishing sections to plan and enforce the more effective monetary policy and administrative action (Figure 4-3). However, each section is not fully staffed, ranging between 3 and 6 persons, and the securing of qualified personnel will be one of urgent and priority tasks. In particular, only 8 persons are assigned to auditing all the commercial bank, so that, even if various banking regulations are enacted, it is difficult for NBK to accurately monitor actual operations of commercial banks.

4-2-2 The Law on National Bank of the Kyrgyz Republic and Major Duties of NBK

The Law on National Bank of the Republic of Kyrgyzstan was enacted and enforced on December 12, 1992. Consisting of 7 chapters and 27 articles, the law vests the central bank with the legal authority to perform its duties, and grants it fairly broad-based and powerful authority including independence from the bank and the fields of monetary policy and supervision of commercial banks. While its institutional

framework can be considered to be reasonable in line with the basic policy related to transition to the market economy, its actual operation and management are facing and will face many obstacles, as pointed out in various parts of this chapter. Each chapter of the law and NBK's roles set forth therein are summarized as follows.

Chapter 1 "General Provisions" defines NBK as the national/central bank of the Kyrgyz Republic, with major objectives to stabilize the country's currency value, implement financial policies, protect creditors and depositors, secure fair competition among banks, and supervise banks in compliance with the Banking Law. The central bank, while reporting to the parliament, is an independent organization and is free from the government intervention. Also, the central bank is financially independent from the government and is not liable for the government's debt, and vice versa.

Chapter 2 sets forth the bank's legal capital requirements, and appropriation of profit and surplus.

Chapter 3 "Monetary policy" grants the bank an exclusive right to issue currency, prohibits the government to issue currency for the purpose of covering budget deficit, and enumerates the authority and means of money supply control. If the government opposes any of the central bank's monetary policy, it may report it to the parliament and cause the central bank to change it only through legislation specifying a reason for change as well as time period.

Chapter 4 "Relationship with the Government" states that, in addition to management of the national treasury as the government bank, the central bank serves as a financial advisor to the parliament, the president, and the government. The provisions also prohibit the central bank to supply credit and accept government bonds for the purpose of covering government budget deficit, with the exception of short-term emergency loan and credit, which is limited to less than 5% of GDP.

Chapter 5 sets forth relationships between the central bank and other banks, mandating the central bank to supply short-term loan and credit to commercial banks, maintain required cash reserves, and operate an inter-bank payment system. In addition, NBK is authorized to issue bank license and to supervise banking activities in general, including bank examination, the request to submit financial statements, and the establishment of banking regulations to be complied with by banks. Finally, the chapter

requires banks to comply with balance sheet based regulations, including the minimum amount of capital, the ratio of owned capital to liabilities, liquidity ratio, restriction on large loans, and price and interest rate risk control.

Chapter 6 authorizes the central bank to represent the country in negotiation with central banks in other countries as well as the IMF and other international organizations, and to render services related to foreign currency reserve and foreign exchange.

Finally, Chapter 7 sets forth management and organization of the central bank, including the appointment of the president by the president under the consent of the parliament (term of 5 years, and reelected once for additional 5 years), and power and authority of the president and the board of directors.

4-2-3 Public Confidence in the Government and NBK, and Independence of NBK

4-2-3-1 Mutual Trust between NBK and Commercial Banks

Under Chapter 5 of the Law on National Bank of the Kyrgyz Republic, NBK is authorized to issue a license of banking business and supervise banks' activities. In particular, NBK is empowered to examine commercial banks, to request submission of financial documents, to establish bank regulations, and to regulate banks based on balance sheets. Thus, the law is deemed to entrust NBK with responsibility for supervision and control of banks. About the current system, commercial banks seem to fear that financial information disclosed to NBK is leaked to the government and used for purposes other than bank supervision. To reduce such concern, NBK should establish an institutional framework to prevent disclosed information from becoming known to the government, such as the tax authority.

