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Ex-ante evaluation statement on EU macro-financial assistance to the Kyrgyz Republic

Accompanying the document

Proposal for a

DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

providing macro-financial assistance to the Kyrgyz Republic

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Ex-ante evaluation statement

EU Macro-financial assistance to the Kyrgyz Republic

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Introduction

The Kyrgyz Republic was hit by the global crisis in 2009 and went through a popular revolt in 2010. In April 2010, the regime of President Bakiyev was deposed under allegations of corruption and lack of democracy. In a vacuum of power, inter-ethnic violence erupted in June 2010 in the South of the country, leaving close to 470 people dead and about 300,000 displaced. In spite of these tragic events, the new, interim government secured an approval vote for democratic reforms in a constitutional referendum held on 27 June 2010. The new Constitution, in particular, strengthens the powers of the parliament. Free parliamentary elections were held in October 2010 establishing the first parliamentary democracy in the region. Elections resulted in a broad coalition government. While the political situation remains fragile, presidential elections took place on 30 October 2011. The government is leading a steady process of democratisation and reform that stands in contrast to the political situation in the neighbouring countries of Central Asia.

The crisis adversely affected economic activity and the government's fiscal position. It brought about substantial expenditures to finance emergency reconstruction and social reconciliation. In response to these events and their economic implications, the international community pledged USD 1.1 billion at a donor conference for the Kyrgyz Republic organised on 27 July 2010 in Bishkek. The EU was among the major donors with about EUR 120 million. In early May 2011, the IMF agreed with the Kyrgyz authorities on a USD 106 million Extended Credit Facility (ECF) in support of a three-year programme of macroeconomic adjustment and structural reforms. This arrangement was approved by the IMF Board on 20 June 2011.

In 2010, the President and the Minister of Finance of the Kyrgyz Republic formally requested the EU macro-financial assistance (MFA) to complement the financing from the IMF. In this context, the Commission has assessed the macroeconomic situation and financing needs of the Kyrgyz Republic. The main conclusions of the assessment are that, although the fall in GDP and the deterioration in the fiscal position in 2010 were less pronounced than initially expected, last year's tragic political events and the related social and reconstruction expenditure have left important external and fiscal financing needs for the period 2010-12. While these needs are being partly covered by the international community, there are still substantial residual needs, not least since the pledge from the Eurasian Economic Community (EurAsSEC) Anti-Crisis Fund has yet to be confirmed.

Given the EU's strong political support for the Kyrgyz Republic's incipient parliamentary democracy, the Commission considers that the political and economic pre-conditions for a MFA operation of a moderate amount are satisfied. While the Kyrgyz Republic is out of the normal geographical scope of MFA, the Genval criteria foresee, in exceptional and duly justified circumstances the possibility of approving operations outside that area[1]. In this case, a MFA operation seems justified by the strength of the political and economic reform

[1] This would not be the first exceptional MFA operation in Central Asia: already in 2000, the Council approved one for Tajikistan, consisting of a combination of a long-term loan of EUR 60 million and of a grant of EUR 35 million grant. The grant component of the assistance was disbursed over a period of five years.

momentum in the country and by its position in a region of strategic economic and political importance for the EU. It would provide a political signal of strong EU support to democratic reforms in Central Asia, consistent with the EU policy towards the region spelled out in the Strategy for Central Asia for 2007-2013 and with statements by EU leaders. Strengthening the link between EU foreign assistance and progress with democracy and human rights would also be consistent with the last review of the European Neighbourhood Policy and with the March 2011 Joint Communication on a new response to a changing neighbourhood.

Therefore, the Commission is submitting to the European Parliament and to the Council a proposal for a MFA to the Kyrgyz Republic in the amount of EUR 30 million. The EU MFA would aim at contributing to covering the country's external financing needs in 2012 as identified in cooperation with the IMF in the context of the IMF ECF programme. It would be disbursed in two tranches between during 2012.

The assistance would be provided half in grants and half in loans to take into account the Kyrgyz Republic's low per capita income, debt indicators and access to the concessional facilities of the Bretton Woods institutions and other financial institutions. The proposed new MFA would be exceptional and limited in time and is intended to run in parallel to the IMFs ECF.

The new MFA would contribute to help the Kyrgyz Republic to address the lingering economic consequences of the global recession and of the ethnic conflict. It would reduce the short-term financial vulnerability still faced by the economy, while supporting reform measures (including those in the IMF and World Bank programmes) aimed at achieving a more sustainable balance of payments and budgetary situation over the medium-term. The proposed assistance would complement the EUR 117.9 million pledged by the EU at the July 2010 donor conference to deal with humanitarian, reconstruction and social protection needs.

The Kyrgyz Republic's macro-economic situation

The marked deceleration in growth experienced by the Kyrgyz economy in 2009 (GDP growth slowed down from an average rate of 8.5% in 2007-8 to 2.3% in 2009) was a consequence of several external shocks, including a fall in remittances from migrant workers, lower demand for exports and shrinking foreign investments. Before the dramatic events of 2010, economic growth was expected to rebound in 2010 to 4.5-5.5%. However, the April popular revolt and, more importantly, the escalation of the ethnic conflict in June led to a serious deterioration in the economic outlook. Border closures, notably with Kazakhstan, hampered trade, while the security situation markedly impacted tourism and partly disrupted agricultural production. Economic activity contracted by 10% in the second quarter of 2010. On the positive side, after a very sharp contraction in the first half of 2010, economic growth recovered in the second half of the year and, for the year as a whole, real GDP is estimated to have declined by only 1.4% compared to the 3.5% decline the IMF had projected in August 2010. According to the preliminary estimates of the Kyrgyz authorities, real GDP expanded by 6.5% in the first seven months of 2011, while the IMF predicts GDP growth to reach about 7% for the year as a whole, as the agricultural and mining sectors and remittances recover.

