



2007 JOINT COUNTRY PORTFOLIO REVIEW

KfW Portfolio

BACKGROUND PAPER

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Review of German Financial Cooperation with the Kyrgyz Republic

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I. Introduction

KfW Development Bank is executing the German Financial Cooperation with the Kyrgyz Republic on behalf of the German Government. The Joint Country Portfolio Review we consider as an excellent opportunity to discuss the critical issues that affect the German Financial Cooperation with the Kyrgyz Republic. This paper provides a brief overview of the project portfolio and the major issues that will need to be resolved for a more effective project preparation and implementation.

II. Assistance strategy and portfolio overview

KfW started its cooperation with the Kyrgyz Republic in 1993. The projects in the middle of the 90th were aiming at rapid assistance to prevent de-industrialisation and to support the emerging private sector through SME credit lines. Assistance to the health sector also started in 1995 and focused on regional cooperation projects to fight tuberculosis as well as on projects to improve mother and child care. It was also envisaged to support the power sector, but only one of the proposed projects in this sector has materialised to date.

Since 2001, German Development Cooperation (Financial and Technical Cooperation) is focusing on support for economic reforms and development of the market economy. In 2004, this rather broad focus has been further specified as: a) support for vocational training, b) private sector development, c) financial sector development, d) economic development at (rural) community level. Under Financial Cooperation, assistance to the health sector will also be continued, particularly for the projects with a focus on regional co-operation.

As per **31st December 2006**, total commitments made by KfW amounted to EUR 107,5 million, of which EUR 62 million (58 %) has been disbursed. Commitments have been allocated as follows:

Health Sector	EUR 49.7 million
Financial Sector and Private Sector	EUR 22.95 million
Energy Sector	EUR 10.4 million
Agriculture & Natural Resources	EUR 9,5 million
Other Sectors	EUR 14.9 million
Total	EUR 107.5 million

Of these EUR 107.5 million, EUR 51,4 million (48 %) have been committed as grants and the remainder (EUR 56.1 million) as loans with an interest rate of 0.75% over a term of 40 years, including 10 years grace period. In 2002 and 2005, the German government signed framework agreements with the Kyrgyz government on debt reduction according to which debt swaps in the amount of up to EUR 13 million can be realized. In 2005 a first sub agreement was signed with the Kyrgyz Republic that reduces the Government's public debt by approximately EUR 0.77 million. Further debt swaps are under discussion.

It is important to note that the German Government has allocated another EUR 31.1 million for future projects under Financial Cooperation.

III. Portfolio review

1. Performance of past projects

A total of ten projects have been officially completed, five of them have been subject to a final evaluation. Out of the latter only one project (Mother and Child Care I) was rated as a

success, the other four projects (SME credit lines I & II, Sector Program Agriculture, Sector Program Textile Industry) were rated as unsatisfactory. Reasons for the insufficient performance of the two sector programs can mainly be attributed to unfavourable economic developments that resulted in low utilisation of equipment procured under the programs for private companies. The two credit lines were mainly rated as unsatisfactory because of the large share of non-performing assets. While this was partly due to a difficult business environment for some of the borrowing private companies, there also have been companies who were and still are simply not willing to repay their loans and who benefit(ed) from a legal environment that encouraged such behaviour. Inadequate design of one of the projects has to be partly blamed for the performance, as the participating banks did not have the autonomy to select the borrowing companies themselves.

As a lesson learned from these failures, the subsequent SME credit lines gave full autonomy to the participating private banks.

2. Performance of on-going projects

Both on-going financial sector projects are currently rated as potentially high risk projects, which is mainly attributed to the difficult environment for financial sector projects in the Kyrgyz Republic. This rating also applies to the in 2005 started financing of communal infrastructure through the Village Investment Programme (VIP-KfW).

Furthermore, a first project in the energy sector (Advanced measures for Severelectro) is rated as potentially high risk due to the unfavourable sectoral environment and thus mainly the still outstanding reforms. In 2005, an agreement totalling EUR 10.4 million was signed to initiate urgently needed measures for Severelectro. Delay with the start of project implementation was due to negotiation and preparation processes that turned out to be more time consuming than anticipated.