4-2-3-2 Public Confidence on the Government and NBK

Public confidence on the government and NBK is still at less than a satisfactory level. This seems to come from public distrust on the previous government that was caused by public intervention in financial transactions, such as the freezing of deposits, and the leakage of personal information through financial transactions. Such distrust would become an obstacle to attraction of personal deposits, and can only be eliminated by building and managing a democratic system.

4-2-3-3 Independence of NBK

Independence of NBK is guaranteed by the Law on National Bank of the Kyrgyz Republic. Chapter 1 prohibits the government to intervene in NBK's activity and separates financial liabilities of the government and NBK. Chapters 3 and 4 bans NBK to issue currency or give credit for the purpose of covering budget deficits. Clearly, the independence of NBK is established within the existing institutional framework, so that it is to maintain the current state in strict accordance with the law.

4-2-4 Regulation Based on Managerial Ratios

NBK regulates commercial banks by imposing 3 types of managerial ratios, K1 – K3, on the basis of IMF's recommendations. Bank Supervision Division conducts monthly surveys on a document basis and imposes a bank which fails to make a monthly report by imposing any of the following dispositions:

- 1) Recommendation on corrective measures within 1 – 3 months
- 2) Recommendation on sales of assets
- 3) Recommendation on replacement of bank management (including temporary control by NBK)
- 4) Disposition to terminate bank license

4-2-4-1 Restriction on Large Loans (K1)

K1 = Amount of loan to a single company/owned capital $\leq 25\%$

(Note: 15% to the investor)

These ratios were originally 40% and 20%, which were lowered under IMF's recommendations.

4-2-4-2 Ratio of Owned Capital to Liabilities (K2)

K2 = Owned capita/total loan $\geq 5\%$

4-2-4-3 Liquidity Ratio (K3)

K3 = Liquidated assets/deposits \geq 30%

4-2-4-4 On-the-spot Inspection on Outstanding Loans

NBK conducts on-the-spot inspection on commercial banks by its inspector under the Law on National Bank of the Kyrgyz Republic, at least once per year. (NBK may contract it to a private company specialized in bank examination. Inspection items include credit standing of borrowers, coverage by collateral, interest rates and other loan terms, and screening of loan application, and will evaluate individual loans and credits under the following criteria:

- <1> Good: Overdue period – Less than 90 days: Cash reserve requirements as a percentage of credit – 5%
- <2> Marginal: Overdue period – Less than 180 days: Cash reserve requirements as a percentage of credit – 20%
- <3> Doubtful: Overdue period – Less than 270 days: Cash reserve requirements as a percentage of credit – 50%
- <4> Bad: Overdue period – 270 days or longer: Cash reserve requirements as a percentage of credit – 100%

(Note: For cash reserve requirements as a percentage of credit, availability of collateral is not taken into account.)

The bank supervision department, which has no detailed evaluation data on loans and credits, feels that, as for small- and medium-sized banks, 50% of loans are rated as "good," 40 – 50% "marginal" and "doubtful," with a small percentage of "bad loans."

4-3 Current State of Financial Institutions and Major Issues

4-3-1 Commercial Banks

As of January 12, 1994, there are 21 commercial banks (179 branches) registered in the Kyrgyz Republic (Table 4-1). 2 banks went out of business thereafter, and 19 banks are in operation as of August 1, 1994. In terms of background related to

ownership, they are classified into 3 major banks that have been privatized from government financial institutions in the former Soviet Union, medium- and small-sized banks established after the independence of the republic, and a savings bank which served as an a national organization to absorb savings in the former Soviet Union.

Major shareholders of the three major banks are state enterprises and privatized state enterprises, because of their background as government financial institutions. Their combined market shares in outstanding balance of credit and the number of branches exceed 85% and 60% respectively. Nevertheless, they face major problems due to weak financial position characterized by overdependence upon NBK loans, a rapid increase in bad loans, and low productivity due to delay in mechanization. As for international operation, they have finally begun to look for corresponding banks, reflecting the fact that it has been solely handled by Gosbank.