The fiscal deficit rose from 3.5% of GDP in 2009 to 6.5% of GDP in 2010, reflecting the budgetary cost of the crisis-related measures and the negative effect of weaker economic activity on tax revenues. This was, however, a much smaller deterioration than foreseen in August 2010 by the IMF in the context of the RCF programme, which assumed a deficit of 12% of GDP. Despite a shortfall in donor support, the fiscal deficit was lower due to a lack of capacities to implement reconstruction projects. However, part of the unrealised spending in 2010 is being transferred to 2011, contributing to the expansion of the forecasted budget deficit to 7.6% of GDP (excluding energy infrastructure projects). The increase in the deficit also reflects the government's decisions to maintain the pension increases granted by the previous government and to triple wages for teachers and health care employees as from the second half 2011, which is estimated to increase the public wage bill by 3 percentage points of GDP in 2011 despite a planned 10% reduction in the number of public employees. The wages of education and health care public employees were very low and, in the current times of economic stress and political difficulty, the authorities decided to use some of the budgetary room created by a lower than initially programmed deficit to bring them to a more acceptable level. The privatisation of a telecommunication company Kyrgyz Telecom is planned, although there is some uncertainty about whether the revenues will be received in 2011.

The IMF considers that the moderate deterioration of the fiscal position in 2011 was understandable from a political viewpoint and would contribute to underpin the economic recovery. At the same time, the IMF programme assumes a considerable effort of fiscal consolidation for the remainder of the programme period, with the fiscal deficit (excluding energy infrastructure projects) targeted to decline gradually to 4.4% of GDP by 2014[2]. In particular, tax collection is planned to be strengthened i.a. by: removing turnover tax exemptions on electricity, heating, and natural gas for commercial users and VAT exemptions on communication services; strengthening customs administration and shifting from weight-based to price-based customs valuation; reforming excise taxation on tobacco and alcohol.

Table 1: The Kyrgyz Republic – Selected macroeconomic indicators, 2009-2012

	2009	2010	2011	2012	2013	2014
	actual	preliminary		projections		
Real Sector						
GDP (US$, millions)	4683	4615	5187	5695	6187	6766
GDP per-capita (in US$)	880	863	960	1044	1123	1216
Real GDP growth (change in %)	2,9	-1,4	6	6	6	5,8
Fiscal indicators						
Total revenues (% of GDP)	32,1	31,7	34,6	32,3	31,6	31,2
Total expenditures and net lending (% of GDP)	36,1	38,1	42,3	39,4	38,5	38
General government balance (% of GDP)	-3,5	-6,5	-7,6	-7,1	-6,9	-6,8
excluding energy infrastructure projects	-3,5	-6,5	-7,6	-6,2	-5,6	-4,4
Gross public debt (% of GDP)	58	62,6	56,5	56,1	57,5	58,4
Monetary sector						
Inflation (average)	6,8	7,8	20	8,7	7,5	7,5
Inflation (end-year)	0	18,9	13	8	7,5	7,1
Credit to the private sector (% of GDP)	12,9	13	13	13,4	15,2	16,4
Broad money (% change, end of period)	20,9	21,1	15,7	16,2	19,7	20,5
Dolarisation of the bank deposits	58,7	55,7	54,2	52,7	na	na
Dolarisation of the loans	59,6	52,9	51,7	51,5	na	na
External sector						
Current account balance	0,7	-2,1	-8,7	-8,2	-6,1	-5,4
Trade balance in goods and services (% of GDP)	-21,1	-29,8	-35	-35	33,4	31,2
FDI (net, % of GDP)	4	5,1	4,2	4,2	4,2	4,2
External vulnerability						
External public debt outstanding (% of GDP)	52,8	57,3	51	50,3	50,5	50,1
Debt service as % of exports of good and services	3,2	3,6	2,8	2,5	2,4	2,3
External financing of the budget deficit (% of GDP)	7,4	3,2	5,2	3,7	3,9	3,8
International reserves (in moths of imports)	4,9	4,2	4,1	3,9	3,8	3,8

[2] The IMF staff level agreement of September 2011 with the Kyrgyz authorities on the first review of the ECF tentatively envisages reducing the fiscal deficit further to 3.8% of GDP by 2014 (excluding energy projects).

Source: IMF staff estimates

The IMF programme and the budget for 2011 assume that the government receives about USD 270 million in the form of external budgetary support (both grants and loans, see also 1.3). This sum includes, in particular, about USD 30 million from the IMF (part of the Fund's monies that will be allocated to budget support), USD 30 million from the World Bank, USD 50.6 million from the Asian Development Bank and USD 106.7 million from the Eurasian Economic Community (EurAsEC) Anti-Crisis Fund. It also includes substantial budget financing from the EU, to be provided in the form of both sector budget support under the Development Cooperation Instrument[3] and MFA.

The central bank has tightened monetary policy substantially since the mid-2010, responding to an acceleration in inflation due to a sharp increase in the global prices of fuel and food (foodstuff constitute 48% of CPI basket in the Kyrgyz Republic). Year-on-year inflation has spiked from 0% at the end of 2009 to 22.7% in June 2011. While food and energy prices (and, thus, external factors) explain most of the acceleration in inflation, there is also evidence that price pressures have begun to spill over to other products. The central bank acknowledged that the planned fiscal expansion in 2011 against a background of a rather robust economic recovery was significantly increasing inflation risks. As part of its tightening measures, the central bank has stepped up its sales of short-term notes (doubling its stock) in order to mop-up excess liquidity. It also increased reserve requirements from 8% to 9% in March 2011 and indicated that it was ready to raise them to 10% if need be. The discount rate has been increased from 2.7% in mid-2010 to over 13% as of September 2011.

