

Kyrgyz Republic

Systematic Country Diagnostic Concept Note

From Vulnerability to Prosperity

Draft – November, 2016

Not for Citation or Circulation

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I. Introduction

1. **The proposed framework for the SCD builds on the analysis of drivers of past progress toward the twin goals, and of constraints that could limit further advances.** Particular focus will be placed on the barriers to more robust, higher productivity job creation in the private sector, with the ongoing Jobs Strategy exercise informing the SCD. Additional challenges, such as addressing the widespread vulnerability of the population and maintaining current high levels of income equality in future growth will also be addressed. Lastly, the SCD will highlight the urgent and important threats to sustainability, as well as opportunities stemming from the unique characteristics of the Kyrgyz Republic.

Country context

2. **Small and landlocked, the Kyrgyz Republic is one of the poorest countries in ECA.** It is located within reach of the huge Chinese, Russian and South Asian markets, bordering Kazakhstan, Tajikistan, and Uzbekistan as well as China. Barely 7 percent of its land area is arable, due to its elevation and topography, with the rest comprising glaciers, mountains, and pasture-land or steppe that support livestock grazing and forests.¹ The country's natural resources include minerals -mainly gold- and abundant water for hydropower generation. Its multi-ethnic population is small (at about 5.8 million), but young and fast growing. In spite of recent progress on the development front, with a GNI *per capita* of \$1,250 in 2014, the country remains at the bottom of the poverty scale in ECA.

3. **While the Kyrgyz economy and society are considered the most liberal and open in Central Asia, the country has experienced significant political and social instability during the last decade.** In 2005, after nearly 15 years in power, Kyrgyzstan's first president was forcibly removed from office following his disputed re-election; and in 2010, his successor was overthrown after widespread public demonstrations against corruption, nepotism, and the misuse of public assets. While a new constitution, approved by referendum, legislated a shift from the erstwhile presidential to a parliamentary system, the country has continued to contend with frequent changes in government and rapid turnover of senior officials, while the system for checks and balances remains largely undeveloped, and institutions are still learning to use their powers effectively. The dynamic constitutional transition -underway since mid-2010- is both a source of opportunity for the future as well as a core constraint in the present, with feedback loops between poor governance and political and policy instability.

4. **Weak governance is a major challenge.** Though ranked 75 out of 190 countries in the *Doing Business 2017*, reflecting incremental reforms in opening the economy and reducing red tape, the Kyrgyz Republic is in the bottom third of all countries on most internationally recognized governance and transparency indicators. The country scores in the bottom quintile on the Bank Group's Worldwide Governance Indicators in Government Effectiveness, Rule of Law, and Control of Corruption. The discrepancy between *de jure* rules of the game and their *de facto* application possibly explains why early liberal reforms have failed to generate sustained economic payoffs, beyond initial gains.

5. **The citizen engagement context is unique but patterns of social exclusion persist.** The Kyrgyz people enjoy the most liberal enabling environment for civil society in Central Asia. However, this is yet to play out consistently at the local level where citizens face difficulty in providing feedback on service delivery. In addition, corruption is a major deterrent and discrimination (ethnic, youth, gender, racial and religious) limits public participation.

¹ Over 90 percent of its 198,500 km² area is at least 1,000 meters above sea level and 30 percent higher than 3,000 meters.

Development overview: a model increasingly under pressure

6. **The Kyrgyz Republic has made significant progress in poverty reduction and shared prosperity in the past two decades.** Poverty fell from 68 percent in 2003 to 32 percent in 2015². Economic growth - averaging 4.5 percent *per annum*- was inclusive, benefiting those at the bottom of the income ladder most, making the Kyrgyz Republic one of the most equal countries in the world (in the 5th percentile by GINI).

7. **These results were achieved against a backdrop of significant economic transformation and social change.** Economically, the period was characterized by: (i) a remittances-enabled domestic consumption boom; (ii) one-time productivity and income gains stemming from labor reallocation toward urban areas; (iii) rapid, though largely informal, growth in the services sector; and (iv) exploitation of natural resources, primarily gold from the Kumtor mine, which supported exports and public finances.

8. **But these growth drivers have built-in limitations on sustainability.** Remittances from migrant laborers abroad are a major source of income and foreign currency, equivalent to 30 percent of GDP. These are largely sourced in Russia and Kazakhstan thus subject to volatility, and insufficiently re-invested in domestic economic activity. Gold exports, which account for about 10 percent of GDP and 40 percent of exports, are subject to high price volatility and rely on a non-renewable commodity. At the same time, these growth drivers crowd-out investment into more sustainable, formal private sector activity.

9. **There is a long way still to transition from vulnerability to prosperity.** While millions were able to escape poverty and equality is high, (i) many are still living below the poverty line, (ii) vulnerability remains widespread, and few have achieved durable prosperity. A large majority of the population is clustered near the poverty line with broken steps for upward mobility (incomes too low to allow for savings and investments) and high risks of falling back (exposure to shocks and insufficient safety nets). Moreover, the country has very limited fiscal space left to respond to shocks, and/or expand social transfers/spending, and could find itself at risk of debt distress.

10. **Critically the economy is not creating enough good jobs.** Not only is the rate of job creation lower than that of labor force growth, but most employment happens in the large informal sector of the economy, which is un-productive and un-dynamic.

Approach and hypotheses

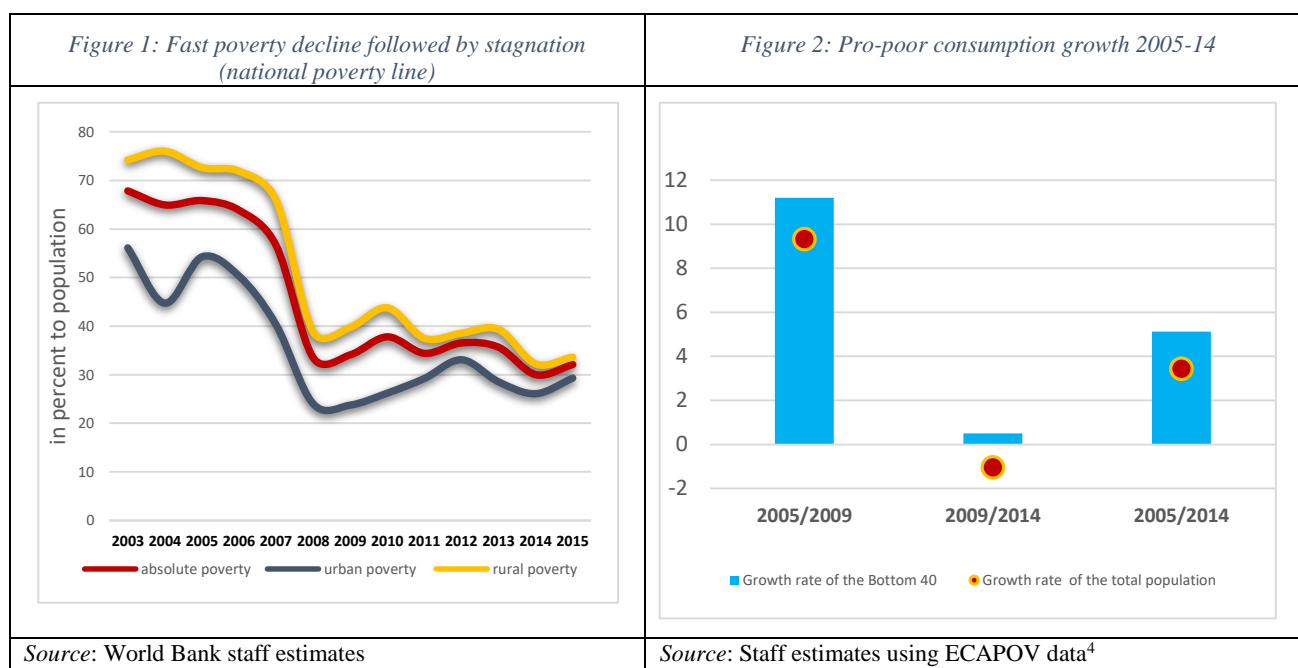
11. **The SCD will examine factors constraining the transition to a new model of inclusive and sustainable private sector-led growth through:**

- Developing the following hypotheses:
 - i. Poverty reduction and shared prosperity will increasingly depend upon the private sector creating formal, higher productivity jobs
 - ii. Governance issues pose the greatest challenge to attracting investment and growing the economy
 - iii. Investing in human capital will be critical both to drive long term growth as well as mitigate the vulnerability of the population
 - iv. Sustainability issues pose a high and imminent risk to the ability of firms and households to build their asset bases.
- Analyzing salient features of the Kyrgyz Republic that are particularly pertinent to sustainable and inclusive growth. These include membership in the Eurasian Economic Union and regional integration challenges; dependence on migration and remittances and associated risks and opportunities; the importance of the rural economy for livelihoods; and finally, the challenge of mineral and natural wealth management. (See **Annex 1** for a complete list).

² Poverty rates were adjusted using the 2015 poverty line; consumption aggregates were inflated using the national CPI data with 2015 as base year.

II. Significant progress towards the twin goals—but many remaining challenges

12. **Progress in reducing poverty has been impressive, but the initial strong momentum has tapered-off.** Absolute poverty—as measured by the national poverty line—fell from 66 percent of the population in 2005 to 32 percent in 2015³, more than halving over the span of a decade, while the depth and intensity of poverty also declined. The Kyrgyz Republic also made significant progress in other dimensions of essential well-being, such as in reducing the incidence of undernourishment. However, the significant progress in poverty reduction (confirmed using international poverty lines) has not followed a steady path: a period of rapid progress was followed by stagnation. While poverty fell dramatically between 2003 and 2008, it remained essentially unchanged in the following five years (2008-13) at around 37 percent, with modest gains in rural areas counterbalanced by a deterioration of urban poverty. Between 2013 and 2015, it dropped by an additional 3.5 percentage points with a dip in 2014 partly negated the following year.



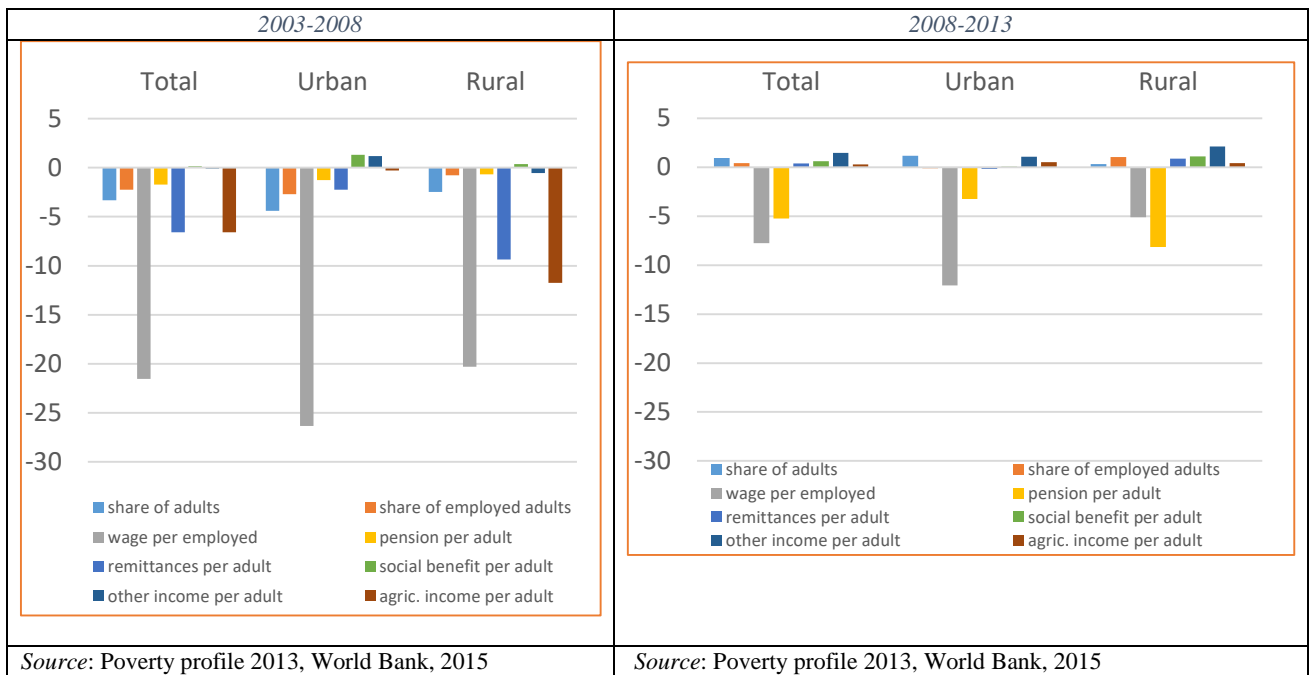
13. **Prosperity was broadly shared, and poverty reduction accompanied by a significant decline in inequality.** Between 2005 and 2015, the *Gini* coefficient decreased from 0.288 to 0.231, largely due to improvement in rural areas. Over the same period, the consumption growth of the B40 percent averaged 5.1 percent, compared to 3.4 percent for the population as a whole, and was therefore much faster than that of the T60. Consequently, the Kyrgyz Republic’s low income inequality—the lowest among comparable countries in ECA—is arguably one of the country’s defining characteristics. Globally, it is in the 96th percentile and the 90th percentile with respect to the share of total income held by the lowest decile (4 percent) and the bottom 40 percent (31 percent) respectively.

14. **Wages drove poverty reduction over the past decade but increasingly weakly so.** During the period of fast poverty reduction, the principal drivers of poverty reduction were wages, agricultural incomes and remittances. Thereafter, the contribution of remittances and agricultural income virtually disappeared, while pensions emerged as a key factor. The full SCD will extend this analysis, looking specifically at the relative contributions of private *versus* public employment and wages, fiscal redistribution and remittances in rural and urban areas respectively. It will use this analysis to assess the sustainability of current trends.

³ To ensure comparability, the 2005 poverty rate is adjusted here using the 2013 poverty line

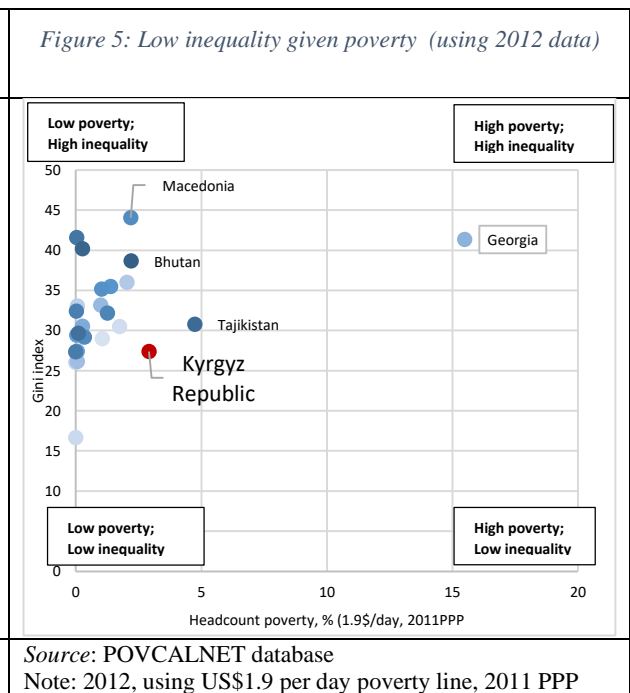
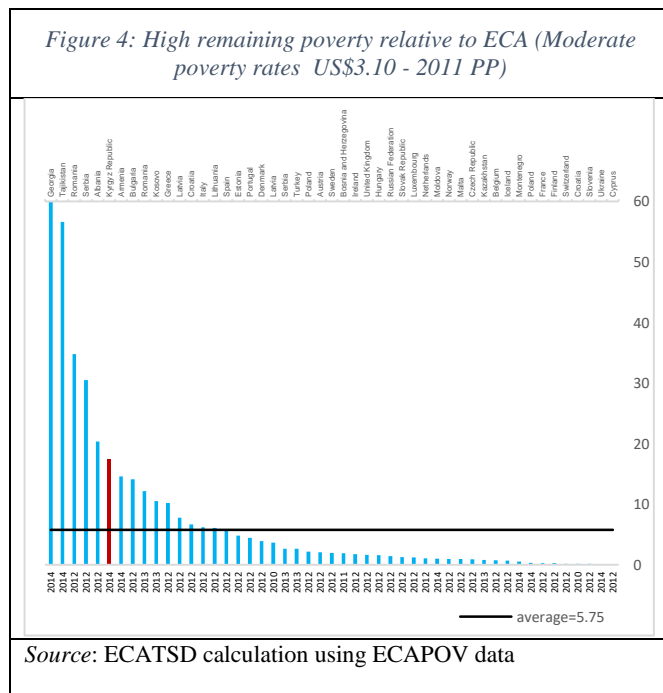
⁴ Note: Aggregate gallT (food+nonfood+durables+rent+health expenditures using ECAPOV harmonization (see ECATSD 2014)