Medium- and small-sized banks have been established as a result of Perestroika, and have only a few branches or have no branch office. While some are innovative in introducing new services such as credit cards and electronic service, some others virtually serve as finance companies, without accepting deposits. Recent and rapid growth of bad loans is also an important issue for these banks.

Medium- and small-sized banks include 4 foreign commercial banks from Hong Kong, Turkey, Switzerland, and Germany. In the economic and financial circles, there are some opinions to oppose or feel reluctant about operation of foreign banks in the country for the interest of protecting domestic banks. At the same time, there are expectations for foreign banks to strengthen foreign financial sources and make up for serious shortage of domestic savings toward the overall improvement of the domestic financial markets. All in all, entry of foreign affiliated banks, mainly in the form of joint venture, may increase in the future.

The savings bank has the largest number of branches (58) throughout the country and is estimated to hold 85% of personal savings. In the former Soviet Union, it has been only one financial institution to collect deposits from the public. It is now a bank with the status equivalent to that of commercial banks. However, the bank has not obtained a license required under the Banking Law of 1992 partly because of political consideration preferring not to terminate the guarantee made by the former national

bank for refund to depositors, and partly because of lack of some licensing requirements such as working capital and documentation.

4-3-2 Issues Related to Insurance Companies

Insurance companies are licensed by National Insurance Supervision Committee. At present, 20 - 30 of them are operating and most of them are very small in size. They are allowed to sell a variety of products including life insurance, non-life insurance, and credit insurance, but life and non-life insurance businesses are virtually nonexistent due to little interest in insurance among citizens. According to the NBK's survey, 23 insurance companies provide credit insurance for commercial banks, with the contract amount of 74 million Som (Table 4-2). However, with the recent rise in bad loans made by commercial banks and very small reserve assets held by insurance companies, they are increasingly unable to pay insurance money. The amount of default totals approximately 42 million Som.

At present, insurance companies cannot be expected to become reliable suppliers of long-term funds. Many people are not interested in insurance, because their income level is too low to afford premium payment, and people do not generally trust insurance companies.

4-3-3 Other Financial Institutions

In many countries including Japan, the banking system has often been emerging and developing from non-institutional financial transactions in the general public. In Kyrgyz where such informal financial transactions have rarely developed in the past, however, there is little ground to foster the banking system. This is evidenced by the fact that various financial institutions including finance companies have been institutionally induced. However, not all of them are not acceptable from the standpoint of the sound financial system to require some improvement.

4-3-3-1 Lombard

Lombard is a legitimate financial institution not having depository function and in fact a finance company to loan its own funds. As of July 11, 1994, there are 34 Lombard companies which are on the rise. Lombard is typically funded by a few

investors, so that most of them have very small working capital to handle and are not in a position to meet financial demand of small enterprises.

4-3-3-2 Local Financial Institution

There is a unique case of establishing a local financial institution by a local government. The Credit Committee for Credit Demanders was established by Issyk-Kul State in April 1993. It is a finance company founded under leadership of the state government (in effect, NBK's branch office) and by 38 individual investors. At present, it is still small in size because of lack of institutional investors in membership. Nevertheless, it represents an example of the public organization's efforts to induce personal savings to investment, without assuming a primary role in financial transaction, as well as an example of local initiative to nurture its own financial institution.

4-3-3-3 Firma

In Kyrgyz, business enterprises are allowed to absorb funds from investors in the form of deposit service. However, they have to use the collected funds only for their own business purposes. These enterprises are called firma which means "company" in Russian.

Figure 4-4 shows a copy of firma advertisements on a major newspaper (Evening Bishkek) in the republic. Although interest rates vary greatly, they are generally much higher than bank deposit rates. There is no statistical data on firma, fairly a large number of them are presumably in operation.

At present, they can operate without obtaining any license and are not subject to supervision or monitoring of the regulatory organization. Also, there is no legal system to protect investors. Thus they present many potential problems from the standpoint of the stable financial system. They should thus be considered as temporary measures to make up for the shortage of commercial funds and need to be replaced with the formal banking system.