The central bank operates a managed floating exchange rate regime, allowing the exchange rate to adjust in case of substantial pressures or shocks while aiming at maintaining a competitive exchange rate. In the context of the global financial crisis, the exchange rate came under significant downward pressure, with the Kyrgyz som, the national currency, depreciating by 25% against the US dollar between August 2008 and August 2009. This was followed by a period of relative exchange rate stability between September 2009 and June 2010. Since then, the som has tended to depreciate at a moderate pace but not enough to compensate for the acceleration in inflation, which has resulted in a significant appreciation of real effective exchange rate. However, the current level of the exchange rate is estimated by the IMF to be broadly in line with fundamentals.

IMF and other donor support

In response to last year's political events and their economic implications, the international community organised a High Level Donors Meeting for the Kyrgyz Republic on 27 July 2010 in Bishkek. At this conference, donors committed to providing USD 1.1 billion in emergency support by the end of 2011 The EU was among the major donors, pledging EUR 117.9 million for support in a number of critical areas[4].

In early May 2011, an IMF staff mission agreed with the Kyrgyz authorities on a three-year programme to be supported by an Extended Credit Facility (ECF) in the amount of SDR 66.6 million (about USD 106 million, or 75% of the Kyrgyz quota in the Fund). The IMF

[3] A programme targeting reforms in social protection and public finance management.

[4] This includes emergency humanitarian assistance, support for the establishment of a democratic constitutional framework, judicial reform and the rule of law, and support for socio-economic development, social protection and educational reform.

Executive Board approved it on 20 June 2011. Under the programme, annual real GDP growth stays close to 6%, inflation declines gradually from current heights of over 20% to 8% in 2013 respectively, the deficit of the general government (excluding energy infrastructure projects) declines from 7.6 of GDP in 2010 to 4.4% of GDP in 2014, and the current account deficit declines from over 8% in 2012-2013 to 5.4% of GDP in 2014. The ECF's structural reform conditionality is focused on tax (abolition of exemptions) and customs measures, increasing fiscal transparency and strengthening the financial sector (including by endowing the central bank with adequate powers to resolve banking problems). The ECF is a macroeconomic stabilisation instrument and a follow-up arrangement to the IMF’s Rapid Credit Facility (RCF) of SDR 22.2 million implemented in September-December 2010. The authorities met all the targets of the RCF programme, building a good track-record for the follow-up programme[5].

The World Bank pledged USD 200 million at the donor conference, including two emergency operations: a USD 70 million Emergency Recovery Project (disbursed in the form of budgetary support) and additional financing for a National Road Rehabilitation Project in the amount of USD 10 million. An Economic Recovery Support Operation (ERSO) in the amount of USD 30 million, also for budget support, was approved by the World Bank's Executive Board in August 2011. The ERSO will support government efforts to strengthen public sector governance (including anti-corruption measures) and address urgent social and reconstruction needs. Another important budget support operation is the Health and Social Protection SWAP, which is being topped up with an additional USD 24 million to finance activities related to last year’s conflict in the Southern provinces of Osh and Jalalabad. As the Kyrgyz Republic is a low-income country, all World Bank support to it is provided under highly concessional IDA terms, both IDA grants and concessional loans. In particular, the ERSO is provided in the form of a mix of grants (45%) and IDA loans[6] (55%). The mix between grants and loans within IDA financing is determined with reference to recipient country's risk of debt distress, the level of GNI per capita, and creditworthiness for IBRD borrowing. Recipients with a high risk of debt distress receive 100 percent of their financial assistance in the form of grants and those with a medium risk of debt distress receive about 50 percent in the form of grants. To note that World Bank IDA loans are also highly concessional entailing repayment over 40 year, a 10-years grace period, zero interest and a small service charge. At the start of 2011, the IDA had 19 active projects in the Kyrgyz Republic, totaling USD 303 million. The World Bank is also involved in 40 multi-donor trust funds (managing 20 of them), which amount to close to USD 100 million. IFC and MIGA are also active in the Kyrgyz Republic.

The Asian Development Bank (ADB) pledged USD 100 million at the July 2010 donor conference in the form of a budgetary support operation known as Emergency Assistance for Recovery and Reconstruction, which combines soft loans (on Asian Development Fund terms[7]) and grants in equal parts. The concessional nature of the loans is similar to the one of the World Bank. The operation was approved by the ADB in September 2010 but disbursements were delayed and part of them moved to 2011. Out of these funds, USD 46

[5] However, not being a fully fledged upper credit tranche arrangement and being of a very short-term nature, the RCF was not sufficient for the Commission to be able to consider putting forward an MFA proposal. Instead, the Commission had to wait until agreement of the ECF was reached, an agreement which was delayed for months, partly reflecting delays in the formation of a new government following the October 2010 elections.

[6] Repayment over 40 year, 10-year grace period, zero interest and a small service charge.

[7] ADF loans have 40-year maturities and 10-year grace periods (as IDA loans) and carry an interest rate for 1% for the first 10 years and of 1.5% for the remaining 30 years.

million are in the form of budgetary support and were disbursed in February 2011. The rest have been used to finance the reconstruction of houses in the provinces of Osh and Jalalabad. In addition, the ADB is planning the disbursement of USD 20 million in the last quarter of this year under ADB's Investment Climate Improvement Program (ICIP), which could, however, be delayed until the first quarter of 2012. This would be the second (ICIP II) of a series of three such operations, the first of which was implemented in 2009. A third such operation (ICIP III), also of USD 20 million, is planned for the second half of 2012.

The Kyrgyz Republic has also requested support from the Eurasian Economic Community (EurAsEC) Anti-Crisis Fund (in the form of a soft loan). However, the amount under discussion (which was initially USD 260 million) was later reduced to USD 106.7 million, and its disbursement repeatedly delayed. While the IMF programme assumes the full disbursement of this loan in 2011, the funds will not be disbursed until after the presidential elections in the Kyrgyz Republic at the end of October 2011 and there are considerable uncertainties concerning the disbursement of these funds.