Figure 3: Wages drive poverty reduction and increasingly pensions (income source decomposition of poverty changes)



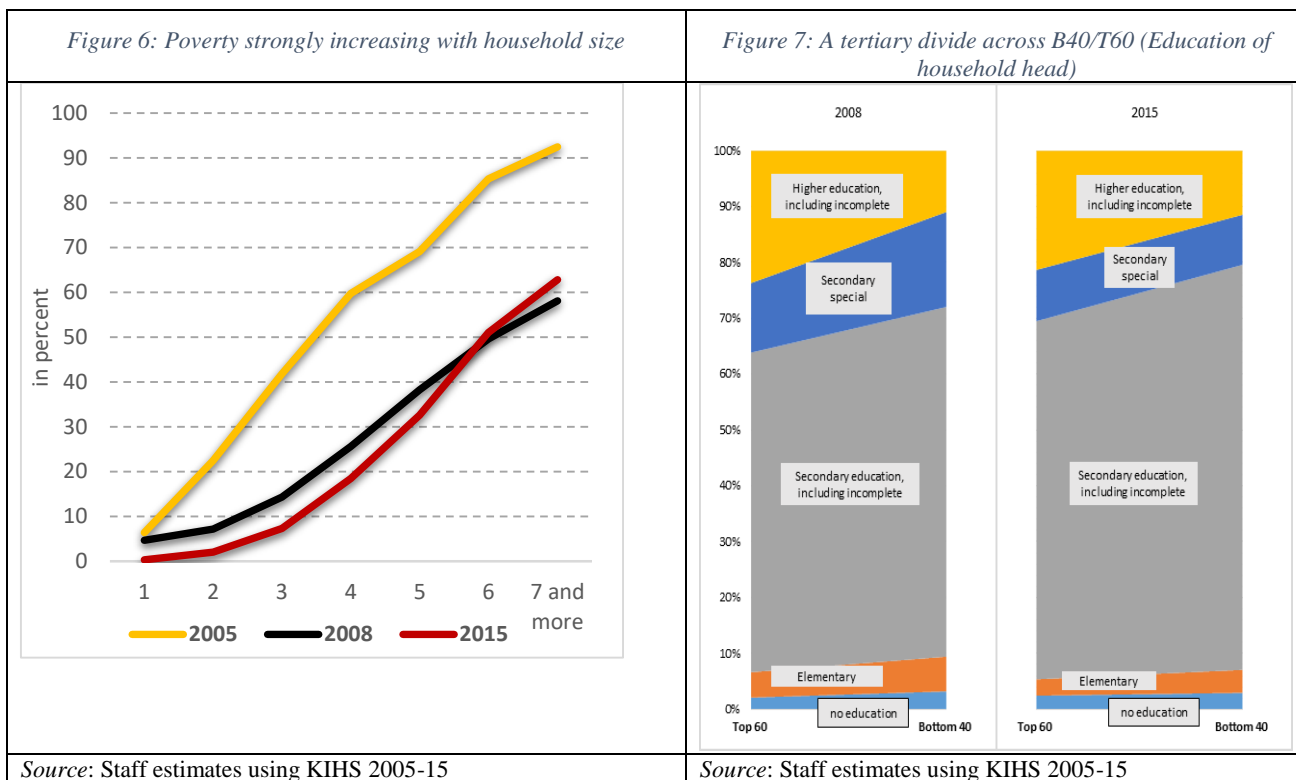
Challenge 1: Persistently high levels of poverty

15. **Despite poverty reduction achievements, poverty prevalence remains high and above that of most other ECA countries.** Extreme poverty⁵ fell from 15.4 percent in 2005 to less than 1.3 percent in 2014. However, at 17.5 percent, moderate poverty is high, exceeded only in a handful of countries including Georgia and Tajikistan. Although this will need to be verified in the full SCD, a significant share of poor households is believed to be chronically poor, meaning that further poverty reduction or its eradication will be increasingly difficult, possibly requiring targeted interventions.



⁵ Using an extreme poverty line of \$1.90/day and a moderate poverty line of \$3.10/day (both in 2011 PPP terms)

16. **The poor tend to have lower stocks of assets, including human capital, and higher reliance on natural resources, limiting their resilience and prospects for social mobility.** The single clearest correlate of poverty appears to be household size, reflecting higher dependency ratios, including more children below working age (possibly indicating the lack of financial access to instruments of protection/social insurance). Some 82 percent of households in the B40 have 5 or more members, while that proportion is only 40 percent in the T60. The poor also tend to be less well educated, with the main difference being access to higher education as opposed to general secondary or less⁶. Female heads of household tend to be less educated, with 12 percent of them having received no education at all, especially in the B40.

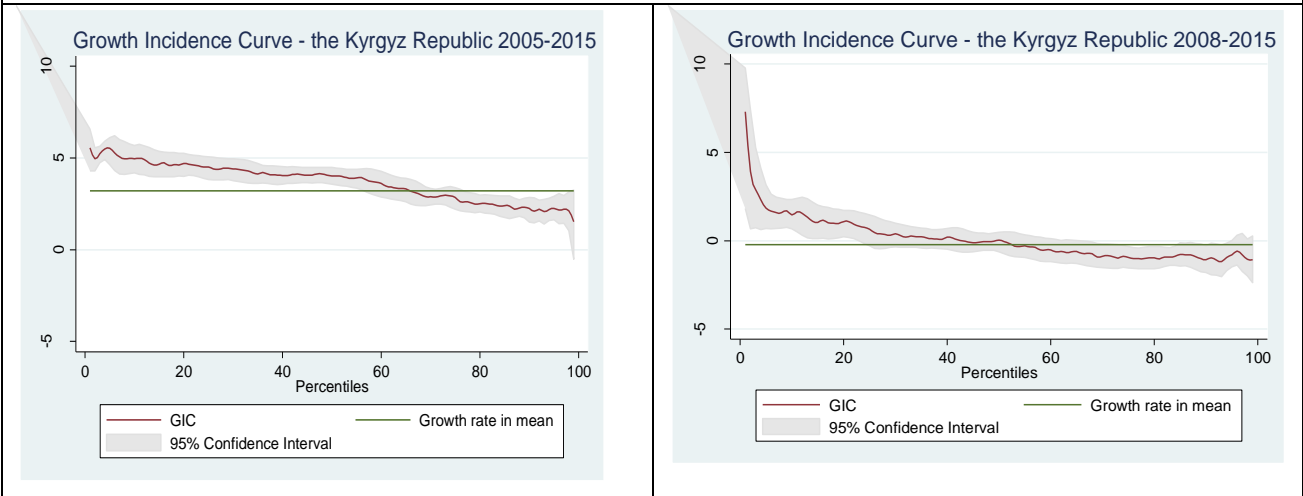


Challenge 2: Many have escaped poverty, but most remain far from prosperous

17. **Although overall growth has been pro-poor, this was partly a result of modest outcomes for better-off populations in urban areas.** Between 2005-15, growth incidence curves show that expenditure growth *per capita* was significantly (and linearly) higher for households at the bottom of the distribution, with the largest gains for the rural poor. However, for a significant portion of urban residents, expenditure growth was either flat or negative. Between 2008-12, urban poverty actually increased by 11 percentage points before declining again by 2015⁷, and between 2009-15 the consumption growth of the T60 was negative (-1.5 percent).

⁶ But no apparent poverty payoffs in pursuing secondary education relative to elementary.
⁷ Possibly reflecting the migration of poor rural residents to cities as well as food prices dynamics

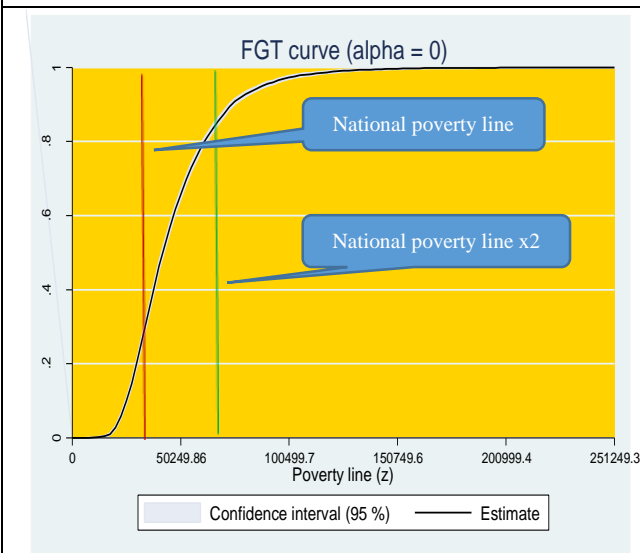
Figure 8: Pro-poor outcomes increasingly at the “expense” of the better off (Changes in consumption expenditures by percentile)



Source: Staff estimates using KIHS 2005-14 and AdePT

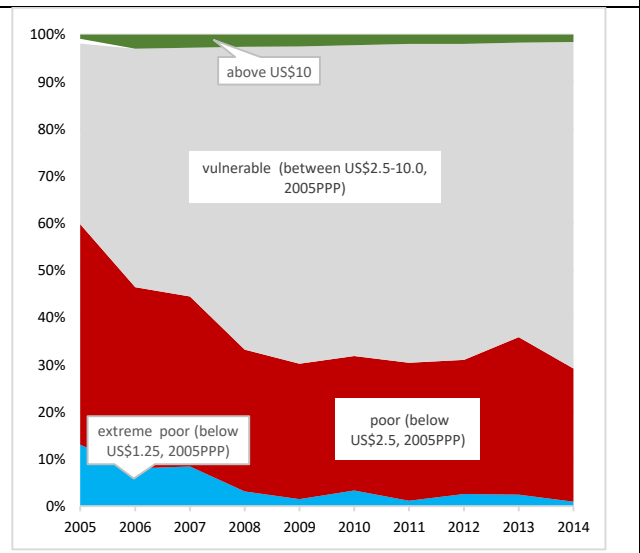
18. From this standpoint, the flipside of low inequality is pervasive vulnerability, with a majority of the population, up to 60 percent, still clustered around, or very close to the poverty line. Specifically, although growth helped reduce the share of the population living below \$2.50/day, there was considerably less progress in terms of the share of those under \$5/day, where over 80 percent of the population still finds itself. In other words, while income gains were broadly shared, true prosperity remains far out of reach for most Kyrgyz citizens, only 1.6 percent of which live with more than \$10/day.

Figure 9: Most Kyrgyz close to the poverty line (FGT Curve)



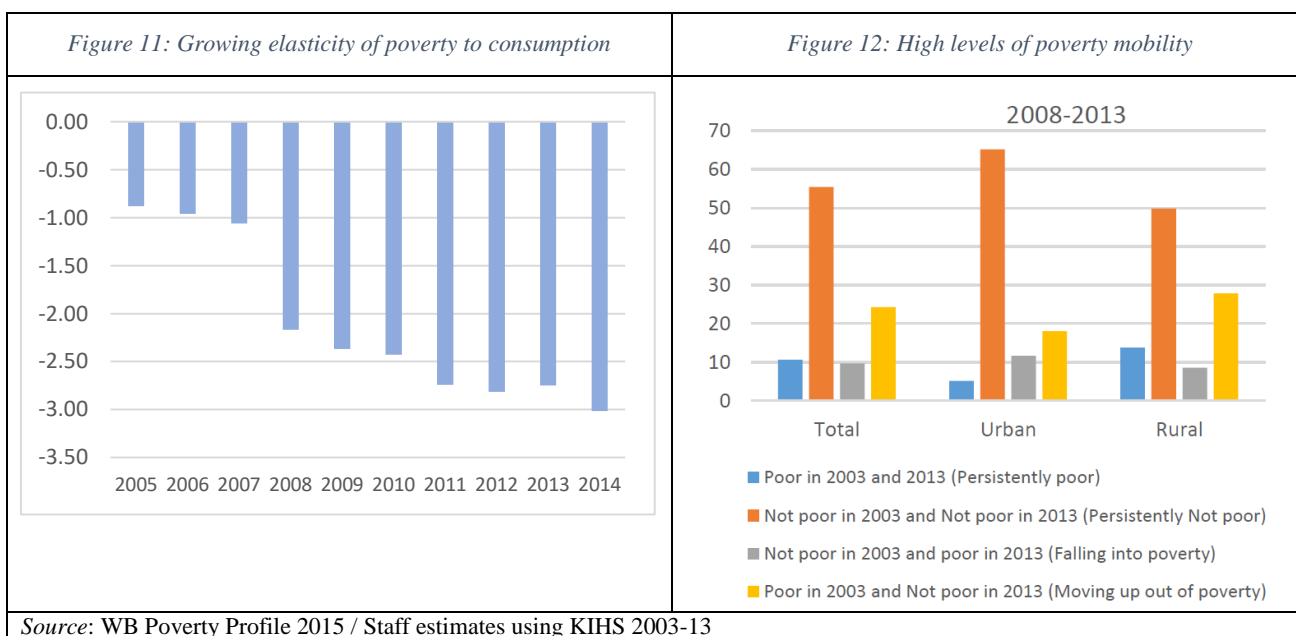
Source: Staff estimates using KIHS 2014

Figure 10: Pervasive vulnerability despite poverty reduction



Source: Staff estimates using ECAPOV data
 Note: Aggregate gallT (food+nonfood+durables+rent+health expenditures using ECAPOV harmonization (see ECATSD 2014)

19. **One consequence of the high clustering of the population around the poverty line is its significant exposure to shocks and high churn into and out of poverty.** While the poverty gap has narrowed, the elasticity of poverty with respect to consumption expenditure has increased in tandem⁸. This means that even small changes in households’ consumption (such as resulting from changes in food prices) lead to sizeable differences in poverty levels. Between 2008 and 2013, over a third of households crossed the poverty line, with 24.5 percent of households moving out of poverty and 9.7 percent falling back into it.⁹ Over that same period, rural areas had higher shares of persistently poor households but also a higher degree of upward mobility. By contrast, urban areas with higher shares of persistently non-poor households also saw a higher degree of downward mobility. The high degree of mobility or “transient poverty” (on top of high levels of chronic poverty) points to the limited capacity of households to save and smooth consumption, as well as the inadequacy of social protection programs in terms of targeting and/or coverage. The full SCD will complement this analysis by looking at the magnitude of income changes experienced by households as well as movements across deciles (given the overlap between the poverty line and the highest density area of the income distribution). In addition it will seek to identify specific macro drivers of micro shocks (such as remittances variations or movements in agricultural prices).



Challenge 3: Spatial inequities in opportunities and monetary and non-monetary dimensions of welfare.

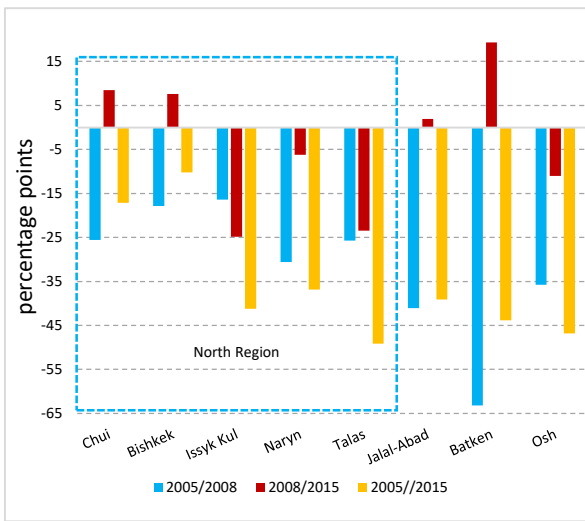
20. **Poverty remains a rural phenomenon and there are also important regional disparities.** Urban and rural poverty rates converged over the past decade such that, by 2014, the gap had shrunk to 4 percentage points. Earlier in the period, this convergence mainly reflected faster relative gains in rural areas; later on, it resulted mostly from increasing urban poverty, while poverty in rural areas stagnated. Nonetheless, almost 70 percent of all poor households are in rural areas. Poverty also varies greatly by region, in particular between the north and south of the country. Although poverty reduction was mostly due to intra-oblast effects, almost half of the poor are concentrated in two southern oblasts (Jalal-Abad and Osh), reflecting both a higher prevalence of poverty in these regions and their greater demographic weight. In terms of trends, *oblast*-level changes appear to be heterogeneous, pointing to local-specific drivers of poverty reduction that may reflect small local markets, production specialization patterns and/or a clustering of the population around the poverty line.

⁸ Also reflecting the limited options available to households for saving / consumption smoothing

⁹ Indicative numbers based upon synthetic panel.