4-3-4 The Law on Banks and Banking Activities

The Law on Banks and Banking Activities in the Kyrgyz Republic was enacted on December 11, 1992, and took effect on December 12. It consists of 6 chapters and 34

articles and stipulates regulations related to the organization and activity of domestic banks in consideration to harmony with banking laws in other countries. While the law grants independence to banks, it its licensing, operation and management under close supervision of NBK. Also, the law clearly endorses freedom of choice for bank customers and protects their interest, while clearly defining accountability of banks for their customers. Contents of the law are summarized as follows.

Chapter 1 "General Provisions" sets forth definitions of banks and deposits, and a general outline of the banking system. Here, banks are defined as organizations to accept deposits, make payments upon the request of customers, and provide loans under their own name that will be eventually settled. The banking system is organized into a two-tier structure consisting of the central bank and other banks. Independence of banks from the government is warranted. Banks are not liable for meeting the government's obligation, and vice versa. Finally, banks are allowed to establish their holding companies.

Chapter 2 contains the provisions related to the establishment of banks and bank license. Among requirements for the establishment of a bank, legal capital must be entirely owned by founders (including other banks) for the purpose of securing a financial source of meeting the bank's obligation. In obtaining a license, the bank pay the amount equivalent to the minimum legal capital (at present, 1 million Som for domestic banks and US\$1 million for foreign banks) to NBK. Finally, banks who have the license and are registered with NBK are authorized to establish subsidiaries, branches, and liaison offices.

Chapter 3 "Banking Activities" sets forth that, unless otherwise specified in a particular license, banks can render the following services. It also requires banks to comply with the managerial ratios and secure credit insurance. Note that banks are not allowed to perform services other than those specified in their license, with the exception to investment in other companies by using their internal funds under certain conditions. Major banking services area:

- 1) Acceptance of deposits and lending of funds based on deposits;
- 2) Lending of funds based on own capital;
- 3) Opening and maintenance of personal and business accounts;

- 4) Payment and cashing services using accounts;
- 5) Issuance, purchase and settlement of payment facilities such as checks and bills;
- 6) Recovering of credits (factoring, etc.);
- 7) Safekeeping;
- 8) Guarantee of obligation for a third party;
- 9) Consultation and intermediary services associated with banking service;
- 10) Leasing; and
- 11) Issuance of securities and entrusted investment in securities upon the request of customers;

In addition, banks may obtain an additional license to provide the following services:

- (1) Foreign currency transactions;
- (2) Trading of rare metals;
- (3) Acceptance and cashing of precious metals through accounts;
- (4) International banking services authorized under each license.

Chapter 4 "Relationships between Banks and Customers" states that both business and personal customers may choose their own banks at their discretion and hold own accounts at different banks, presumably declaring the dissolution of the "one bank for one industry" system under the previous regime. Also, the chapter stipulates responsibilities of banks such as keeping secret of depositors.

Chapter 5 covers the accounting, reporting, and auditing of banks.

Finally, Chapter 6 lays down regulations related to dissolution and liquidation of banks.

4-3-5 Relationship between Financial and Industrial Capitals

In the Kyrgyz Republic, privatization of state enterprises progresses in the process of transforming itself to the market economy, and many private enterprises are established. Banks are often required to invest in these privatized enterprises or new enterprises because of serious shortage of domestic savings. At the same time, enterprises have incentive to become shareholders of banks in order to obtain favorable treatment in loan and credit service. As a result, mutual share holding between corporations and banks is widely observed, and it is often the case that major shareholders of commercial banks are major bank customers. This presents a problem from the standpoint of separation between financial capital and industrial capital.

As pointed out in the portfolio selection theory, diversifying assets consisting of an investment portfolio makes the risk for the entire portfolio smaller than that for individual assets, unless values of individual assets vary in perfect positive correlation. If funds are small in amount, however, investment in diverse assets is discouraged by the increase in transaction cost, and the investor cannot fully enjoy benefits from diversified investment. Also, selecting the most productive combination of assets requires a high level of expertise and skills. Generally, a final lender (individuals in the macroeconomic context) has major limitations in fund size and know-how in portfolio selection, thus cannot enjoy the risk minimization effect through diversified investment.