The EU was among the major donors in the July 2010 donor conference and pledged EUR 117.9 million for support in a number of critical areas. Part of these commitments came under emergency instruments (such as Instrument for Stability - IfS[8] and ECHO humanitarian aid). Another part, coming mostly from the allocation under the Development Cooperation Instrument (DCI) and allocations under a number of thematic budget lines, consisted in the increase and the acceleration of disbursements under already approved programmes/projects. The assistance focuses mainly on rural development and agricultural sector, the education sector, social security and legal reforms. The EU intends to provide Sector Budget Support to the Kyrgyz Republic under the DCI for a total of EUR 33 million over the period 2011-2013 to support reforms in Social protection, Education and Public Financial Management. Disbursements under these programmes and projects are taking place over the medium-term and are conditional on the implementation of agreed actions by the beneficiary authorities.

The Kyrgyz Republic, with support from several donors (the EC, the ADB, the World Bank and the UN), is preparing a Country Development Strategy (CDS) for 2012-14, to be adopted by the Parliament in September-October 2011. The CDS will cover a wide range of policy areas ranging from judicial macroeconomic policy to public order and judicial reform and trade and environmental policy.

The Kyrgyz Republic's external financing needs

In 2010 the current account experienced a marked deterioration, moving from a temporary surplus of 0.7% of GDP in 2009 to a deficit of 2.1% of GDP (or 3.8% excluding official transfers). The deficit was projected to increase to 8.7% of GDP in 2011 and stay high at 8.2% of GDP in 2012 before gradually declining to 5.4% of GDP by 2014. The balance of payments difficulties emerged already in 2008 (when the current account deficit temporarily reached 8.1% of GDP), because of a hike in imported commodity prices (by 20% in 2007-2008) and a drop in electricity exports, reflecting a major shortfall in domestic hydro-power capacity due to low water levels. Prices of imported commodities went up again in 2010 (by 25%). Moreover, in 2010 agricultural exports and services such as tourism and transit

8 The IfS intervenes in the area of conflict prevention, crisis management and peace building. In 2010 a Democratisation and Stabilisation package was put in place for a total amount of EUR 7,2 mn for emergency humanitarian assistance, support for the establishment of a democratic constitutional framework, judicial reform and the rule of law.

transportation were hit by the shutdown of the borders by the neighbouring countries due to security concerns. In addition, the value of oil imports was driven up by the 100% temporary export tax on oil products imposed by Russia in April 2010 (and abolished in February 2011). The deterioration in the current account was, however, partially mitigated by higher price of gold, the Kyrgyz Republic's main export. In 2011, growth in remittances and the sustained high price of gold may lead to a marginally better current account situation. These inflows, however, are vulnerable to the economic situation in Russia (main origin of remittances) and global market developments. Moreover, as borders reopen and the economy recovers, imports are rebounding strongly, outpacing the growth of exports. The recovery of domestic demand and high prices of oil (accounting for one quarter of imports) will therefore limit the expected decline in the current account deficit during 2011 and 2012. In the long term, the planned, foreign-financed energy infrastructure projects to secure energy supply to the South of the country, with construction costs of around 4.5% of GDP by 2014, contain a very high import-element and hence will limit the decline in the current account deficit position.

Foreign direct investment and other private capital inflows were negatively affected by the 2009 global crisis but began to recover in 2010 despite the political crisis. Under the IMF programme, the capital and financial accounts are expected to show an average annual surplus of about USD 400 million during 2011-14, reflecting sizable external loans for public investment projects, including loans by the EurAsEC and China for energy projects, and steadily increasing FDI (which is projected to average USD 250 million per annum, or about 4.2% of GDP).

The nominal value of the foreign exchange reserves reached USD 1.9 billion by September 2011, but the import coverage ratio by the foreign exchange reserves declined from 4.9 months in 2009 to an estimated 4 months in mid-2011, as the nominal value of imports grew faster than the official foreign exchange reserves. While the import coverage ratio is close to an appropriate level based on conventional assumptions, the IMF estimates that reserves would fall below advisable levels in the absence of official balance of payment support. Moreover, the external position remains highly vulnerable to exogenous shocks linked to fluctuations in international commodity prices. Under the ECF programme reserves are targeted to increase from USD 1.7 billion at end 2010 to 2.3 billion at end-2014, but this implies a slight reduction in the import coverage ratio.

Reflecting the disbursement of official loans, the Kyrgyz Republic's external public debt rose from about 41% of GDP at end-2008 to over 57% of GDP at end-2010. The Kyrgyz Republic is negotiating with Russia a swap of early post-soviet era debt (USD 193.5 million) against a military factory but the deal has not been closed yet. The Kyrgyz Republic first had to pay USD 14.5 million to clear arrears on this debt in April 2011. It has recently paid over USD 0.2 million to settle obligations on the similar debt with Belarus as part of a debt restructuring agreement and has agreed with Turkey on USD 49.5 million debt write-offs. The government will also take loans from China on preferential terms to the tune of USD 450 million over the next years for the energy projects (including USD 208 million for the next two years).