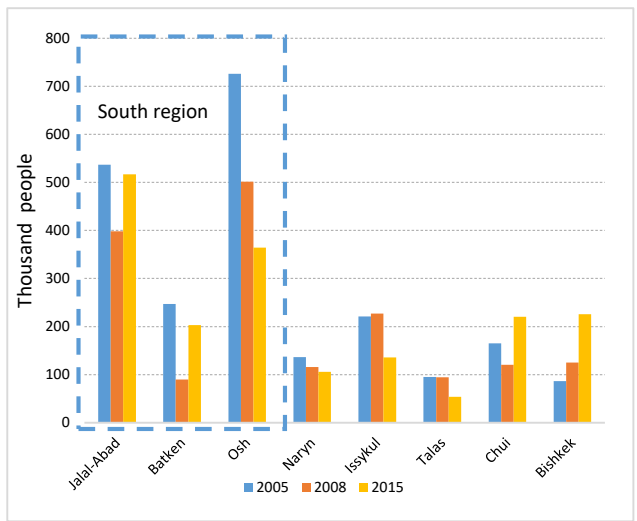
Source: *Kyrgyz Republic: Poverty Profile for 2013*, World Bank Working Paper, Report No. 99772-KG.

Figure 13: Despite massive reductions
(Change in absolute poverty by oblast)



Source: Staff estimates using KIHS 2005-15

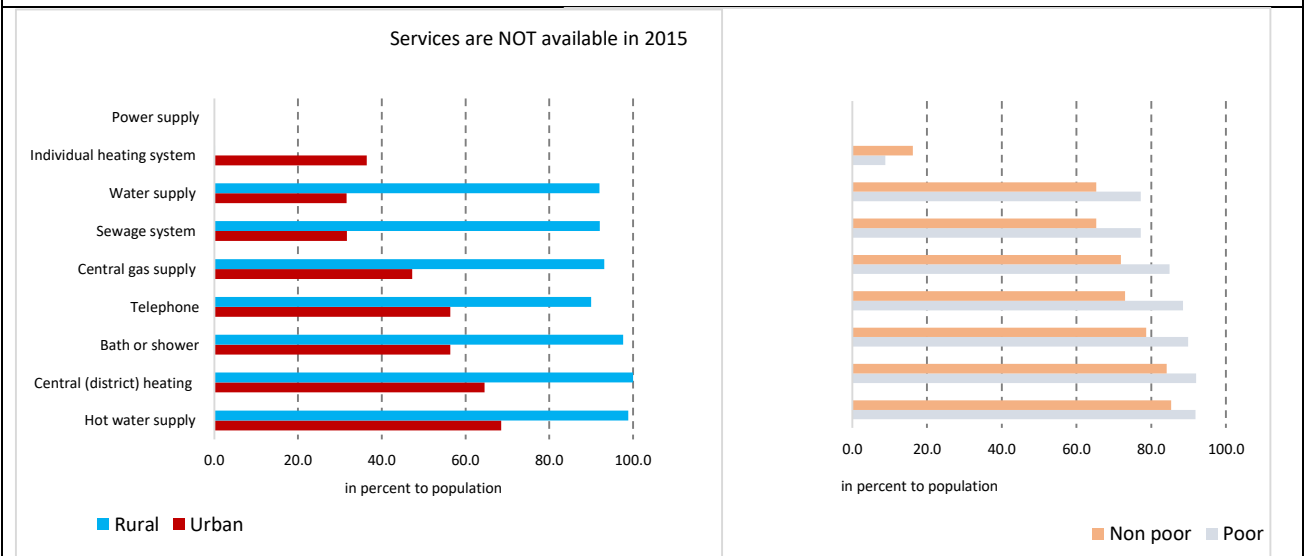
Figure 14: Most of the poor in two southern oblasts
(Absolute number of poor by oblast)



Source: Staff estimates using KIHS 2005, 2008, 2015

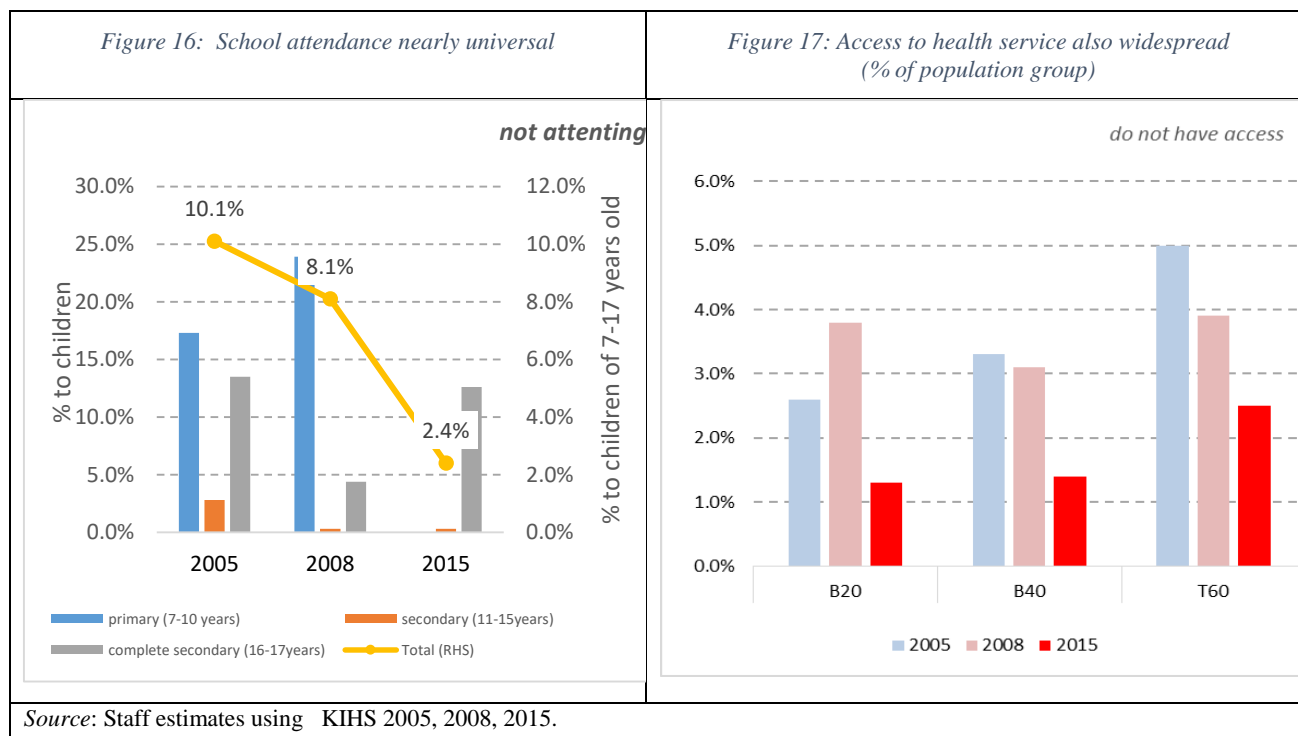
21. **In terms of access to basic services, differences across income groups appear to be dwarfed by geographic divides** (though the two categories overlap). While the poor have less access to basic services such as water supply, sewage, telephone and central gas supply, this is almost entirely a function of their concentration in rural areas. The poor, and rural residents more broadly, additionally suffer from inferior quality of utility services, as demonstrated by the frequency of supply disconnect. They are also disproportionately vulnerable to changing weather patterns given the natural resource/agriculture basis of their livelihoods.

Figure 15: Access to basic service more “spatial” than “social” (by location and poverty status)



Source: Staff estimates using KIHS 2015

22. **At first glance, access to basic education and health opportunities appears to be relatively equitable.** Some 97% of all school age children under 17 years of age attend school, even if fewer children in poor and rural households pursue secondary level education and above, beyond compulsory requirements. Similar findings are observed with respect to health opportunities. In 2015, some 2 percent of the population did not have access to health services, though 80 percent of those were in rural areas.¹⁰



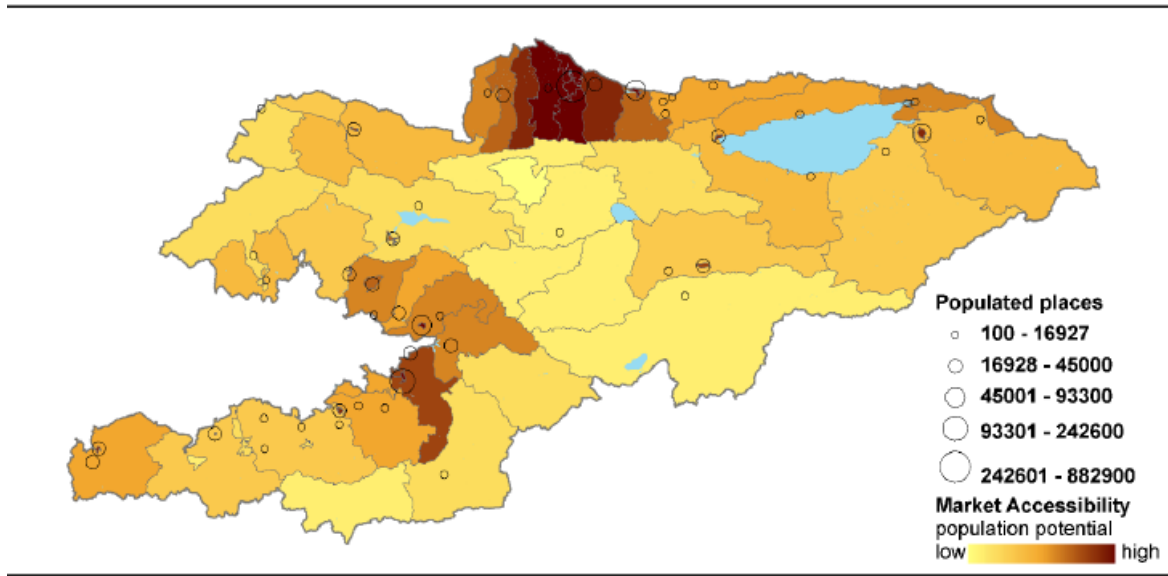
23. **The SCD will examine whether apparently equitable outcomes do not understate challenges.** Specifically, it will check whether populations in specific geographic locations or groups face particular constraints in accessing opportunities and more importantly how access translates into outcomes. A possibility is that equal access to services is undermined by significant quality variability across space and social divisions. For instance, the rate of under 5 mortality is over 50% higher for the B40 than for the T60, respectively 37.4 and 24¹¹.

24. **Finally, it is also worth stressing the extent to which spatial disparities in poverty and access to services and opportunities overlay topographic divides and ethnic and cultural differences.** Indeed, urban/rural contrasts are largely reflective of a North / South division, which is also cultural, with populations in the former closely linked to Kazakhstan and Russia, while those in the latter have strong bonds to neighboring countries Uzbekistan and Tajikistan. The full SCD will therefore look closely at the social inclusion dimension of access to services and opportunities (see spatial distribution of human opportunities in **Annex 4**).

¹⁰ No access characterizes cases in which an individual in need of health services, did not receive them due to the following reasons: refusal to provide services, too expensive services, did not reach out a hospital due to significant distance.

¹¹ MICS 2014

Figure 18: Market access along a North/South divide (Accessibility Index, Population Potential)



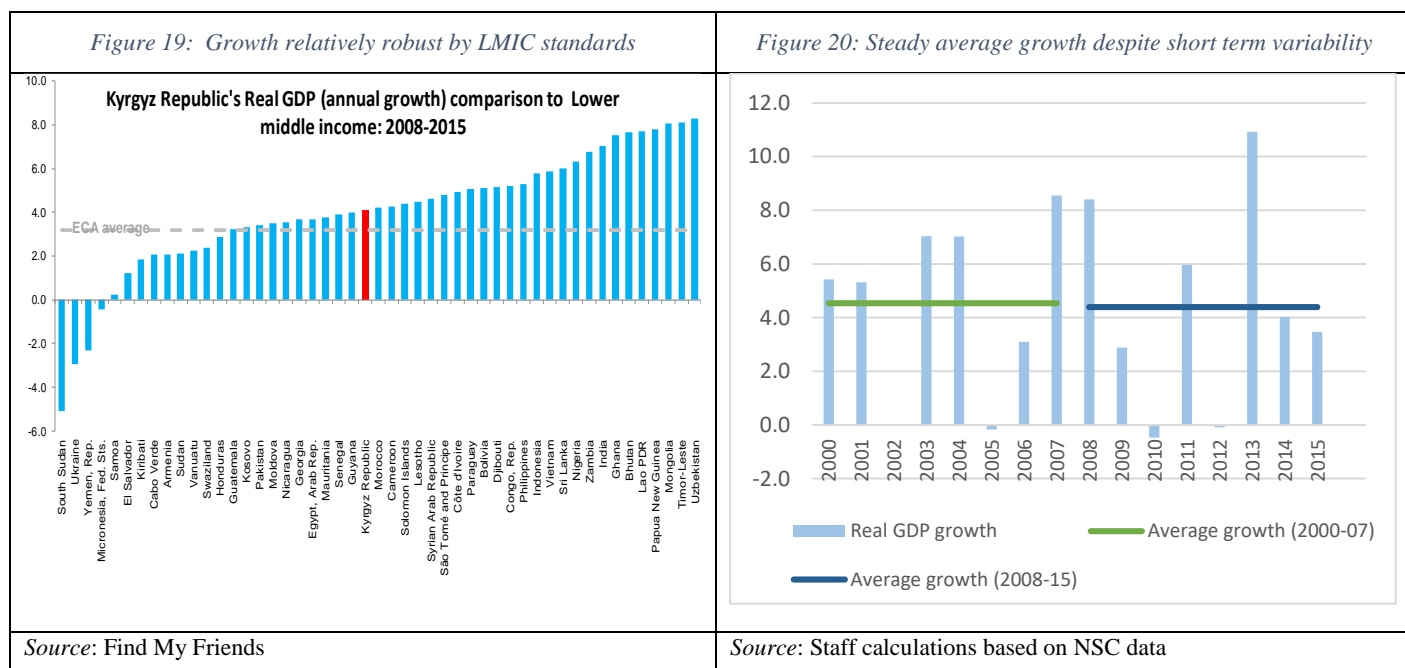
Source: Blankespoor (2013).

III. Past drivers of progress towards twin goals, increasingly ineffective.

25. The factors that have driven the old growth “model”¹² of poverty reduction and shared prosperity over the past decade and-a-half cannot provide a blueprint for the future. In recent years, the poverty reduction and shared prosperity payoffs of growth have begun to slow, reflecting the inherent limitations and vulnerabilities of heavy reliance on labor and commodity exports. At the same time, the relatively high and pro-poor growth of the past was not accompanied by good jobs creation, undermining the sustainability of the gains that have been made. Going forward, therefore, a new growth model that creates more jobs and enhances competitiveness will be required to sustain and build on the gains of the past.

The old model of growth, poverty reduction and jobs

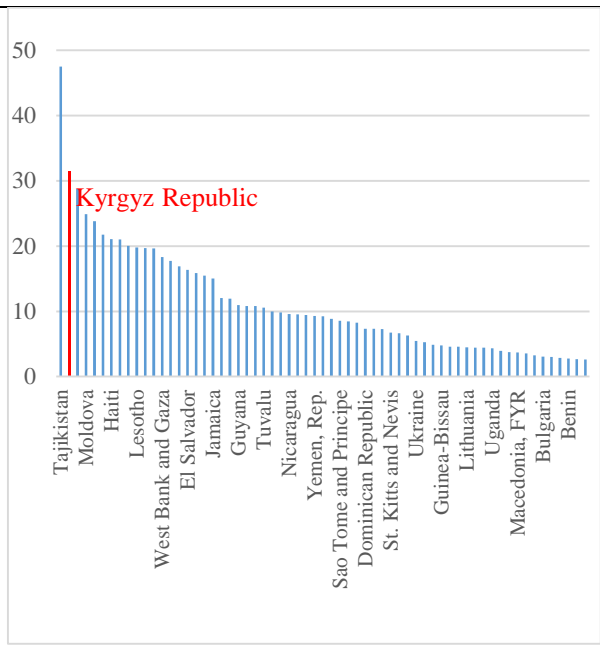
26. Until recently, poverty reduction and shared prosperity have been driven by relatively robust overall growth, underpinned by remittance-fueled consumption and a significant expansion of services. Since 2000, GDP growth has averaged 4.5 percent annually, in line with that of ECA developing countries. Between 2005-12, changes in poverty mirrored trends in output, with economic expansion going hand in hand with poverty reduction (except for 2006-07).



27. Underlying these trends was a major shift in economic drivers, concomitant with the onset of mass migration. At the turn of the century, migration to Russia and Kazakhstan expanded rapidly, peaking during 2006-08, with estimates varying between 0.5 million and 1 million workers, or up to about 20 percent of the working age population. By 2010, remittances amounted to over 30 percent of GDP and represented the second largest source of foreign currency after exports, and ahead of foreign direct investment, and external loans assistance. While migration provided a first safety valve for the lack of rural jobs, the rapid expansion of remittances not only helped raise the incomes of receiving households, but also fueled an expansion of urban services and a further transfer of employment from rural to urban areas.