Under these circumstances, banks collect large funds from many economic units and invest in diversified assets. This way, they are expected to improve a level of safety per lending unit. However, the wide spread mutual share holding of enterprises and banks seen in Kyrgyz results in insufficient risk spreading in loans, lowering the risk bearing capacity of banks. The limited risk bearing capacity may limit the choice of projects financed by banks and thus impede the development of much needed industries. Thus, the not-at-arms-length relationship between industrial capital and financial capital and other risk factors should be gradually removed.

4-3-6 Issues Related to Long-Term Finance

The Law on Banks and Banking Activities in the Kyrgyz Republic defines a bank as "an institution which accepts deposits and others and loan them under its name, while assuming responsibility for payment and settlement at request of customers." Basically, it is not the universal bank system seen in Europe, but the banking system separating

securities service. At present, the country has 19 banks operated under the Bank Law, which are called commercial banks. Commercial finance forms a central part of fund operation business, following the principle of commercial banking. As discussed in "4-7-1 "Deposit Service," the current state of banks in Kyrgyz, facing a high liquidity risk, makes it desirable to avoid long-term funds operation in a fixed form until the banking system reaches a maturing stage. Thus, the current policy direction to foster the banking system under the principle of commercial banking matches the current situation of financial and economic systems.

In fact, commercial banks make it a rule not to make long-term loans in order to avoid the tying-up of funds. According to hearings from banks, long-term loans account for a merely few percent of their loan portfolio. Clearly, the current banking system following the principle of commercial banking does not supply sufficient long-term funds that are indispensable in building industrial infrastructure.

4-3-7 Issues Related to Public Finance

The privatization process underway in the Kyrgyz Republic includes financial institutions, which is basically acceptable as a desirable policy direction toward the market economy. At the same time, however, the serious shortage of savings in the private sector makes it very difficult for private finance to supply capital investment funds for industrial infrastructure, which have to rely on guidance policy finance such as government funds and foreign aids. Previously, guidance policy finance had been made through refinance loans by NBK to commercial banks (special purpose credit), but it caused a serious financial problem as discussed in 4-5 "Current Monetary Policy and Major Issues" and has been discontinued. Now that government financial institutions are all privatized and the refinance loan program is not available, development of an appropriate instrument to provide guidance policy finance becomes a major issue.

The issue will be discussed in more detail in "8-2 Type and Size of Financial Institution" which examines a desirable form of public financial institutions, including the proposal for the development bank, on the basis of the Decree on Establishment of the Bank of Reconstruction and Development of the Republic of Kyrgyzstan issued on July 9, 1994.

4-3-8 Issues Related to Small Business Finance

Since the horizontal division of labor among industrial sectors has been well established in the former Soviet Union and East European countries, Kyrgyz has very small production capacity for consumer products, which development is in urgent need for economic growth. Although many private enterprises have been founded since the independence, a financial system to support them is not fully developed.

In the country where funds are in absolute shortage, private funds tend to flow to (1) large corporations with a relatively low credit risk, and (2) short-term loans in order to avoid the tying-up of funds. Obviously, it is difficult to expect smooth fund flow to the development of small businesses. In fact, hearings from commercial banks indicate that most of loans to small businesses are limited to less than one year. This results in very limited supply of long-term funds for capital investment, and the current banking system does not provide effective financial support for the fostering and expansion of small businesses.

4-4 Current State of Financial, Capital and Foreign Exchange Markets

4-4-1 Short-Term Financial Market

Since there is no established financial market in Kyrgyz, there is no benchmark interest rate to determine loan and deposit rates for commercial banks. At present, NBK's credit auction rates are used as reference rates.