Table 2. External Financing Requirements in 2011 and 2012 (in USD million)

in million USD	2011	2012
1. Current account balance	**-453**	**-464**
Trade balance	-1640	-1849
Services	-175	-145
Income (net)	-198	-251
Net transfers (excluding external budget support)	1559	1780
2. Capital account and financial account	**349**	**361**
Capital account (net)	289	-1
Financial account	60	362
Medium and long term loans, net	-149	-107
Foreign direct investment	219	240
Commercial banks	-10	15
3. Errors and omissions	0	0
4. Overall balance (1+2)	**-104,0**	**-104,0**
5. Gross reserves (-increase)	-167,0	-45,0
6. Overall financing needs (4+5)	**271,0**	**149,0**
7. Exceptional financing by the IMF and WB	**59,8**	**29,7**
IMF purchases	29,8	29,7
World Bank (gross)	30,0	na
8. Residual financing gap after IMF and WB (6 – 7)	**211,2**	**119,3**
Financing of the residual financing gap		
The EU Budget Support program	16,4	17,1
EURASEC anti-crisis fund	106,7	na
Asian Development Bank	50,6	na
Others	10,0	na
The EU MFA (EUR 15 mn for each year)	20,5	20,5
Memorandum item		
Total MFA as % of the residual financing gap for 2011-2012		**12,4**

Sources: IMF and Commission staff estimates

Based on the above- projections for the current account, private capital inflows and official financing (excluding budgetary support operations), the IMF programme estimates a balance of payments financing gap of USD 271 million in 2011 and of USD 149 million in 2012. After deducting net financing from the IMF and disbursements of budgetary support operations from the World Bank, this leaves a residual external financing gap of some USD 330 million for the two years, to be covered by other donors. The assumed donor financing includes, as indicated already, contributions from the ADB, the EurAsEC Anti-Crisis Fund (still to be confirmed), other bilateral donors, and finally the EU. The disbursements under the EU sectoral budget support programmes in 2011-12 are expected to amount to EUR 12 and 12.5 million respectively (USD 33.5 million for the two-year period). A MFA operation amounting to EUR 30 million (USD 41 million) would correspond to about 12.4% of the residual external financing gap for 2011-12.

Structural reform challenges

Banking sector: the banking system was severely affected by the crisis. In April 2010, seven banks were put under temporary administration, although the problems were mostly concentrated in the largest bank (the Asia Universal Bank, AUB), which accounted for 44% of banking system deposits. Subsequently, two banks were released from temporary administration, four were placed under conservatorship and AUB was nationalised and separated into a "bad bank" and a "good bank" (called Zalkar Bank). The assets of Zalkar Bank are being audited to get a clearer picture of their value. If the audit confirms the solvency of Zalkar Bank, the authorities intend to privatise this bank. If the audit concludes that the bank is insolvent, the authorities intend to start bankruptcy procedures and dispose of its assets and liabilities. The authorities will cover the losses from AUB restructuring operations. The IMF estimates that these losses, which will be covered by issuing state bonds, will amount to up to 0.6% of GDP in 2011.

On the positive side, a run on deposits was avoided and the four banks under conservatorship now account only for 3% of system deposits. Capital adequacy ratios remained at elevated levels (of over 30%), but non-performing loans rose to 13.8% of total loans by March 2011. The credit expansion remains tame and credit to private sector stands at only 13% of GDP. The domestic financial sector remains underdeveloped, lending interest rates are high and about 50% of loans and deposits are denominated in foreign currency (mostly USD).

The banking crisis has revealed deficiencies in the bank resolution powers and degree of de facto independence of the central bank, including its exposure to interference by the government and the courts. Consequently, banking regulations are being amended and upgraded to a Banking Code to strengthen the central bank's early intervention and resolution powers, while the IMF program address issue of the independence of the central bank.

Public finance management (PFM): on-going work is based on a medium-term PFM reform action plan for 2009-2013 adopted by the government in 2009, which was in turn based on the Public Expenditure and Financial Accountability (PEFA) study undertaken in 2009. The PFM action plan is being supported by a Multi-Donor Trust Fund (MDTF)[9]. The political events of 2010 hindered progress in PFM reforms over the last year and a half, but this situation has been reversed. An IMF technical assistance mission examined PFM issues in August 2011. A PEFA update is envisaged for 2013. The World Bank is planning to undertake a Public Expenditure Review in 2012.

One of the main weaknesses in PFM is the system of external audit and this area requires longer term support in capacity building. The Law on the Chamber of Accounts (supreme audit institutions) is broadly adequate but the capacities of this institution need to be developed. The World Bank is providing technical assistance in this area. Public procurement is another source of concern. An amended law on public procurement is supposed to tackle some o the deficiencies but has yet to be assessed by international experts. A specialised agency on public procurement has been abolished and the Ministry of Finance is in charge of procurement issues for the time being. While there has been tangible progress on internal audit in some line ministries (notably in the Ministry of Health supported by the World

[9] The MDTF, which is managed by the World Bank, was established in 2009 with contributions from the EU, Sweden (SECO), Switzerland (SIDA), the UK (DFID) and the World Bank. The EU is contributing EUR 2.8 mn to MDTF out of total USD 4.6 mn.

Bank's Health and Social Protection project), there remains significant room for improvement.

Poverty alleviation: the Kyrgyz Republic is a poor country, with a 2010 GNI per capita income of 880 international US dollars, i.e. well below the World Bank's official criteria for IDA eligibility of less than 1,175 USD per capita income. The dynamics of poverty alleviation were rather favourable before the outset of the global recession and internal shocks. During 2000-08, the extreme poverty ratio declined by an average of 4 percentage points per year while general poverty declined by an average of 3.8 percentage points per year. However, by 2008 around 6% of population still lived in extreme poverty and 32% under the general poverty threshold. Moreover, poverty ratios in the rural areas are much higher (51% of people living under the poverty threshold) and significant gender disparities in poverty levels persist[10]. Also, the 2010 events and the recent spike in food and energy inflation are expected to result in a partial reversal of the previous gains in the fight against poverty. The UNDP estimates that general poverty increased by 4.3 percentage points in 2010 as a result of hike in energy and food prices. On the other hand, the government's fiscal policy plans should contribute to the poverty reduction efforts. Overall social spending is safeguarded under the IMF programme and targeted social assistance programmes (notably the so-called Unified Monthly Benefit and Monthly Social Benefit programmes) will be reinforced.