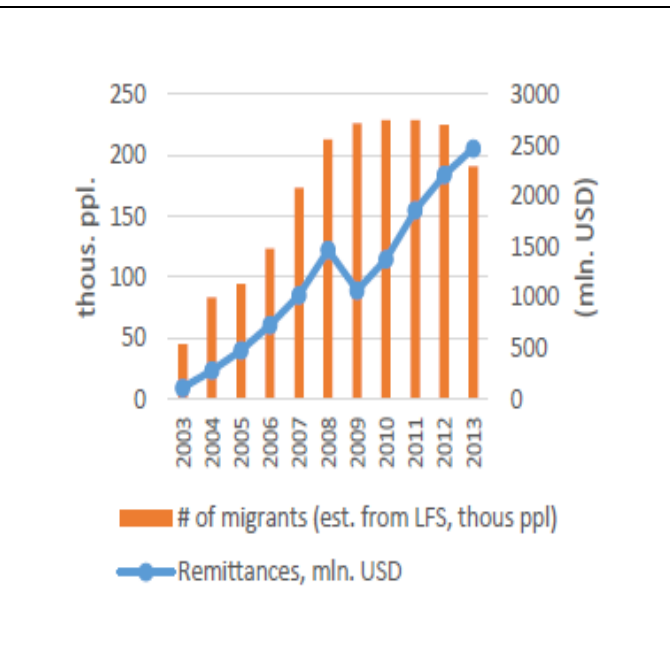
¹² Perhaps more accurately characterized as an *ad hoc* response by households to economic constraints and opportunities after independence.

Figure 21: One of the most remittance dependent countries (Personal remittances received, 2013 % of GDP)



Source: WDI

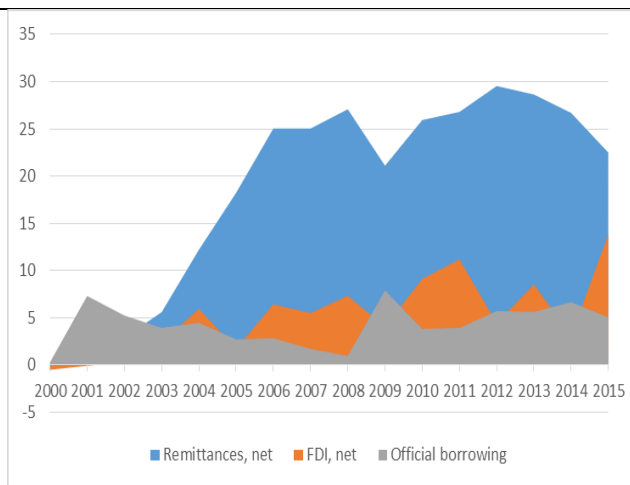
Figure 22: Increasing remittances / plateauing migrants



Source: WB Poverty Profile 2015

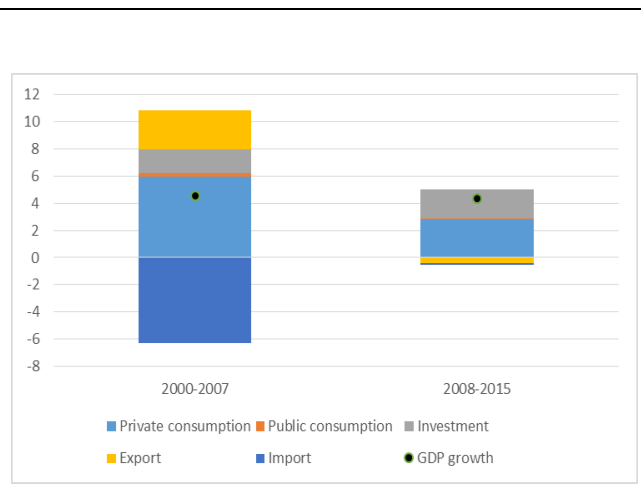
28. **Remittances were channeled into consumption, investment, and imported goods.** Total consumption rose by an average of 19 percent annually between 2005-13, and, by 2013, reached 135 percent of GDP, up from around 90 percent in 2001. Investment also increased dramatically, from about 12 percent of GDP in 2003 to 35 percent in 2012. The bulk of the increase in consumption and investment centered on households and financed children’s education, health care, and housing. On the downside, this explosion of remittances (similar to a natural resource boom) triggered a reallocation of resources from tradable toward non-tradable sectors, underpinning a significant expansion of activity and jobs in urban services.

Figure 23: Remittances dwarfing other foreign inflows (% of GDP)



Source: Staff calculations based on NSC data

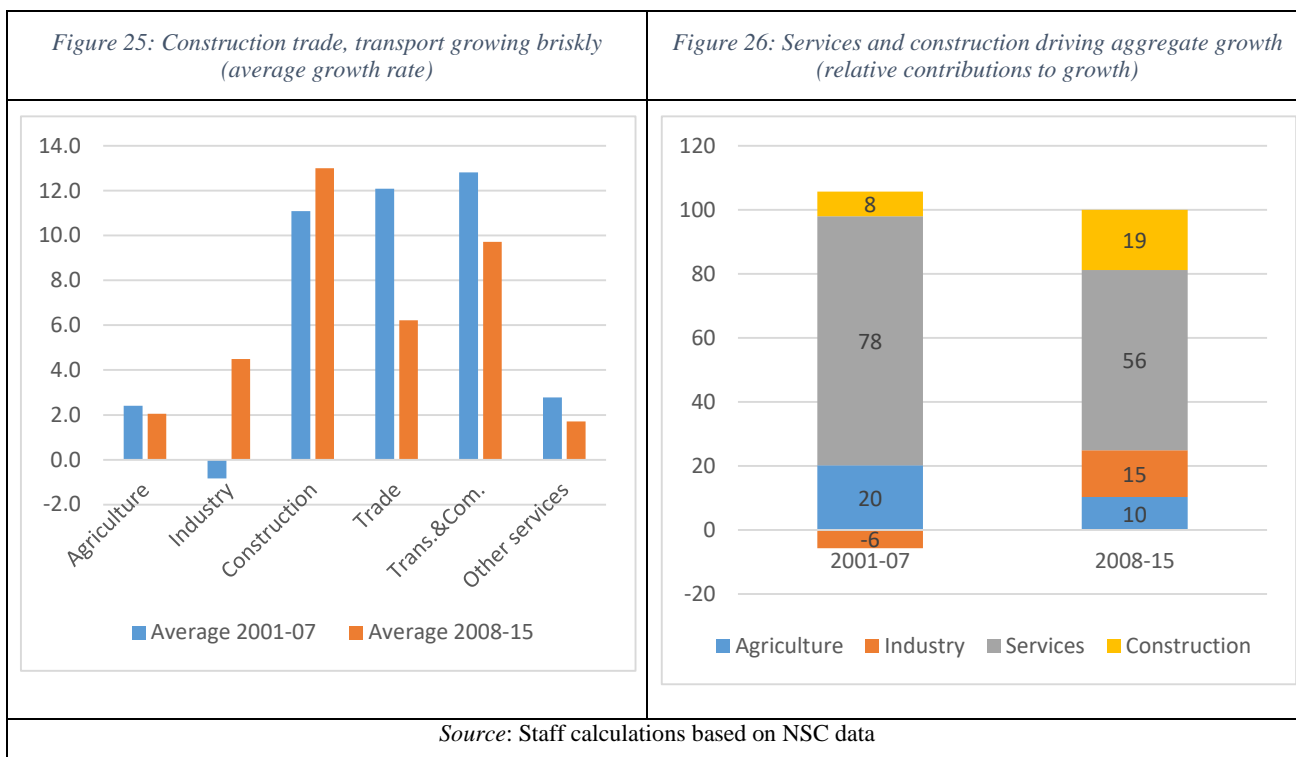
Figure 24: Private consumption and investment drove growth



Source: Staff calculations based on NSC data

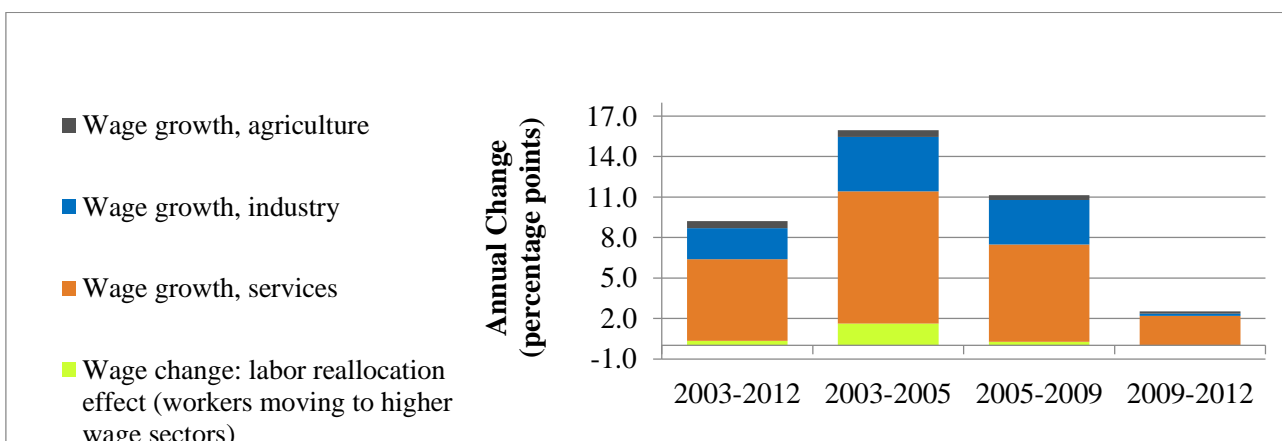
29. **At the sectoral level, growth was driven overwhelmingly by non-tradables: the services sector and, increasingly, construction.** Very high growth rates were observed in construction, trade, transport and

telecommunications. By contrast agriculture and industry grew well below average overall growth¹³. As a result services and construction were the principal contributors to overall growth.



30. **The structural shift from agriculture to services generated gains in productivity and labor incomes, especially for the poor.** Whereas agriculture employed about 54 percent of all poor workers in 2003, it was only about 37 percent by 2012. With low initial productivity in agriculture, the move to other forms of employment—even to very low value informal jobs—effectively raised overall labor productivity, whose growth averaged 7 percent annually between 2005-09. Likewise, real wages rose by almost 9 percent annually between 2003-12.

Figure 27: Wage growth driven by services (decomposition of wage growth, 2003-12)



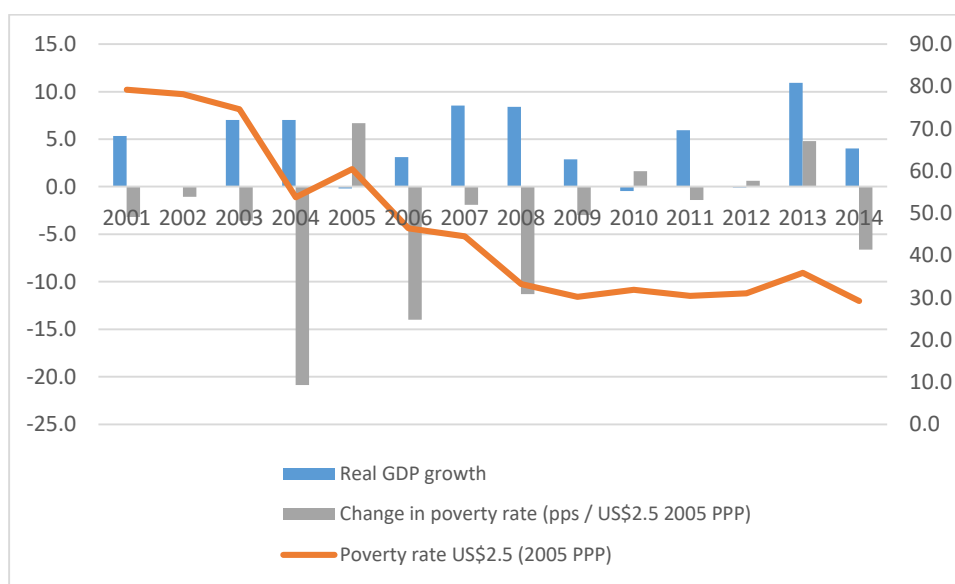
Source: WB Jobs Diagnostic 2015 (Kyrgyz LFS and staff estimates)

¹³ with the pickup in industrial production over 2008-15 essentially attributable to gold

The old model appears to have run its course in terms of delivering improved outcomes

31. **The relationship between GDP growth and poverty reduction appears to have weakened.** While growth and poverty reduction went hand-in-hand over 2000-2008, the strength of that association decreased significantly thereafter. The poverty reduction elasticity of growth¹⁴ declined from 4 over 2003-2008 to 2 in the subsequent period (2009-13). In addition, a delinking appears to have taken place. Fast economic growth did not prevent an increase in poverty over 2012-13, and slower growth in the following year coincided with a sharp dip in poverty. Likewise, while the consumption growth of the population and the B40 averaged 4.6 percent and 7.8 percent respectively over 2005-2014, the figure dropped to -1.1 percent 0.4 percent in 2009-14. Shared prosperity was only achieved because the outcome of the B40 were relatively “less bad” than those of the T60. The full SCD will complement the analysis of the declining elasticity through examining underlying macro-micro transmission mechanisms.

Figure 28: Declining poverty payoffs from growth

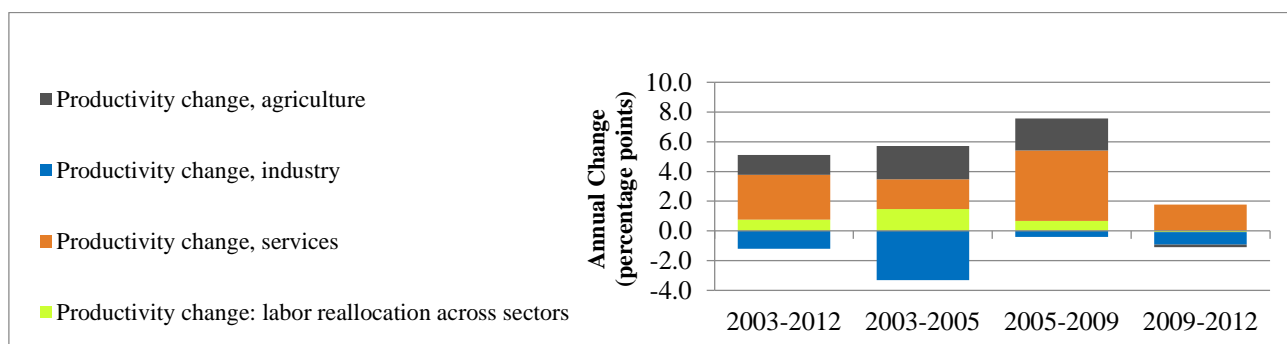


Source: Staff calculations based on NSC data and KIHS

32. **Both job and productivity growth slowed significantly toward the end of the 2000s.** Between 2009-13, job growth averaged only 0.9 percent annually, barely two-thirds of the increase in the labor force, with relatively steady official unemployment data explained by continued out-migration and withdrawals from the labor force, particularly of women whose participation declined from 62 percent to 50 percent between 2000-13. At the same time, productivity growth also dropped markedly across all sectors, falling from 7 percent annually between 2005-09 to a mere 0.7 percent annually between 2009-12, with negative productivity growth in both agriculture and industry.

¹⁴ The percentage change in poverty associated with a one percentage point change in GDP growth

Figure 29: Low productivity growth driven by services (Shapley decomposition of average output per worker growth 2003-2012)



Source: WB Jobs Diagnostic 2015 (Staff estimates using value added (WDI) and employment data at the sectoral level (LFS)).

33. **Moreover, the modest productivity growth was limited to services, and concentrated mainly in transport and communications.** Strong output growth in services supported economy-wide increases in productivity as well as employment. However, two thirds of the growth in services came from transport and communications, which only account for about 15 percent of employment in services¹⁵. Except for transport and communications, performance was modest, with productivity growth averaging less than 1 percent annually between 2005-12 and employment growth averaging 2 percent annually (Table 1).