In the mean time, inter-bank loans emerge among some of commercial banks and seemingly form a market at an infant stage. The inter-bank borrowing of funds started as credit auction was resumed with the launching of the overdraft reform plan on April 1, 1994. After credit resources are allocated at each credit auction, they are traded between banks participating the auction or between a participating bank and a non-participating bank in the form of loan. For instance, a bank participating in a credit auction obtained funds at an interest rate of 120% and lend them to other banks at 200% to gain the 80% spared. Nevertheless, these loans are still limited to informal matchmaking of surplus and deficit units through personal connection between bank owners and are thus far from the emergence of an official inter-bank market. NBK's Credit Resources Division and Bank Supervision Department are making effort to

monitor and estimate the number of such inter-bank loans and the amount involved, but not enough data have been collected to this date.

As for short-term fund transaction in the form of asset sales, NBK conducts 3-month TB auctions (under competitive bidding). As pointed out in "4-5 Current Monetary Policy and Major Issues," however, the auction is principally designed to cover government debt and has no intention to develop it into a place of open market operation. Although outstanding TBs are sold by commercial banks to investors in some instances, as well as direct trading between commercial banks, the volume of trade is far from the emergence of the TB market.

To create and foster short-term money markets in the future, there are various hurdles that are closely related to primary functions of short-term money markets:

- (1) To ensure that each financial entity can adjust a temporary surplus or deficit of funds, thereby to maximize the efficiency of fund operation in the entire economy; and
- (2) To enable the central bank to hold the final control of cash flow as a sole provider of high-powered money, and to control short-term interest rates through it, which serves as a means of manipulating monetary policy.

From the viewpoint in (1), who will provide funds in the inter-bank market becomes a problem. In the present situation where commercial banks do not have the ability to absorb funds from the public, most of banks are expected to become borrowers. In fact, hearings from commercial banks reveal that a majority of responses expect the emergence of the short-term money market as a place to raise funds. Moreover, most of commercial banks rely on credit from the NBK in the form of overdraft on a permanent basis, and after the overdraft reform has been effected, they are expected to replay rescheduled loans. Under these circumstances, even if a temporary surplus of funds occurs at some banks, they are likely to use it for repayment of the NBK loans, rather than supplying it to the short-term money market. Thus, the establishment of the short-term money markets depends heavily upon the improvement of commercial banks in terms of deposit service, the ability to absorb funds, and the progress of NBK loan repayment.

As for (2), the NBK does not perform open market operation at present due to the absence of the short-term money market of sufficient size. One market which will become suitable for NBK's open market operation is the TB market. As discussed in Chapter 7 "Forecast of Financial Transaction and Volume," the volume of TB issue is expected to grow significantly, and accordingly, the market is expected to play a leading role in fostering the short-term money market.

4-4-2 Securities Market

The issuance of public bond on a regular basis is limited to 3-month TBs that are sold through the auction, and no corporate bond is issued. As a result, there is no medium- and long-term public and corporate bond market. Similarly, there is no securities market since shares of privatized state enterprises has been sold through private offering.

Generally speaking, in any country where private savings remain at a very low level, savings principally flow into financial assets offering high safety and liquidity, making it difficult to foster the capital market. Thus, growth of the capital market in Kyrgyz is not expected in the near future.

If any sign of the capital market is to be found, vouchers to be distributed by State Property Fund (SPF) as part of the state enterprise privatization program are the primary candidate. Currently in the advertisement phase, once vouchers are distributed, they can be exchanged for shares of private enterprises. If many people obtain such shares, they may desire to sell or buy them through the market. In fact, the establishment of a securities exchange is being considered for such potential demand.

Another potential area is the bond market. Since NBK is banned from covering a government budget deficit under the Law on National Bank, the government will have to secure funds through the issuance of long-term government bonds. Finally, as discussed in Chapter 8, the establishment of a long-term financial institution is likely to entail the issuance bank bond which will create opportunity for the secondary market.

4-4-3 Foreign Exchange Market

Foreign exchange transactions in Kyrgyz are primarily made through foreign exchange auctions (Table 4-3), which are hold by NBK to sell foreign current to