Trade issues: the Kyrgyz Republic is a member of the WTO and is a very open economy, with a trade-to-GDP ratio of almost 140%. The bulk (40% in 2010) of its exports goes to Kazakhstan and Russia – which are members of a trilateral customs union (CU), also including Belarus. In April 2011, the Kyrgyz Republic applied for membership of this CU. However, the economic impact of such a decision has yet to be properly assessed, while the negotiations over the terms of joining the CU may take some time, i.e. from two to five years. The main benefits the Kyrgyz Republic expects to obtain from entering this CU, apart from possible foreign policy considerations, is to preserve the supply of oil supplies from Russia and Kazakhstan at favourable prices and to limit the risk of disruptions in trade flows with those important trading partners (such as last year's temporary border closure with Kazakhstan).

Entering the CU would entail a number of significant costs. First, it might clash with the Kyrgyz Republic's WTO commitments, as the Kyrgyz Republic would be the only CU member with WTO membership (depending on progress in the WTO accession process of Russia). Since the CU has a relatively high Common External Tariff (CET), the Kyrgyz Republic would have to compensate other WTO members. More importantly, joining the CU would restrict the important transit trade with China. Since both China and the Kyrgyz Republic are WTO members, the Kyrgyz Republic imports Chinese goods cheaply (gray imports are also pervasive) and re-exports them to neighbouring countries, with which the Kyrgyz Republic has a free trade agreement under the CIS framework. A possible demise of open air markets serving such trade is a very sensitive social issue, since according to various estimates the two biggest markets provide direct and indirect employment up to 100,000 people.

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[10] The Kyrgyz Republic. Second progress report on the millennium development goals, UNDP The Kyrgyz Republic, 2011.

OBJECTIVES AND RELATED INDICATORS OF THE MACRO-FINANCIAL ASSISTANCE

Objectives

The objectives of the proposed MFA operation are to:

- Contribute to covering the external financing needs of the Kyrgyz Republic and to alleviating budgetary financing needs.

- Support the fiscal consolidation effort and external stabilisation in the context of the IMF programme.

- Support structural reform efforts aimed at improving the overall macroeconomic management (e.g. targeting the transparency and efficiency of public finance management and the financial stability) and at improving conditions for sustainable growth.

Indicators

The fulfilment of the objectives of the assistance will be assessed by the Commission, including in the context of the ex-post evaluation (see below), on the basis of the following indicators:

- Progress with macroeconomic and financial stabilisation, notably by assessing the degree of adherence to the IMF-supported programme.

- Progress with the implementation of structural reforms, notably the specific policy actions identified as conditions for disbursement of the assistance, which will be included in a Memorandum of Understanding, to be negotiated between the Commission and the Kyrgyz authorities. Conditions will include structural measures most relevant for ensuring macroeconomic stability, e.g. measures in the field of public finance management reforms and reforms to strenthgten the financial sector.

DELIVERY MECHANISMS AND RISK ASSESSMENT

Delivery mechanisms

The proposed new MFA would amount to EUR 30 million. Regarding the form of the assistance, the Commission proposes to disburse it half in loans and half in grants[11].

The Kyrgyz Republic clearly falls in the group of countries qualifying for grant support. Its per capita income is well below the World Bank's threshold for IDA eligibility (1,175 USD per capita) and its poverty ratios are high (with over 30% of people living below the general poverty line and over 50% in the rural areas). Due to the events in 2010, poverty ratios, after progress in previous years, are likely to have again deteriorated, also linked to a hike in the

[11] See Commission Staff Working Paper SEC(2011) 874 of 7 July 2011 on criteria for determining the use of loans and grants in EU MFA. According to these criteria the Kyrgyz Republic would even qualify for a full grant. However, initial feedback by Member States underlined their preference for a 50-50 split between the grant and loan components.

price of foodstuff's. Debt ratios all exceed the recommendable benchmark levels (with the exception of the debt service ratio, reflecting the large share of concessional debt). The proposed form of the assistance is also consistent with the way the IFIs treat the Kyrgyz Republic. Indeed, the World Bank, the Asian Development Bank (ADB) and the IMF all treat this country as a fully concessional assistance country, rather than as a blended country. The EU methodology establishes for such countries a presumption of including concessional assistance, provided that also the other two criteria (high poverty levels and low debt sustainability) are met.

In the case of the World Bank, support under IDA terms consists of the mix of grants (45%) and IDA concessional loans (55%). The ADB uses a similar split between grants and concessional loans for countries eligible to benefit from the Asian Development Fund (the concessional arm of the ADB). However, one should bear in mind that the loan components of the World Bank and ADB support are much more concessional than loans provided by the EU under the MFA instrument. The WB IDA loans entail repayment over 40 year, a 10-years grace period, zero interest and a small service charge. The ADB provides soft loans with 40-years maturities, 10-years grace period and an interest rate of 1% for the first 10 years and of 1.5% for the remaining 30 years. The IMF ECF (SDR 66.6 million) carries a zero interest rate, with a grace period of 5 and half years, and a final maturity of 10 years.

These conditions result in a grant element of the loan part of the World Bank and ADB financing packages of about 75% and close to 85% for the whole packages, including the part provided in grants. In the case of the IMF assistance through the ECF, the grant element is smaller (amounting to around 30%). In this context, it should be noted that under the IMF arrangement the Kyrgyz Republic is not allowed to take up loans with a grant element lower than 35%.

MFA is an untied and undesignated macroeconomic support instrument, which helps the beneficiary country meet its external financing needs, and may contribute to alleviating budgetary financing needs. The funds would be paid to the National Bank of the Kyrgyz Republic. Subject to provisions to be agreed in the Memorandum of Understanding, including a confirmation of residual budgetary financing needs, the funds may be transferred to the Treasury of Kyrgyz Republic as the final beneficiary.

Risk assessment

There are fiduciary, policy and political risks related to the proposed MFA operation.