The remaining projects, which are all in the health sector, are mostly rated as medium risk projects. An exception is the Sector-wide Approach (SWAp) which is considered as a potentially high risk project. The reasoning for this is mainly due to the fiduciary risk of a budget financing as well as the potential risk of a financing gap. Regarding the health portfolio in general, there are concerns whether there will be sufficient allocation of funds for operation and maintenance of hospitals. In the framework of the SWAp, though, this issue is supposed to be tackled. As further support, the German Financial Cooperation consented to the respective use of return flows from the SME program I.

Many of the current projects have also started with a considerable delay due to time consuming procedures for the ratification of Government Agreements in Parliament and delayed approval of loan/grant agreements and consulting contracts.

3. Future projects

While the progress of the on-going projects is overall satisfactory, preparation of future projects suffers as in the years before from two major constraints: ratification of Government Agreements in parliament and insufficient reforms in the energy sector.

1) Ratification of Government Agreements in Parliament

As German Financial Cooperation projects cannot be disbursed until the respective Government Agreements have become effective, a timely approval of these agreements is vital. It would therefore be advisable to shorten the approval process especially for grant agreements and exempt them from the requirement of ratification through parliament.

2) Insufficient reforms in the energy sector

In 2003 it was mutually decided with the MoF to support the commercialisation of the electricity distribution companies together with the World Bank and other donors. Thereby in 2005, a first agreement totalling EUR 10.4 million was signed to initiate advanced measures for Severelectro. Under German Financial Cooperation, a total of EUR 23.1 million (EUR 21.3 million for investments and a grant of EUR 1.8 million for TA) to support a concession agreement and in addition a grant of EUR 4 million for tariff subsidies have been earmarked. The latter amount is designated for the support of poor households in order to partly compensate the financial impact of tariff increases

During last year's Intergovernmental Negotiations the German and the Kyrgyz governments decided to reprogram the above mentioned funds, earmarked for the commercialisation, for a program in loss reduction.

Essential preconditions for progress in the energy sector are reforms, particularly concerning the legal environment for private investors as well as tariff increases. Due to the recent negative decision of the Kyrgyz government in regard to the HIPC initiative there is concern on the intention to take up a reform program in the energy sector.

IV. Outlook

Due to the Kyrgyz Republic's constraints in the Public Investment Program during the last years, the MoF has requested the German Government to increase the share of grant funding. The German Government is undertaking great efforts to meet this request. This can be seen in its last year's commitment to the Sector-Wide Approach in the health sector for which it made available Euro 16 million on grant basis.

Regardless of this, more serious efforts need to be made in order to utilise the funds that have been earmarked by the German Government already but cannot be disbursed by KfW for the reasons mentioned above. As the majority of these funds have been earmarked for the energy sector, it needs to be stressed once more that it is particularly important that the sector reforms will pick up again.

Acknowledging the role in donor coordination that is being taken over by the MoF, the importance of this function and the urgent need to continue and further improve this activity needs to be emphasized. The growing sense of responsibility and initiative on the side of the Kyrgyz partners is sure to be met with the outmost support through the German development cooperation.