Table 1: Transport and Telecoms driving services output growth but not employment (Contributions, 2005-2012)

	Real output growth 2005-2012	Employment growth 2005-2012	Productivity growth 2005-2012	Contribution to total growth of output in the services sector /a	Contribution to total employment growth in services
Transport/communication	24.1%	3.1%	20.4%	71.9%	20.4%
Wholesale/retail trade	4.9%	4.1%	0.8%	23.6%	58.9%
Other services	1.5%	0.8%	0.7%	4.5%	20.7%
Total services sector	8.9%	2.1%	6.6%	100.0%	1.0%

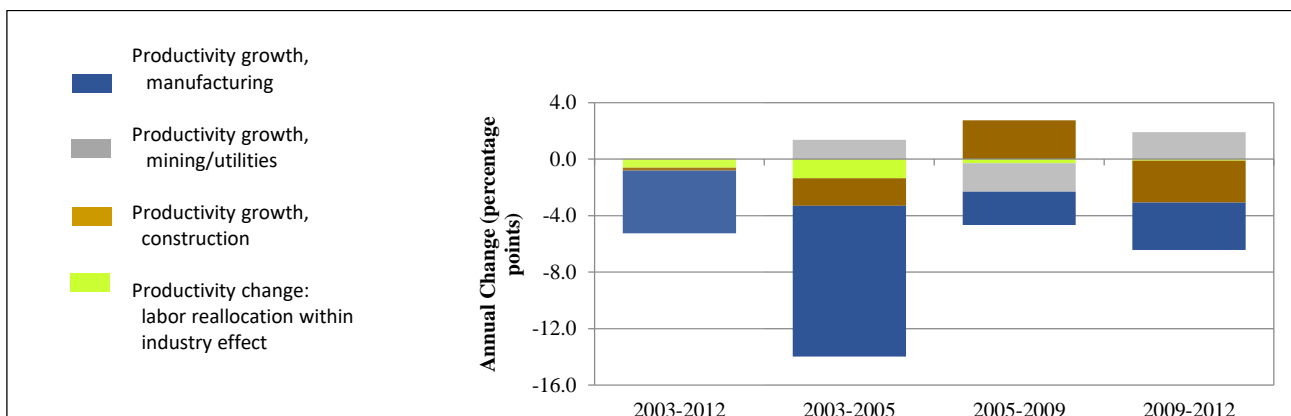
NB: Output growth estimated from national accounts data to 2008 and KER data from 2009-2012

Source: WB Jobs Diagnostic 2015 (Staff estimates using national accounts data, KER service sector data and LFS data).

34. **Productivity declined strongly in the industrial sector.** The inflow of remittances supported a boom in demand for housing, leading to a large number of new jobs in construction. With productivity in construction only half that of other industries (such as mining, manufacturing and utilities), growth in construction depressed productivity in industry overall. The sector also experienced significant declines in manufacturing productivity, averaging almost 6 percent annually in recent years.

¹⁵ Supporting this stellar growth (averaging almost 25 percent annually) was the penetration of new communications technologies, including mobile telecommunications and the internet, driven mainly by expanding private sector demand.

Figure 30: Manufacturing productivity declining steadily (Decomposition of productivity growth in industry, 2003-2012)



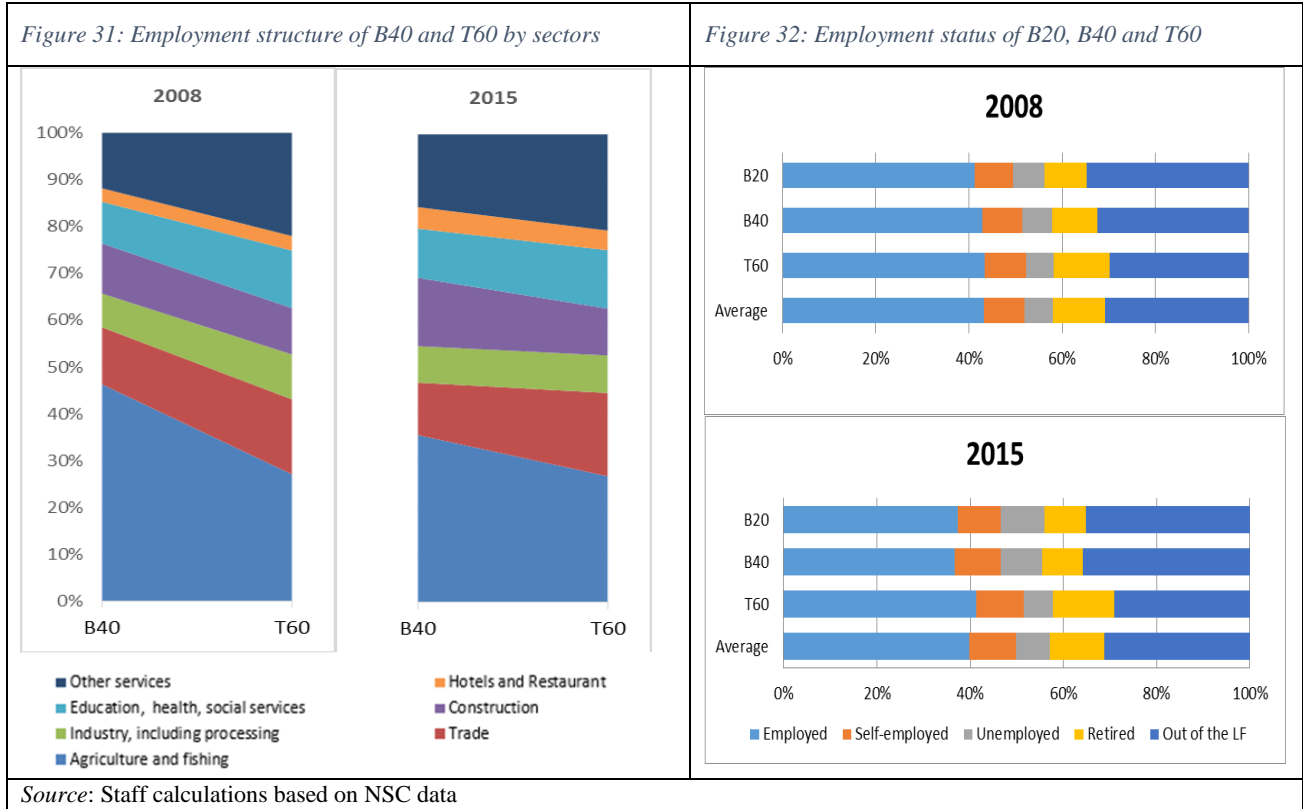
Source: WB Jobs Diagnostic 2015 (Staff estimates using value added data (WDI) and employment data at the sectoral level (LFS)).

35. **Reflecting these changes, wages no longer drive income growth of the most vulnerable as strongly as they did, and public transfers have gained in importance relative to private ones.** Pensions have become increasingly significant: their share in household income rose from 8.7 percent in 2005 to over 16 percent in 2015¹⁶, and they became the second most important driver of poverty reduction after wages. By contrast the importance of remittances¹⁷ declined dramatically as the stock of migrants abroad stabilized and the share of households receiving remittances declined; as did that of agricultural income which was a significant contributor over 2003-08 but made no contribution at all thereafter. The greater importance of transfers also raises concerns over the sustainability of poverty reduction and exposure to shocks. The full SCD will seek to understand these trends better to determine whether they reflect changes in the relative importance/volume of the various sources of income and/or a shift in the profiles and characteristics of poor households.

36. **In terms of employment, there are significant differences across the B40/T60 divide.** The former are more likely to be employed in agriculture and construction (with low wage *premia* corresponding to fewer skills requirements). While average working hours have tended to converge across the two groups, this has been partly offset by a negative trend in employment status for the B40. The share of B40 “employed” fell from 42.8 percent in 2008 to 36.7 percent in 2015, while the share of those “out of the labor force” and “self-employed” increased by 7 and 1.5 percentage points respectively. Female household heads in the B40 are predominantly unemployed.

¹⁶ 16.4 and 16.2 percent for the poor and non-poor respectively

¹⁷ With the estimate providing a lower bound approximation since it focuses only on first order effects.



Looking ahead, the old model is also unsustainable

37. **Not only did the ‘old model’ fail to deliver improved outcomes for the population in recent years, but future growth prospects also appear constrained** by: (i) the weak regional environment depressing migration and remittances prospects; (ii) the small size of the domestic market and the lackluster dynamism of exports; (iii) widespread informality in the private sector inhibiting sustained productivity growth within sectors; and (iv) reduced fiscal space to expand public transfers, improve service delivery, and boost public investment.

38. **Migration and remittances can no longer be relied upon to drive growth and support consumption, while alleviating labor market weaknesses.** In the past, potential labor market pressures from a growing adult population were largely alleviated directly, by increased outmigration, and indirectly via reduced labor force participation (as welfare rose). However, the “stock” of Kyrgyz migrants abroad plateaued at the end of the previous decade and has been falling in recent years, indicating net returns. While remittances continued to grow in dollar terms until 2013 (albeit going to a smaller fraction of households), they declined thereafter, significantly affecting the purchasing power of recipients and the national income. Given the poor prospects for fast economic recovery in Kazakhstan and Russia, and the fast pace of labor force growth, the Kyrgyz Republic will be faced with a significant jobs challenge.

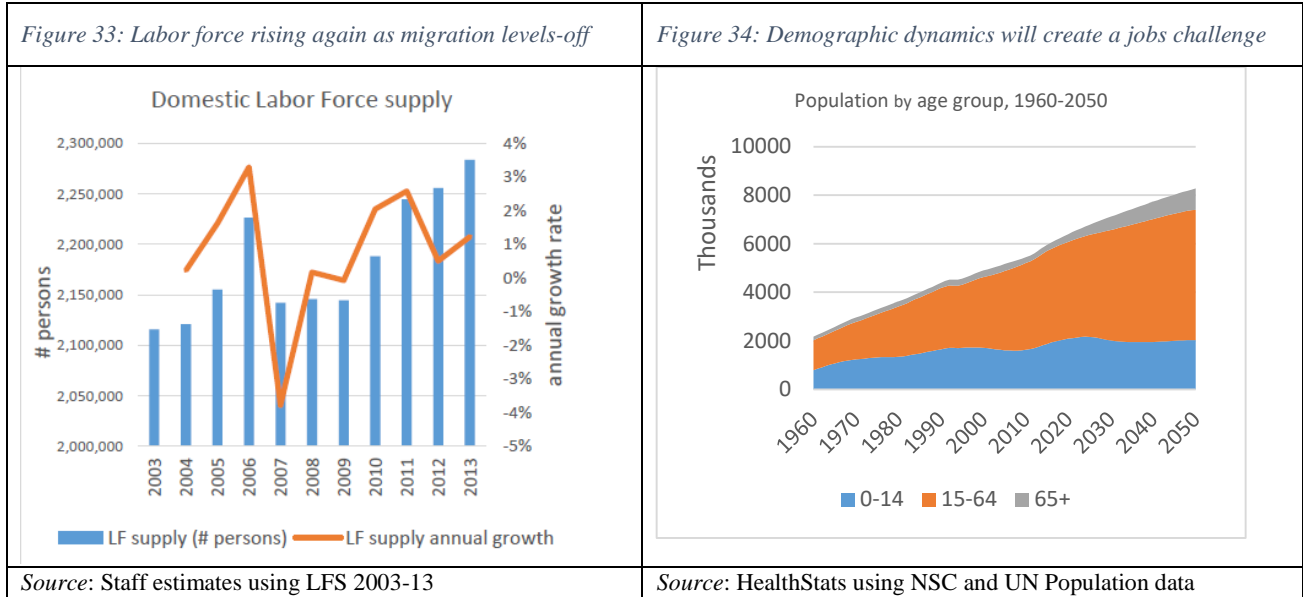
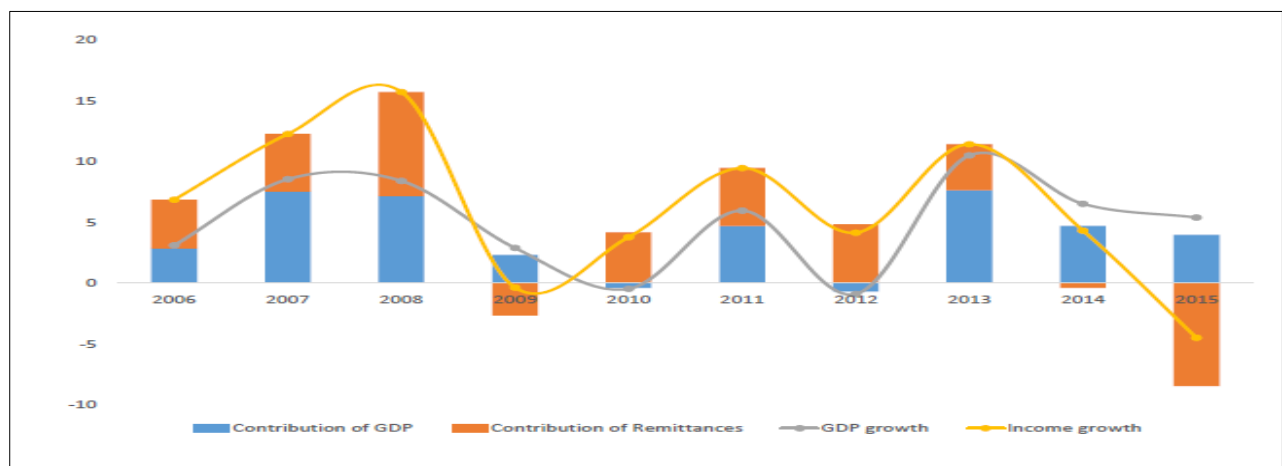


Figure 35: The contribution of remittances to national income growth: past boon, current liability

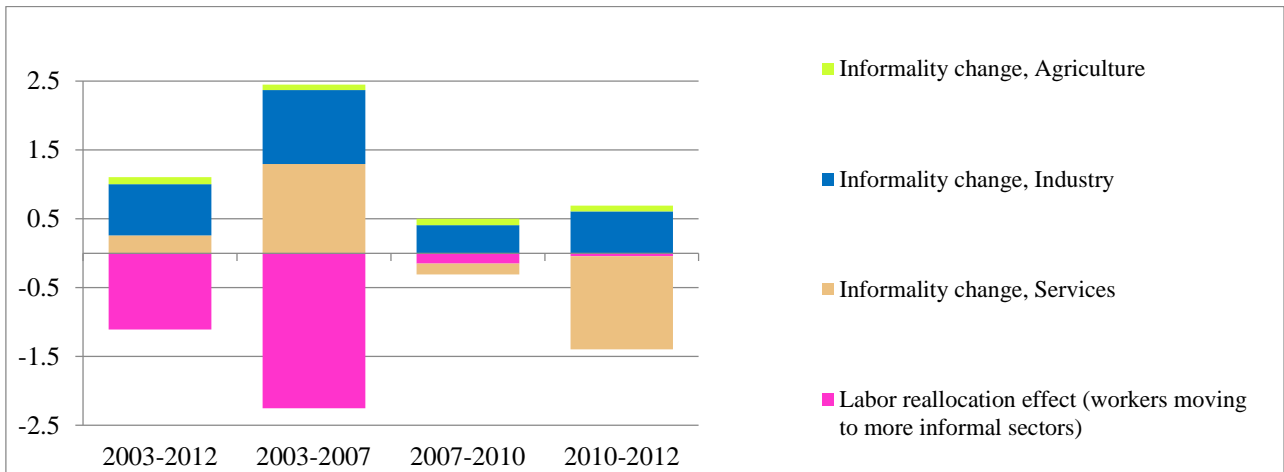


Source: World Bank: Low Commodity Prices and Weak Currencies, ECA Economic Update October 2015.

39. **A macro-level downside of remittances has been low external competitiveness.** As in the case of natural resources, remittance inflows created a wedge between tradables and non-tradables, *i.e.* boosting demand for services, but also undermining incentives to invest in export-oriented industries and activities. Thus, the economy is experiencing many of the classic symptoms of ‘Dutch Disease’. Between 2005-12, overall manufacturing declined by 2.3 percent annually (17 percent over the period), while services expanded by 8.9 percent annually (60 percent over the period). Export growth also deteriorated sharply: since 2008, exports have declined by 0.5 percent annually, trailing far behind the average annual 7 percent increase recorded in most other CIS countries. Merchandise export growth has been slower still, falling from 72 percent of total exports in 2009 to 58 percent in 2013.

40. **Meanwhile, employment growth has been overwhelmingly in the informal sector, characterized by low productivity.** Overall, job growth has been confined mostly to the informal sector, with workers moving from informal agriculture to informal activities in other areas. Thus, while total informality is broadly unchanged since the early 2000s, it increased significantly in industry and services.