There is a risk that the macro-financial assistance, which is not dedicated to specific expenses (contrary to project financing, for example), could be used in a fraudulent way. In general terms, this risk is related to factors such as the quality of financial circuits and management systems in the central bank and the ministry of finance, administrative procedures, control and oversight functions, the security of IT systems and the appropriatedness of internal and external audit capabilities.

To mitigate the risks of fraudulent use several measures will be taken. First, the Memorandum of Understanding and the Grant and Loan Agreements will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to a dedicated account at the National Bank of the Kyrgyz Republic (NBKR). Moreover, before the agreement on the Memorandum of Understanding is reached, the Commission services will conduct, with the support of external consultants, an

Operational Assessment, in order to assess the reliability of financial circuits and administrative procedures that are relevant to this type of assistance and will determine whether the framework for sound financial management of macro-financial assistance is sufficiently effective in the Kyrgyz Republic. In the light of this assessment, specific mechanisms applying to the management of the funds by the beneficiaries may be introduced in agreement with the national authorities. The Commission is also using budget support assistance instrument to help the Kyrgyz authorities improve their public finance management systems and these efforts are strongly supported by other other donors. Against this background, special conditionalities on improving public finance management will potentially be required. Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

There is also a risk that the Government of the Kyrgyz Republic will not comply with the IMF programme conditions, as the programme targets may turn out more difficult to reach than assumed and as political conditions in the country may change. However, the authorities have so far shown strong commitment to work with International Financial Institutions to implement the reform agenda. The good track-record under the previous short-term IMF operation in Kyrgysztan bodes well in this respect.

The main risks to the proposed operation relate to a possible reactivation of the inter-ethnic tension and political instability and an insufficient implementation of the fiscal consolidation programme agreed with the IMF. The Kyrgyz Republic also remains vulnerable to negative changes in terms of trade stemming from possible exogenous shocks.

Consolidation of the democratic reforms and institutions in establishing the first parliamentary democratcy in the region is at the core of continued social and economic progress. While the country is preparing for an orderly conduct of the presidential elections scheduled for 30 Octorber 2011 to transfer power to the democratically elected head of state, political risks remain manageable, given recent impressive efforts of Kyrgyz authorties to establish legitimate democtratic institutions.

Having made a thorough assessment of the risks, the Commission services consider that there are sufficiently strong grounds to proceed with the MFA to Kyrgyz Republic.

The Commission services will maintain close contacts with the authorities during the implementation of the macro-financial assistance in order to address quickly any concerns that may arise.

ADDED VALUE OF EU INVOLVEMENT

The Kyrgyz Republic is the country in the region most committed to democratic reforms. By helping the country overcome the economic shock caused by the global recession and inter-etchnic conflict, the proposed MFA will contribute to promoting macroeconomic stability and political progress in the country. By complementing the resources made available by the international financial institutions, bilateral donors and other EU financial institutions, it contributes to the overall effectiveness of the package of financial support agreed by the international donor community in the aftermath of the crisis.

In addition to the financial impact of the MFA, the proposed programme will strengthen the government's reform commitment and its aspiration towards closer relations with the EU. This result will be achieved, inter alia, through appropriate conditionality for the disbursement of the assistance. In a larger context, the programme will signal to the other countries in the region that the EU is ready to support countries like the Kyrgyz Republic, embarking on a clear path towards democratization and political reforms, in moments of economic difficulties.

GENVAL CRITERIA ON MACRO-FINANCIAL ASSISTANCE

In October 2002, the Council reconfirmed a set of principles for the use of the European Union's macro-financial assistance (Genval criteria)[12]. The five criteria are: (i) the exceptional character of the assistance; (ii) its complementarity to financing of the International Financial Institutions (IFIs); (iii) the existence of policy conditionality attached to the assistance; (iv) the existence of political pre-conditions; and (v) strong financial discipline that needs to accompany the MFA.

Exceptional Character and Limited Timeframe

The proposed MFA operation will be exceptional and limited in time and will run in parallel to the IMF's ECF, even with a shorter time span than the ECF itself. Against this background and given the expected time of approval of the programme, the assistance is expected to be implemented in 2011-2012. The disbursement of the first tranche could take place beginning of 2012. The second tranche, conditional on a number of policy measures, could be disbursed in the third or fourth quarter of 2012. While in the short-term the country faces substantial balance of payments financing needs, the macroeconomic and structural adjustment programme agreed with the IMF and supported by the proposed MFA is expected to produce a gradual strengthening of the balance of payments and fiscal positions.

Political preconditions

While the Kyrgyz Republic lies outside the primary geographical scope of the instrument of MFA, normally reserved to pre-accession and neighbourhood countries, a MFA operation is justified by the existence of substantial external financing needs, the strength of the political and economic reform momentum in the country and by its position in a region of strategic economic and political importance for the EU. In political terms, MFA is reserved to third countries that respect democracy and human rights and with which the EU maintains close political and economic links. The Kyrgyz Republic has emerged as the first parliamentary democracy in Central Asia following the recent constitutional reforms and has conducted reasonably fair and free parliamentary elections. The EU Foreign Affairs Council, in its conclusions on The Kyrgyz Republic of 26 July 2010, welcomed the efforts of the new Kyrgyz government to establish a democratic institutional framework and invited the Commission to 'continue providing assistance, including new assistance programmes, to the Kyrgyz authorities in the implementation of their reform programme and to contribute to sustainable economic and social development of the country'. In October 2010, High Representative and Commission Vice-President Ashton welcomed the peaceful conduct of the

[12] Council conclusions of 8 October 2002 on MFA and the accompanying letter of the Council President to the Commission President.

Parliamentary elections and reiterated that the EU stands ready to assist the Kyrgyz Republic, including in promoting economic recovery.