Annex 1: Approved Loans, Grants and TAs by Sector

As of 31 December 2006

Project	Start date	Description of Project	Partner/ EA	Loan/ Grant/ TA	Amount, Mio EURO (1 Euro= 1,2 USD)
ONGOING PROJECTS					
HEALTH					
TB Control Program – II	2000	The project's objective is to support the implementation of the DOTS- strategy of WHO through purchasing of medical diagnostics equipment, laboratory equipment, consumables and tuberculosis drugs for all TB facilities in Kyrgyzstan. Staff training in the introduction of 4 FDC (fixed drug combination) and other TA activities to accompany the investment component.	MOH	Grant (Investment/AM)	2.56 EUR
Maternal and Child Health Program - III	2004	The project contributes to the improvement of the basic health infrastructure in the scope of "mother-child care" through procurement of new medical equipment as well as training of medical and maintenance staff of oblast and central rayon hospitals in Chui, Talass, Naryn, Issyk-Kul, Bishkek Perinatal Center and Obstetric Hospital No 1. 1) Delivery of medical equipment for obstetric and neonatal departments of oblast and rayon hospitals; 2) Staff training in the implementation of the diagnosis and treatment system on the basis of the delivered equipment as well as development and implementation of maintenance concept.	MOH	Grant (Investment) Grant (TA/AM)	5.84 EUR/ 0.3 EUR
Prevention of HIV/AIDS	2005	The Project contributes to the improvement of the diagnostics of HIV infection through the coordination of development of HIV- diagnosis concept, reconstruction of HIV-labs, developing of Voluntary Counselling and Testing (VCT), procurement of new medical equipment and consumables as well as training of medical and maintenance staff of rayon labs.	MOH	Grant (Investment Grant (AM)	2.8 EUR 0.8 EUR
Health sector programme (Sector Wide Approach)	2006	The objective of the project is to improve health status in the Kyrgyz Republic by improving access, financial protection, efficiency, equity and fiduciary performance; to ensure sufficient and reliable financing for the health sector. The Project will support implementation of the Manas Taalimi Health Reform Program through a Sector-Wide Approach. 1) Contribution to the SWAp-Pool (budget support) Accompanying measure (TA for e.g. standardization and rationalization of physical assets at all levels of the referral system etc.).	MOH	Grant (Investment) Grant (TA/AM)	14.0 EUR 2.0 EUR
DEBT-SWAp for social programmes	2006	The project contributes to the improvement of the living conditions and food quality of TB patients in prisons.	MOJ	DEBT-SWAp	0.77 EUR
Improvement of the medical emergency system	2007	1. The project contributes to the improvement of the quality of the emergency care system and of the access of the population to health infrastructure through procurement of new medical equipment, vehicles, communication means, instrument sets, etc. in selected facilities of Osh-Oblast and Bishkek. 2. Training of medical staff in emergency care, regional conference, development of concept to rationalize the emergency system.	MOH	Loan (Investment) Grant (Investment) Grant (TA/AM)	3.0 EUR 2.3 EUR 1.0 EUR

FINANCE

Kyrgyz Investment and Credit Bank II	2001	Improvement of the Financial Sector and Promotion of Small and Medium Size Enterprises (SME) by supporting the establishment and expansion of KICB. Measures: 1. Financed the equity participation of the Kyrgyz Government in the bank 2. Two SME Credit Lines 3. Technical Assistance 4. Guidance provided through KfW presence on the Board of Directors.	KICB	Credit Lines (Loan)	5.11 EUR
				Grant (TA)	0.3 EUR
SME Credit line IV	2001	Promotion of SME through: 1. SME Credit Lines for investment loans 2. Technical Assistance for capacity building and trainings in the implementing bank.	AKB Kyrgyzstan	Credit Lines (Loan)	4.6 EUR
				Grant (TA/AM)	0.51EUR

RURAL INFRASTRUCTURE

KfW-VIP (Village Investment Project)	2005	The project's objective is to improve access of the poor population in Jalalabat and Osh to economic and social infrastructure. The individual project measures are planned and executed by the village population itself with the support of the project executing agency, ARIS.	ARIS	Loan (Investment)	6.0 EUR
				Grant (TA/AM)	2.1 EUR

ENERGY / INFRASTRUCTURE

Advanced Measures Sever-electro	2006	The project aims at reducing the high losses of Severelectro. Project measures include supply of meters, improvement of the billing system and network rehabilitation. The project is closely connected to the Loss Reduction Program that it supported by the World Bank and the Swiss Development Cooperation. The general public will benefit from the improved financial situation of Severelectro which will in return reduce the fiscal deficit in the energy sector.	JSC "Sever-electro"	Loan (Investment)	10.23 EUR
				Grant (TA/AM)	0.2 EUR

PLANNED PROJECTS**HEALTH**

TB Control Program - III-IV	2007	The project contributes to the improvement of the basic health infrastructure through the reconstruction of Bishkek-city-TB-hospital and the national TB-lab (Bishkek), procurement of TB-drugs, new medical equipment and training of medical and maintenance staff of hospitals (nationwide).	MOH	Grant (Investment/AM)	5.0 EUR
TB Control Program (Regional)	2007	The project contributes to improving the quality of capacity building and trainings activities for medical and labor staff (due to the TB- control specific and DOTS implementation issues).	MOH	Grant (TA)	1.2 Euro (for 4 CA Countries)

IN THE PIPELINE**ENERGY / INFRASTRUCTURE**

		Further financial commitments for the energy sector are under discussion with the Kyrgyz government and stand upon the condition of progress in the reform program.		Loan (Investment)	21.3 EUR
				Grant (TA/AM)	1.8 EUR
	2007	Social protection measures to compensate tariff increases.		Grant	4.0 EUR