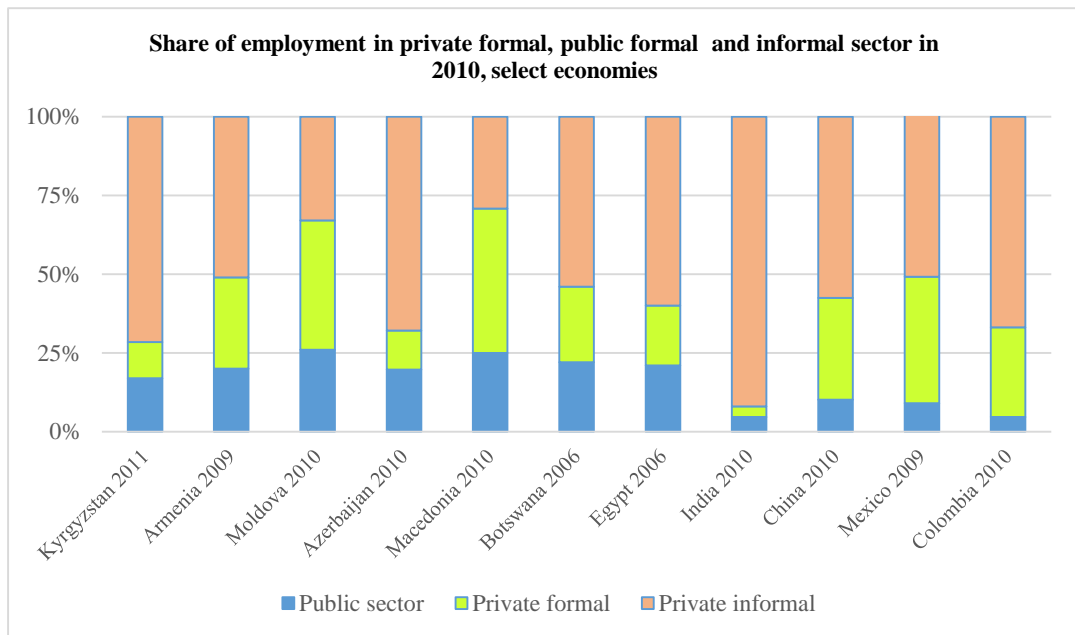
Figure 36: Growing urban informality (decomposition of informality growth by sector, 2003-12)



Source: WB Jobs Diagnostic 2015 (Staff estimates based on Kyrgyz LFS and NSC establishment reports).

41. **As a result the Kyrgyz economy is the most informal among CIS countries.** According to LFS data, informal employment¹⁸ increased slightly overall from 67 to 70 percent over 2003-13, with the labor market dominated by self-employed individuals. At 11 percent of overall employment, the formal private sector is the smallest among all CIS countries.

Figure 37: Employment in the formal private sector among the lowest in the world



Source: WB Jobs Diagnostic 2015 (Staff estimates from country data, including World Bank 2014a and 2014b; National Statistics Committee of Kyrgyz Republic data and Kyrgyz LFS; IZA 2011; ILO 2011, 2012; Bayramov 2012; Bino 2009; OECD 2012)

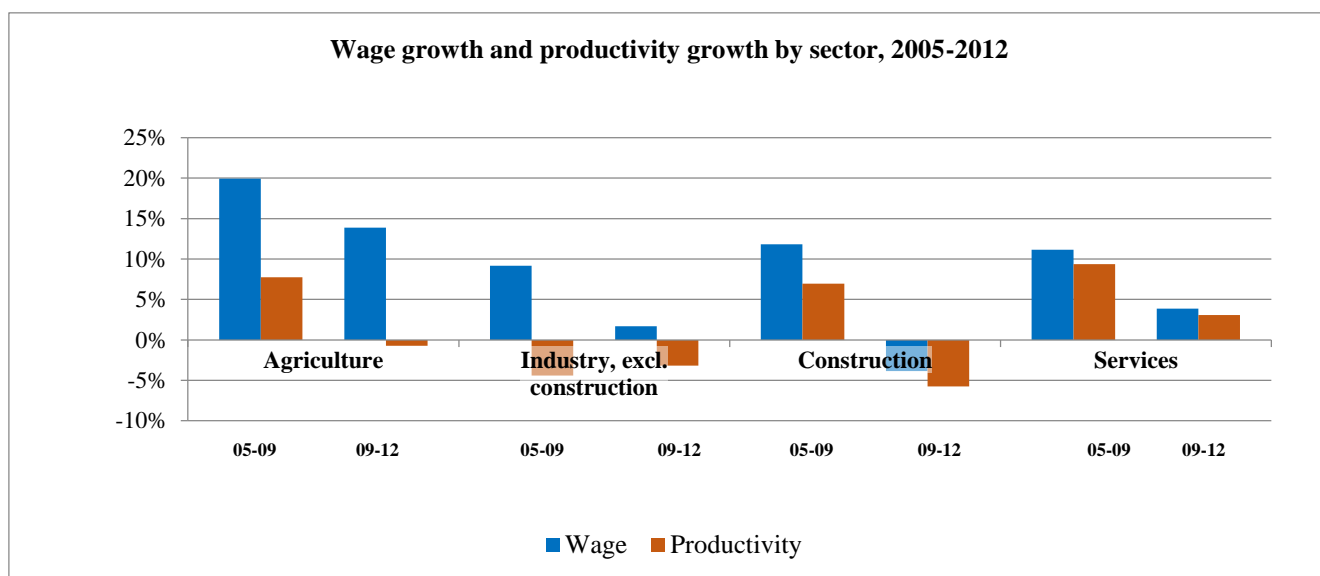
42. **In turn, informality is clearly related to low productivity—although the direction of causality is unclear.** A comparison of economy-wide productivity estimates with formal economy productivity estimates suggests that increasing informality is strongly correlated to decreasing productivity. Data from formal sector firms suggest that aggregate productivity growth has been strong, averaging 6.7 percent annually over 2009-12. Economy-wide, however, productivity growth averaged less than 1 percent annually. This differential in

¹⁸ Defined as employment outside of incorporated enterprises and/or without a formal contract

productivity between the formal and the full economies is particularly large in industry, where informality has increased significantly.

43. **Low productivity growth provides limited scope for wages to rise without undermining the competitiveness of the economy.** Real wages have grown by 10 percent a year since 2005, but productivity growth averaged less than 5 percent a year. The difference has been particularly high in the tradables sectors, - agriculture and manufacturing- weakening external competitiveness. Overall output per worker increased only by 4.3 percent annually since 2005, below the average of all CIS countries.

Figure 38: Wage growth exceeds productivity growth in tradables, weakening competitiveness



Source: WB Jobs Diagnostic 2015 (Staff estimates from LFS).

Figure 39: Kyrgyz Republic productivity lowest in the region and growing slowly



Source: WB Jobs Diagnostic 2015 (Estimates based on data from country sources and WDI)

44. **The full SCD will discuss more extensively the relationship between patterns of economic growth and the inclusiveness of growth.** Specifically it will look at the sectoral composition of growth (particularly the dependence on mining and weakness of the manufacturing sector), as well as the pervasiveness of informality, to explain past patterns of inclusion and anticipate the trajectory going forward.

IV. Toward a new growth path—from vulnerability to sustainable prosperity

45. **Since 2000, the Kyrgyz Republic has made significant progress in reducing poverty and boosting shared prosperity, but the drivers that made this possible are increasingly ineffective and ultimately unsustainable.** Historically, GDP growth has relied mainly on external transfers to drive consumption, coupled with initial gains stemming from labor reallocations and ‘catch-up’ productivity increases in services. This trajectory represented a natural response to the country’s main development constraints, especially its limited connectivity and weak governance. The migration of surplus labor was a logical adaptation to the former and the growth of the informal service economy a realistic adjustment to the latter. But these drivers have limited growth potential and are vulnerable to external factors beyond the country’s control.

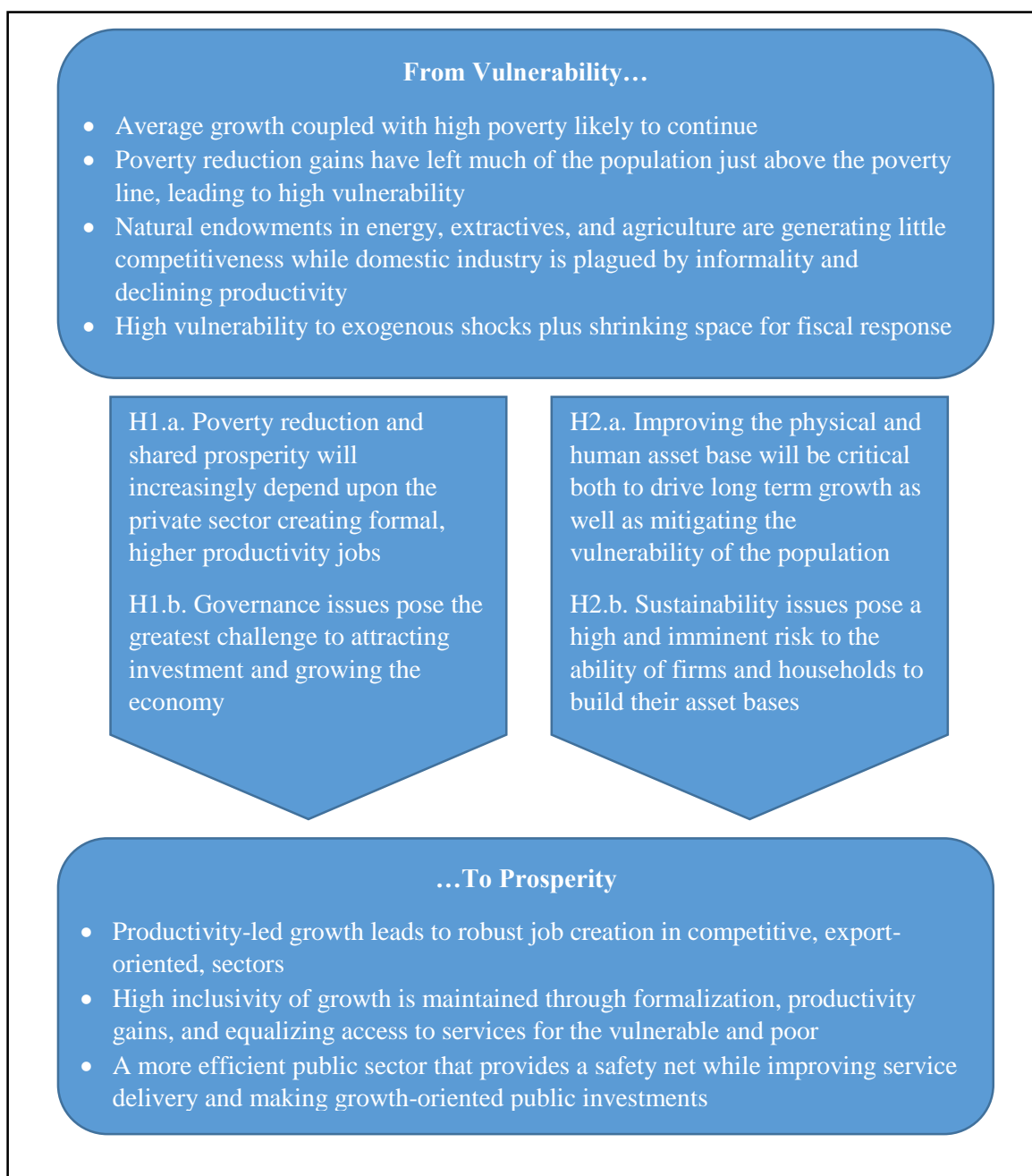
46. **Going forward, the priority is to create the conditions for the private sector to grow, create jobs and expand the opportunity set of the entire population; however, this will also require measures to mitigate the vulnerability of the population and of the country to shocks.** The full SCD will address not only the growth pathways available to the Kyrgyz Republic, but also the ways in which the benefits of growth can be made more equitable and inclusive. This will entail examining how assets are distributed and utilized across categories of the population and the quality of public service delivery, including challenges related to the policy-making capacity and service delivery efficiency of public administrations at the regional and local government levels. Finally the SCD will also look at the vulnerability of the country as a whole to climate, economic and social shocks for which mitigation and preparation is critical and urgent.

47. **In this context, the SCD will consider two sets of hypotheses:**

48. **The first set will explore issues around private sector development, including exports, focused on improving conditions for higher productivity and job creation. It also considers governance as a key binding constraint limiting private sector development.** H1 will analyze in more detail the governance constraints as well as those related to access to other assets and services that hinder private sector growth, increased productivity, and employment creation. It will also explore the sectoral and spatial comparative advantage of Kyrgyz firms and enterprises, particularly those linked to exports. To improve conditions for a more productive rural sector (including agriculture and forestry), the SCD will examine the drivers of farm growth and market integration and whether current policies, instruments, and institutions promote higher productivity, especially of small farms, the occasional volatility of agricultural GDP and its vulnerability to weather and price shocks, and whether they are adequate to respond to small farmers’ coping and risk mitigation strategies.

49. **The second hypothesis set explores the human asset base that will be critical both to drive long term growth as well as mitigating the vulnerability of the population; it also considers sustainability as a high and imminent risk to the development of this asset base.** This is because much needs to be done immediately to ensure that tomorrow’s gains are preserved over time. The SCD will look at sources of vulnerability – including climate change and environmental stress- but also ways in which the country’s significant assets could be better exploited going forward.

Figure 40: Pathways to Prosperity



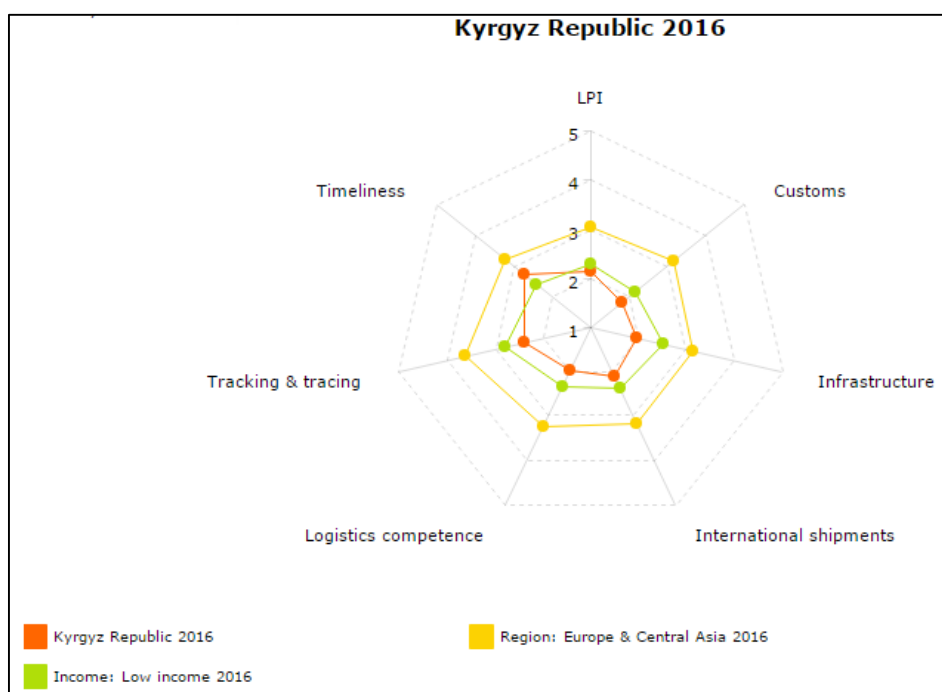
Hypothesis 1.a.: Going forward, poverty reduction and shared prosperity will increasingly depend upon the private sector to formalize and grow, creating more high-productivity jobs in regionally and globally competitive sectors.

50. **Significant declines in productivity have eroded labor cost advantages and undermined competitiveness.** Productivity growth has fallen over the past decade, particularly in the industrial sector, undermining the low wage advantage of the Kyrgyz Republic. This has coincided with a sharp increase in informality outside of agriculture. It remains unclear how the causal relationships works between informality and productivity, but at a minimum, the lack of formal employment growth is mirrored by the overall diminishing competitiveness in the industrial sector, in turn driven by several factors. Some of these constraints to growth are further explored below.

51. **Regional integration and connectivity remain underutilized sources of growth.** Despite measures to improve international integration, most notably WTO and Eurasian Economic Union (EEU) membership, the Kyrgyz Republic has yet to capitalize on access to these markets. This is both a consequence of the need to improve national standards, technical regulations, and quality infrastructure to meet the requirements of export markets, as well as fundamental competitiveness issues discussed in the following paragraphs. In addition, physical connectivity in air, road, and rail connections remain costly. The planned CASA-1000 project will link surplus energy generation in the Kyrgyz Republic to off-takers in Afghanistan and Pakistan and is a good example of how regional connectivity can drive opportunities for the Kyrgyz Republic to leverage competitive potential. Similarly, greater investment in digital connectivity, particularly high capacity broadband, may help sustain high productivity growth in the ICT sector and improve the relatively low access of households to internet connectivity. Approximately 30 percent of individuals use the internet in the Kyrgyz Republic relative to an average of 66 percent in the CIS¹⁹.

52. **Access to finance is constrained with terms not suited to productivity-enhancing investment.** Like many low-income developing countries, the Kyrgyz Republic has a low level of aggregate domestic savings—estimated at about one-third of GDP—despite the significant inflows of remittances. The combination of high real interest rates, a shallow finance sector, and inefficient financial intermediation are key factors limiting growth in the financial sector. While the role of micro-finance institutions has been widening, their interest rates are high, collateral requirements significant, maturities short, and the available amounts small. With a low bank credit to GDP ratio, the financial system needs to be developed in line with the needs of the economy. Together with the legislative and regulatory changes outlined in the National Sustainable Development Strategy, improved intermediation of remittance flows through finance institutions (*e.g.*, mobile payment platforms) and greater development of financial markets infrastructure would help instill banking habits in rural areas, where only 2% of the population have accounts with a formal finance institution. As a consequence of these factors, according to Enterprise Survey data, only 18.4 percent of firms obtain investment finance through banks with a slightly higher 23.3 percent using banks to finance working capital. The majority of investment is financed internally, placing a significant constraint on the scope, speed, and responsiveness of firms to market opportunities.