Presidential elections were carried out on 30 October 2011. The election observation delegation of the European Parliament stated in a preliminary report that "the delegation positively assessed the voting procedures on election day but would like to underline the necessity to improve the voter registration system to further increase public confidence in the electoral system". In a statement on the elections the High Representative and Commission Vice-President Ashton underlined "the EU's readiness to continue its support for the necessary reforms in the country, in particular in the areas of rule of law and socio-economic development, which should go hand-in-hand with further national reconciliation, consistent progress on democratic reforms and full respect for human rights in Kyrgyzstan".

Cooperation with the EU is based on a Partnership and Cooperation Agreement (PCA) that entered into force in 1999. The EU grants Generalised System of Preferences (GSP) treatment to the Kyrgyz Republic.

Complementarity

The proposed MFA would supplement, as noted, the assistance being provided by the IMF (in the context of an ECF arrangement) and by other donors, helping to cover part of the residual balance of payments financing gap. The share of residual financing covered by the EU's MFA (12,4% for the period 2011-12) would be consistent with the Council's guidelines. The complementarity and fair burden-sharing criterion would therefore be fulfilled.

Regarding the complementarity with other EU instruments, the key added value of MFA would be to help create an appropriate macroeconomic and structural reform framework, which can increase the effectiveness of the actions financed through other instruments (see 1.3). The PFM reform conditionality, to be attached to the MFA, would complement the PFM measures agreed in the context of the EU's budget support operation in the social sector.

Conditionality

As usual with the MFA instrument, disbursements would be conditional on successful programme reviews under the IMF arrangement. In addition, the Commission and the Kyrgyz authorities would agree on specific structural reform measures in a Memorandum of Understanding. The areas of structural conditionality will be determined at a later stage, based on the government's current reform programme and the on-going cooperation of the donors, and in particular the EU, with the authorities. The Commission's current intention is to focus on structural measures most relevant for ensuring macroeconomic stability, in particular measures in the fields of public finance management, tax reform and financial sector reform.

Financial Discipline

Based on the currently foreseen pipeline of possible MFA operations, the planned appropriations on the macroeconomic assistance budget line (01 03 02) for 2012 are deemed sufficient to finance a grant of EUR 15 million to the Kyrgyz Republic, subject to the final decision of the budgetary authority.

The 2012 budget is not approved yet but the Commission's proposal to the budgetary authority (draft budget), foreseeing for budget line 01 03 02 CA of EUR 105 million, has been reduced by the Council and the Parliament to EUR 95.550 million. Out of this amount, EUR

23 million could be used for the grant component of the MFA to Georgia, which is still being discussed in the Council and the Parliament. There is still high uncertainty over possible new MFA operations to be launched in 2012. Two possible operations could be programmes for Egypt, in case the Egypt authorities review their plans for an agreement with the IMF, and for Armenia, in case it is confirmed that despite the implementation of the on-going three-year arrangement with the IMF under the combination of the Fund's Extended Fund Facility (EFF) and ECF Armenia will still be facing substantial uncovered financing needs. In both cases, the Commission would envisage proposing a mix of loans and grants, with higher loan components.

PLANNING OF FUTURE MONITORING AND EVALUATION

This assistance is of exceptional and macroeconomic nature and its monitoring and evaluation will be undertaken in line with the standard Commission procedures.

Monitoring

Monitoring will involve the review of reports and data provided by the authorities and by review missions to the Kyrgyz Republic by Commission staff. To monitor the fulfilment of the objectives of the programme throughout the implementation period of the assistance, the Commission will use two types of indicators:

- Adherence to the IMF-supported programme, including compliance with macroeconomic performance criteria and structural reform benchmarks identified under the ECF, as reported by the IMF in the context of the regular review of the programme.

- Progress in the implementation of structural policy indicators, which are to be agreed with the Kyrgyz authorities in a Memorandum of Understanding. In this process, the Commission services will monitor key areas of the public finance management system, as they will be identified in the update of the Operational Assessment, so as to have the relevant information on any changes in the control environment. Ahead of the disbursement of the second instalment, the authorities will be asked to submit a compliance statement in relation to the policy conditionalities. In addition, under the Memorandum of Understanding monitoring system, the authorities will be required to submit quarterly reports of certain economic and reform indicators.

Although this assistance is centrally managed, where appropriate, the EU Delegation in the Kyrgyz Republic will also be called to provide reporting. An annual report, as well as regular information on developments in the management of the assistance, to the European Parliament and to the Council are foreseen.

Evaluation

Ex-post evaluations of macro-financial assistance operations are foreseen in the Multi-Annual Evaluation Programme of the Commission's Directorate-General for Economic and Financial Affairs. An ex-post evaluation of the proposed macro-financial assistance to the the Kyrgyz Republic will be launched within a period of two years after the completion of the operation. A provision for the ex-post evaluation is included in the proposed Decision for the assistance, and will also be included in the Memorandum of Understanding. Budget appropriations from the macroeconomic assistance budget line will be used for this evaluation.

ACHIEVING COST-EFFECTIVENESS

The proposed assistance would entail a high degree of cost effectiveness for several reasons:

- First, since the assistance would be leveraged by that provided by the international financial institutions, with which, as noted, it would be closely coordinated, its ultimate impact could be very significant compared to its cost. Moreover, in negotiating specific policy conditions, the Commission will be able to draw on the expertise of those institutions, including the International Monetary Fund and the World Bank, and to influence their conditionality as well in ways that will take into account the EU's views.

- Second, providing a coordinated macroeconomic support to Kyrgyztan on behalf of the EU countries, the MFA would be more cost efficient than the provision of a similar total amount of financial support by EU Member States individually.

- Third, part of the assistance would be provided in the form of loans, the budgetary impact of which is more limited.

- In addition, the Commission will aim at achieving synergies with other EU policies and instruments used to support the implementation by the beneficiary of the relevant measures (notably in the area of public finance management).