Figure 41: Kyrgyz logistics underperforms on most indicators



Source: World Bank Logistics Performance Index

¹⁹ Source: ITU data for 2015

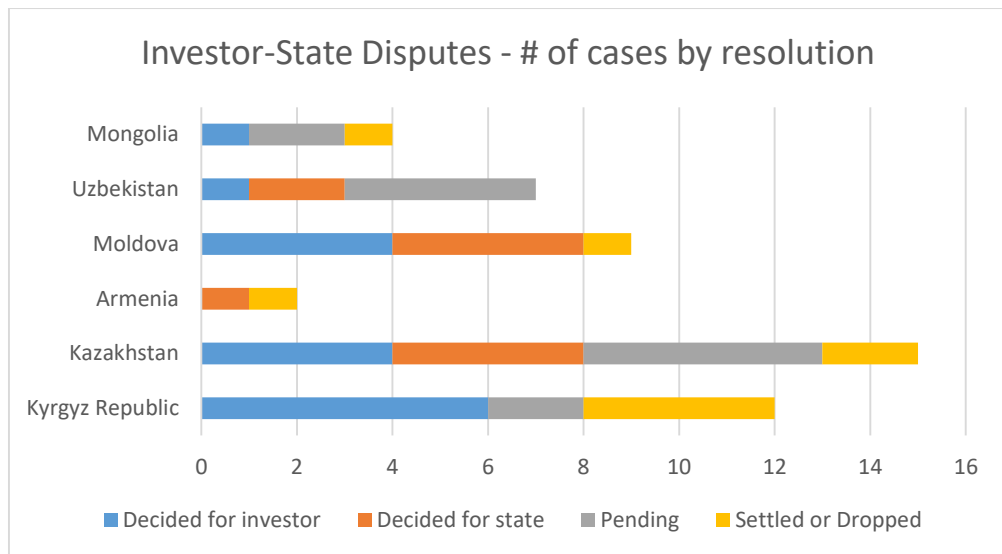
53. **Physical and quality infrastructure constrain market access.** Particularly for a landlocked country with an export-oriented growth strategy, the poor quality of physical infrastructure is increasing costs for firms and reducing competitiveness. While much new investment is underway or planned as part of greater regional initiatives, domestic connectivity via road and rail remain limited, partly by the mountainous terrain of the country. Border and trade infrastructure are also relatively underdeveloped, with a Logistics Performance Index score of 2.16, making the Kyrgyz Republic 146th from the 160 countries surveyed. While firms are paying among the lowest energy tariffs in the world, supply quality and reliability are particularly poor. Moreover, below cost-recovery tariffs undermine public and private investment and growth in the sector, and create a short-term risk that energy supply will not keep up with demand. Finally, the limited quality infrastructure including testing facilities, metrology, standards, and related physical infrastructure such as cold storage limits market access for Kyrgyz goods in higher value-add markets such as the EU as well as within the EEU.

54. **The Kyrgyz regulatory environment imposes high compliance costs for firms, possibly encouraging them to limit their size or grow informally.** While the government has prioritized investment climate reform, leading to steady improvement in international indicators such as the Bank Group's *Doing Business*, some procedures such as paying taxes, obtaining connections to utilities, and cross-border trading remain excessively complex and prone to corruption. For example, in a 2013 World Bank-EBRD Business Environment and Enterprise Performance Survey (BEEPS), 21 percent of firms identified tax administration as a major obstacle, with more than half reporting that they were expected to provide gifts to tax officials. In addition to complex regulations, compliance costs increase significantly as firms grow from small to medium and large size. For example, the average time required to obtain an electrical connection for small firms is only 6 days, but 88 days for medium-sized firms. The latter also have higher tax rates and encounter more requests for informal payments. Small firms experience the highest 'churn' (market exit) rate, which is the global norm, but, more concerning, also very low rates of graduation to medium or large size, suggesting that they either lack the competitive potential to grow or are voluntarily capping their formal growth.

Hypothesis 1.b.: Governance issues pose the greatest challenge to attracting investment and growing the economy.

55. **Governance and corruption remain key concerns for firms, posing long term risks and undermining returns for investors.** The Kyrgyz Republic scores poorly on most governance indicators, in contrast to stronger performance on indicators of *de jure* reforms. Just over 60 percent of firms in the World Bank Enterprise Survey report corruption to be a major constraint to their operations, while the Global Competitiveness Index ranks the Kyrgyz Republic 130 of 140 countries in the use of irregular payments and bribes and 124 for protection of property rights. This is consistent with the Corruption Perception Index, where the Kyrgyz Republic ranks 123 of 168, with very little improvement since 2012. Another reflection of poor governance is the relatively high incidence of investor state disputes taken to arbitration. Not only does the Kyrgyz Republic have a very high number of such cases for an economy of its size, but it also has a track record of losing these cases, reflecting a very real risk for firms. Governance reform is a central element of the National Sustainable Development Strategy (NSDS), 2013–17.

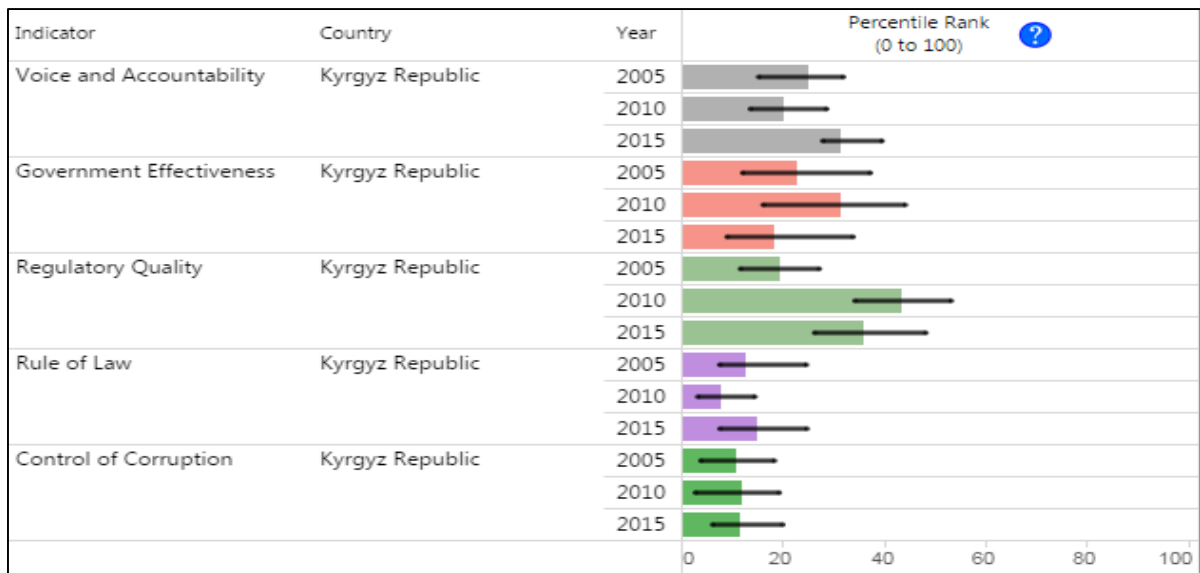
Figure 42: Investors have been successful in arbitration cases against the Kyrgyz Government



Source: UNCTAD data

56. **In addition to broad governance issues, implementation capacity is constrained, leading to significant gaps between *de jure* design of regulation and *de facto* implementation.** These gaps create additional risk and delay for firms as well as opportunities for rent seeking and corruption. They also undermine the efficiency of public investments and the quality of service delivery by the public sector, where weak management tools and capacity are prevalent. Overall the Kyrgyz Republic scores poorly on the Worldwide Governance Indicators, particularly in Government Effectiveness, Rule of Law, and Control of Corruption. Both Government Effectiveness and Regulatory Quality have declined between 2010 and 2015.

Figure 43: Worldwide Governance Indicators for the Kyrgyz Republic



57. **Finally, political instability remains a continuing constraint.** The 2013 BEEPS found that 36 percent of firms identified political instability as their single biggest obstacle. The nature of concerns has changed over time—from security related issues following the 2005 and 2010 revolutions to public dissatisfaction with the ability of the government and the legislature to create a long-term, sustainable political environment. For example, since 2010, there have been frequent changes in government, with significant turnover in senior policy roles such including Primer Ministers, Ministers of Economy, and Ministers of Finance. Finally, there remains

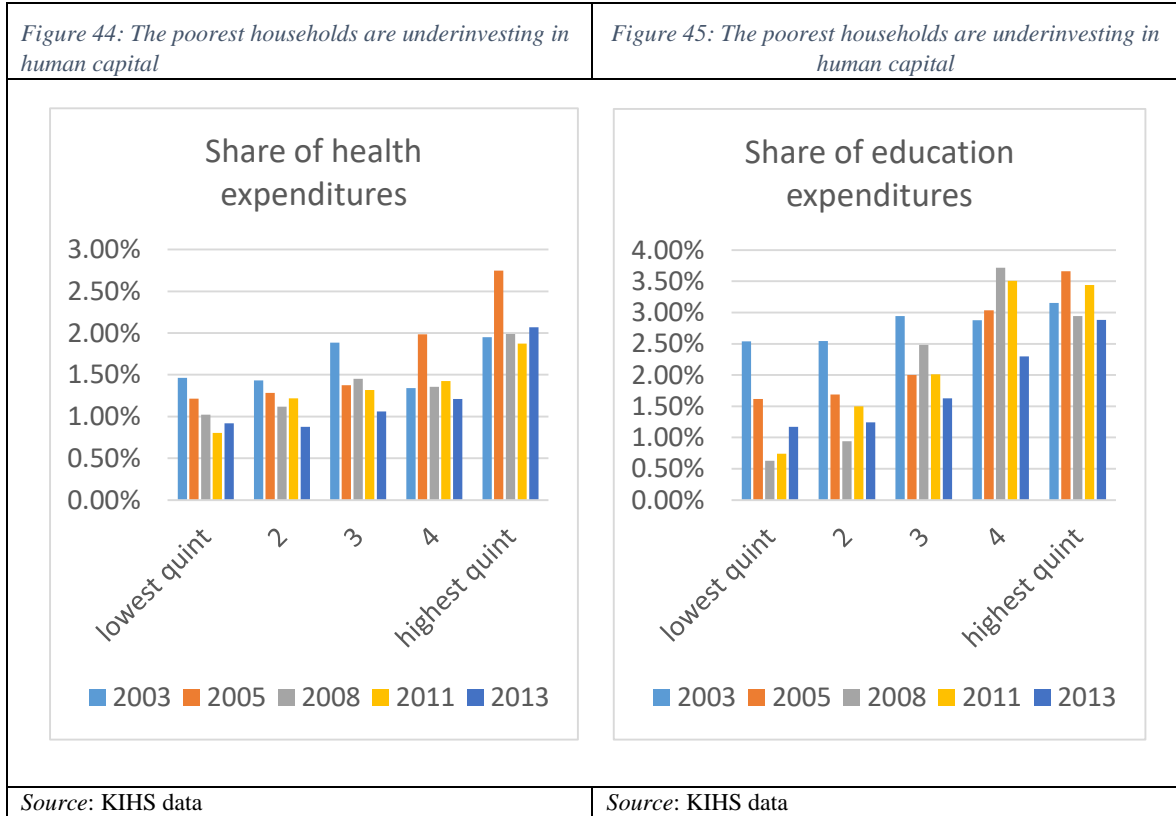
uncertainty about the economic and social impact of changing bilateral and regional relationships, especially since the country's recent accession to the Eurasian Economic Union.

58. **One positive factor of resilience that may lead to sustained improvement in governance is ICT and the greater use of e-government.** The Kyrgyz government has increasingly moved to provide government to business services electronically, beginning with tax reporting, but now expanding these options to pilot customs, permits, and registration transactions online. In addition, the government has begun to implement feedback mechanisms, allowing firms to report on the quality of their interactions with officials. Given the ICT sector's contribution to aggregate productivity increase in the Kyrgyz Republic, it is likely that further investment can promote both economic growth as well as better governance.

Hypothesis 2.a.: Investing in human capital will be critical both to drive long term growth as well as mitigating the vulnerability of the population

59. **The inclusiveness of growth remains a defining challenge for the Kyrgyz Republic.** The high level of vulnerability is exacerbated by disparities in access to services and the related ability of poor households to invest in their human and physical asset base. The SCD will examine the extent to which inclusiveness in growth is constrained either by access to, and/or quality of, public services in areas such as skills and education, social protection programs, and healthcare. Geographic, gender, and demographic lenses will be used to assess disparities in access to these services.

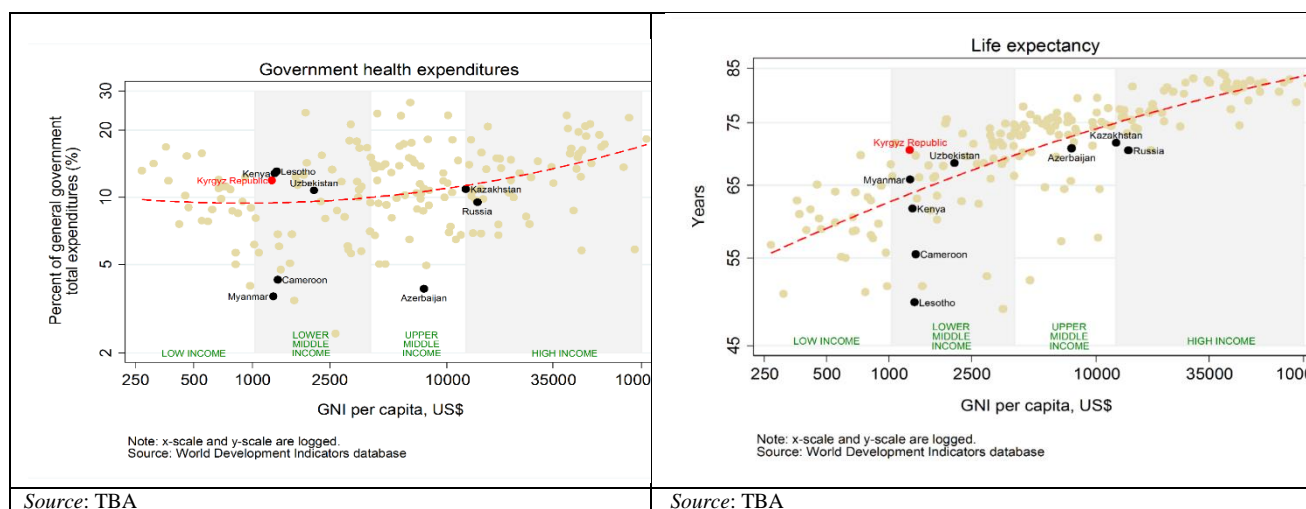
60. **Poor households have a lower, and declining, share of budget spend on health and education, suggesting lower investment in human capital.** Particularly for the bottom quintile of the population, household spending on health and education declined from 2003 up to 2011 with a modest improvement in 2013. This is likely a reflection of the inability of poor households to accumulate a sufficient asset base to cushion increases in food and energy spending, which are disproportionately high in the bottom quintile. The lower household expenditure is further exacerbated by uneven access to these services, as well as the quality of service delivery – issues further examined below.



61. **Education and skills acquisition are key to improving the capacity of individuals to generate income and exploit expanded opportunities.** While skills are valued in the labor market, important gaps persist. At the primary and secondary levels, enrollment is effectively universal and even in tertiary education, enrollment is on par or higher than in OECD countries. Moreover public expenditure on education has also been among the highest as a share of GDP in the ECA region. However, by contrast, available learning outcome evidence point to serious quality concerns. In the most recent PISA assessments (2006 and 2009), the Kyrgyz Republic was a bottom performer indicating the failure of the education system to provide children with the relevant tools to become integrated in labor markets. The assessments found that 83 percent of the 15 year old population was functionally illiterate, while achievements in math and science were also low. Moreover, about half of the youth entering the labor market lack the cognitive, non-cognitive, and technical skills needed to secure quality jobs, while too many tertiary graduates have skill levels little better than those of secondary school graduates.. In addition, increasing migration may be undermining human capital accumulation because young workers increasingly opt for work abroad over completion of secondary education. As migration has risen, labor force participation among young workers has increased, while the proportion of workers not completing secondary education has almost doubled. The decision to leave school early is particularly prevalent among students of poor families. Between 2004-07, labor force participation among young workers increased from 72 to 76 percent, while the share of those with incomplete secondary education grew from 5 percent to 11 percent.

62. **In the health sector, where public spending as a share of GDP is also among the highest in ECA, outcomes have been relatively better.** The Kyrgyz Republic has managed to reduce the incidence of child (under 5) mortality from 70.5 deaths per 1,000 live births in 1990 to 26.6 by 2012, while also making strides in terms of reducing maternal mortality from 100 deaths per 100,000 live births in 2000 (putting the country at the 11th percentile of the raw distribution) to 79 deaths by 2010 (51st percentile). Life expectancy as a result increased from 66.5 years in 1996 to 70.4 in 2014. Improvements in undernourishment have been dramatic over the past decade and the prevalence of tuberculosis was halved between 2000 and 2012. This relatively good performance can be partly attributed to comprehensive health reform (following the demise of the Soviet Union), which included restructuring the hospital sector, strengthening primary care, developing family medicine and establishing an explicit state guaranteed benefit package to be purchased by a Mandatory Health Insurance Fund. With this, the Kyrgyz Republic has in principle achieved Universal Health Coverage. The SCD will recognize these achievements and examine the extent to which relatively high value-for-money in the sector can be linked to specific policy initiatives (such as introducing output-based financing).

Figure 46: Health outcomes generally above predicted levels



63. **A robust social protection framework is fundamental to reduce the population’s vulnerability and improve its resilience, particularly in the context of an aging population.** To build up the assets especially of the poor and the bottom 40 percent, social protection systems need to ensure that households can meet basic

needs and are protected from fortuitous and aggregate shocks. Given the country's gradually aging population, both service delivery and social protection systems will come under pressure. In the circumstances, a credible medium and long-term growth strategy will require an assessment of the adequacy and sustainability of the state pension system, as well as the coverage of those not eligible for contributory benefits.

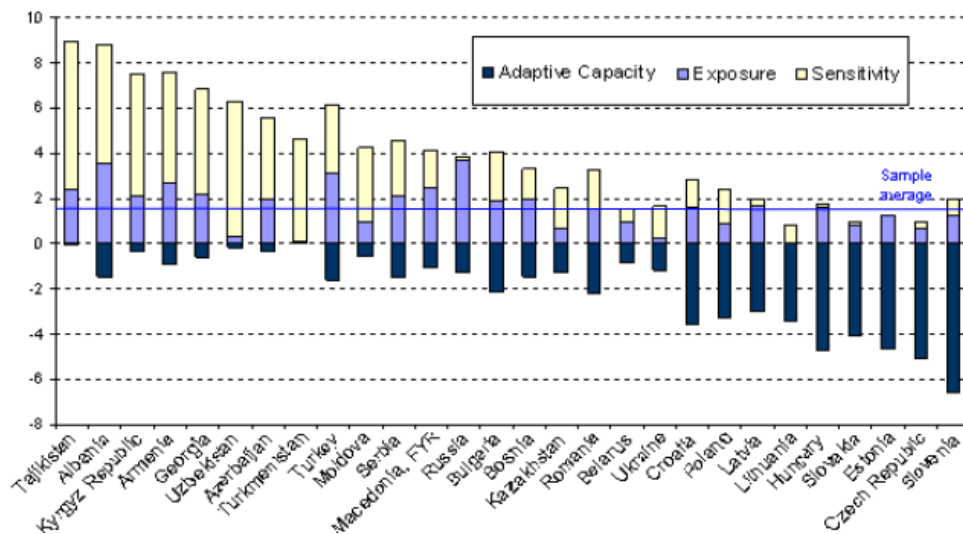
64. **Geographic disparities in access to basic public services constrain the accumulation of assets and the equalization of opportunities across the population.** Inequalities in access to public services by income group are compounded by significant inequities by location. The mountains that divide the north and south of the country reflect a parallel socio-economic divide. While the poorer, predominantly rural south is connected economically and physically more to neighboring Uzbekistan and Tajikistan, the north borders Kazakhstan and looks more towards Russia. Owing partly to the country's challenging topography, which makes access to many services, including education, health, infrastructure and markets, very difficult, large socio-economic disparities exist between rural and urban areas. For instance, while 70 percent of the urban population has access to improved sanitation, in rural areas the share is only 8 percent. Indeed, almost all human development indicators show a huge divide between rural and urban areas. These economic and social differences, exacerbated by ethnic and other divisions between the rural south and urban north, have generated communal tensions resulting in violent conflict at least twice during the last twenty years. The SCD will examine the trade-offs involved in alleviating these disparities in particular in between equity and efficiency considerations when allocating limited public resources across competing uses, knowing that the Kyrgyz authorities have embraced the 2009 WDR concept of growth agglomerations. .

Hypothesis 2.b. Sustainability issues pose a high and imminent risk to the ability of firms and households to build their asset bases

65. **In order to sustain gains over the medium, the Kyrgyz Republic will need to manage emerging sources of risk; it can also amplify payoffs by leveraging opportunities.** Among the main sources of vulnerability, climate-change and environment-related risks have the potential to significantly impede both growth and equity objectives. The energy and extractive sectors present an interesting case whereby how the sector is managed will largely determine if it becomes a source of liability or dynamism. The openness of the political process and opportunities for voice and agency are arguably among the country's greatest assets to be leveraged over the medium term. Finally, the Kyrgyz economy is well diversified across the product space: this implies that, with supportive policies, the country could benefit from greater integration in regional and global value chains.

66. **The country needs to be prepared to deal with the impacts of climate change, as well as other country-specific environmental vulnerabilities, especially those affecting the poor.** In ECA, the Kyrgyz Republic is among countries most vulnerable to climate change, chiefly because of high sensitivity (linked to its reliance on hydropower and agriculture), as well as low adaptive capacity. The full SCD will draw on the Climate Screening Tool to assess impacts from various climate change scenarios, including across regions, the North / South divide, and socio-economic groups. Exploring how the country can enhance preparedness for natural disasters and adaptation to climate change, as well as ensure sustainable use of its natural resources—in particular of its biodiversity, land, mineral, and water resources—should be key elements its medium- and long-term growth strategy. For instance with respect to water, signs of stress are beginning to emerge despite abundant freshwater endowments, stemming from massive inefficiencies in water use. Growth opportunities for the Kyrgyz Republic are inextricably linked to the environment, particularly in sectors such as agriculture, hydro-energy, extractives, forestry and tourism, and this creates a significant risk of poor management of these natural resources ultimately undermining the competitive potential of the economy. By contrast, more strategic and holistic management of natural resources would be needed to fully exploit these sources of comparative advantage.

Figure 47: High Vulnerability to Climate Change



Source: Adapting to Climate Change in ECA, World Bank 2009

67. **The Kyrgyz Republic remains a conflict-prevention priority, with vulnerability at the regional, national and local levels.** At the regional level, contested border delimitation and management of transboundary resources provoke inter-community confrontations and frictions with neighboring countries. At the national level, risks stem from poor delineation of political power among government branches, brewing competition among elite groups for control of resources and entrenched corruption in government agencies. Subnational risks include urban overpopulation, youth unemployment and marginalization, and inter-ethnic tension. Long-term stability and growth depend on meaningful reconciliation in the South, and the promotion of a national identity that includes all ethnic minorities, alongside tackling governance/corruption challenges. The growing specter of religious radicalization, particularly among disenfranchised ethnic Uzbek youth who face chronic lack of economic opportunities compounds pre-existing sources of vulnerability. These challenges and risks would be exacerbated in a context where public policies fail to stimulate growth and job creation and/or to translate into significant improvements in service delivery. In the past, political instability and civil unrest has been inextricably linked to perceptions of mis-governance.

68. **The state has significantly eroded its fiscal buffers, limiting the scope for fiscal policy to respond to shocks going forward.** The period from 2000 to 2008 (the global financial crisis) was one of fiscal prudence and consolidation, during which the budget was brought from a 10 percent deficit position to equilibrium. However, government spending increased significantly thereafter, reaching 39 percent of GDP in 2012 (and remaining at similarly high levels), and the fiscal deficit climbing to one of the highest levels in the ECA region. Over this period, the fiscal position of the government remained solvent essentially due to increased external support and debt write-offs, as well as to *ad hoc* measures to boost revenues and make selected expenditure cuts. The result was a mounting debt burden, and overall low value for money of spending.

69. **The ad hoc nature of adjustments may have hurt the efficiency of spending.** To a large extent, the fiscal stimulus responses to crises have taken the form of wage and pension increases (eventually followed by freezes), as well as increases in un-targeted social allowances (including initially temporary programs that were made permanent). Overall the result has been to increase the structural deficit, while reaping only very modest gains (if any) in terms of poverty reduction or improved social outcomes.

70. **Although a significant share of spending has also gone to build up the capital stock of the country, with public investment on infrastructure increasing from 4.8 percent of GDP in 2011 to 7.6 percent in 2015, this remains far below needs.** While it is worth highlighting that budget deficits have been entirely attributable to capital investments, with the gross operating balance of the government remaining in significant

surplus, such capital investment have still remained far below the level needed to even maintain the capital stock at existing levels (let alone building it to levels that would be needed to fill the country's massive infrastructure gap). Moreover, the efficiency of capital expenditure is believed to be low implying that only a fraction (estimated at 40 percent) of each dollar invested is effectively transformed into public capital. In the public investment management quality index compiled by Dabla-Norris et al. (2011) the Kyrgyz Republic ranks 48th out of 71 countries (1.41 on a scale of 4) and much below regional peers.

71. While buffers have been eroded, there are significant sources of pressure likely to mount on the budget going forward. The recent significant investment push combined with currency depreciation have heightened the risk of debt distress. At the same time, contingent liabilities and the projected rise in pension obligations are also cause for concern. A significant share of external borrowing has been channeled (i.e. on-lent) to public sector entities, notably energy utilities that operate well below cost recovery and therefore constitute a source of contingent liability. The accumulated publically-guaranteed debt of these public sector entities is estimated to be high and will be assessed fully in the SCD. The pension obligations of the government are estimated to grow significantly in the future.

72. The fiscal challenges, therefore, are daunting. With limited margins of maneuver on the revenue side (the Kyrgyz Republic already has a high share of revenue to GDP, averaging over 35 percent of GDP in recent years and an informal economy estimated at over 40 percent of GDP) adjustments will nonetheless be needed to simultaneously (i) restore fiscal buffers, (ii) while ensuring that growth / formal firms do not suffer, (ii) improve the quality and effectiveness of services, and (iii) fill the country's massive infrastructure gap.

73. In this respect the full SCD will look in detail at the sustainability of public service provision. Indeed most public utilities are believed to be managed inefficiently, with poor planning adding to the cost of service delivery and significant waste for instance in water use, or electricity and heating consumption.

74. The energy and extractives sectors are currently characterized by significant hardships and large untapped potential. While the Kyrgyz Republic sits on large reserves of precious metals, those fields that are currently exploited face sustainability risks posed by environment degradation, mismanagement of rents, poor coordination with affected communities, and long term depletion of the underlying assets. Given the substantial lead time necessary to move from exploration to exploitation it is imperative that an attractive framework for investors is put in place immediately²⁰. In addition, although it has large hydro-electricity generation potential, the Kyrgyz Republic has only been able to exploit a small fraction of that asset. Scaling up hydro generation capacity, however would require massive investments, extensive technical preparation and progress on regional cooperation. In both cases, the long term nature and size of the required investments mean that political stability and policy predictability would need to improve significantly.

75. The Kyrgyz Republic is uniquely characterized, in Central Asia by the openness of its political process and scope for voice and agency. The democratic process is vibrant, including a strong –at times vociferous- parliament and institutions of local representation exist, including for local communities. The country ranks high, relative to Central Asian peers, on international indicators of freedom of the press and of the political process. However, to date, the Kyrgyz Republic has been unable to capitalize on this asset and instead, political instability is seen by investors as a major deterrent to taking large / long-term positions in the country. The SCD will explore in greater detail how this current source of vulnerability can be turned into a factor of resilience. Specifically it will examine the role of local governments to support local solutions to local problems. Local government capacity and accountability varies considerably across the country, impacting on service delivery and poverty reduction. Collaboration between local governments and communities in defining and implementing their development priorities is key to promoting social coherence, mitigating social and political tensions, and ensuring the sustainability of local development. With the 2008 amendment to the legal framework for local governance which assigned more political, administrative, and fiscal autonomy to local governments, the 467 local authorities now have increased responsibilities towards local populations, and there

²⁰ While there are modern and comprehensive laws in place on environmental protection regulatory enforcement is weak.

are increased opportunities for the *ayil okmotu* to work closely with communities in local development initiatives. Nonetheless, local governments and communities are limited in their capacity to undertake participatory approaches to governance and development, the lack of capacity at the local level to resolve state-citizen and inter-community tensions, and the limited capacity to address grievances has weakened the relationship between local governments and their constituents - poor management and inequitable distribution of basic services, resources, and employment opportunities then trigger inter-community and inter-ethnic conflict. Local governments are underfunded, understaffed, poorly managed, inefficient, and distrusted by citizens across the country. They also suffer from lack of transparency, accountability, and an unclear division of responsibility with other state agencies, providing space for the elite capture of resources, exacerbating regional disparities in access to public services and goods, and fueling various social conflicts.

76. **Finally the Kyrgyz economy is also characterized by a highly “open” product space, implying that there is significant scope for diversification and value chains development.** A notable feature of the Kyrgyz economy is the dispersion of economic activity and exports which exemplifies the challenges faced by producers in reaching scale but also entails broad potential for forward and backward linkages from agriculture and livestock to industry. In other words a key, currently under-exploited challenge is for the country to support the development of value chains and greater insertion of Kyrgyz producers in such chains at the regional and global level.

V. Knowledge and data sources

77. **The SCD will draw on existing evidence and ongoing analysis to explore and identify the main constraints for sustainable progress on poverty reduction and shared prosperity.** A bibliography of existing documents in key areas will be completed, including work carried out by external stakeholders. In addition GP inputs will be sought to identify World Bank-led materials and ongoing analysis that will also inform the SCD. Key datasets include Household Budget Surveys, Labor Force Surveys, BEEPS, and other specialized datasets such as Governance Indicators, etc. As the diagnostic is carried out, the team will aim at identifying data and knowledge gaps that could help strengthen the evidence-base going forward.

VI. Prioritization

78. **The SCD prioritization process will focus on identifying the main constraints and opportunities to/for poverty reduction and shared prosperity.** For this, the team will rely on:

- **Evidence presented in the SCD:** key constraints for each of the identified hypotheses put into perspective through benchmarking
- **Brainstorming** with a wide group of internal and external stakeholders;
- **Qualitative assessments** by the SCD core team, incorporating both the SCD and results of brainstorming.

79. **The team will consider the standard suggested filters/criteria to select and rank priority areas.** The dominant criterion will be the following:

- **Impact:** The team will prioritize areas with expected substantial (medium to large) impacts on the twin goals, and sustainability, while also taking into account the proposed focus on the additional objective of addressing widespread vulnerability.

80. **Other criteria to be considered include:**

- **Time horizon:** The team will consider the time horizon of the expected impacts, so as to balance issues with short-term and longer-term impacts.
- **Pre-conditions:** The team will assess whether unlocking certain constraints is an essential precondition for progress in other areas.
- **Complementarities:** The team will aim at favoring issues that will have large or important complementary effects.
- **Evidence:** The team will consider the degree of confidence in and scope of the evidence base presented in the analysis.

VII. Consultations

81. **The SCD will inform not only the World Bank Group’s strategy formulation, but also that of the Government.** The timing for the preparation of the SCD is well aligned with that of the new Kyrgyz National Sustainable Development Strategy (NSDS). In order to exploit synergies between the two processes, the SCD team will meet periodically with government officials (Ministry of Economy) in charge of developing the new national strategy as well as with the broader group of non-government, private sector and academic stakeholders involved in its formulation. Further, if useful, the SCD team could also work directly and regularly with a government-designated working group.

The SCD team will further “field test” its initial hypotheses through structured interviews with representative stakeholders (including ordinary citizens and members of civil society). The main objective of these focused interviews or workshops will be to confront the findings coming out of data analysis and desk reviews with the reality experienced by individual households and firms, as well as to add a layer of granularity to the findings. Although the consultation strategy will be refined post-PCN, the SCD team intends to conduct:

- **Structured interviews:** with individuals representative of households in all social strata and types of occupations; business executives representative of firms, domestic and foreign, large and small, formal and informal in various domains of activity; public sector officials responsible for implementing policy; as well as opinion leaders and academia;
- **Workshops:** with community, civil society and business associations, with a particular emphasis on understanding regional differences and the specific constraints faced by households and firms in remote areas.

82. **The schedule of the proposed consultation process is as follows:**

- In January 2017, the team will make a formal presentation to Government counterparts, as well as other stakeholders involved in the NSDS, on the initial findings and hypotheses contained in the PCN.
- Structured interviews and workshops will take place over January-March and be systematically documented.
- In early March, once the full draft SCD is ready, another round of presentations will be organized in Bishkek for key Government counterparts, as well as IFIs / development partners.

83. **A Multi-stage consultation with internal stakeholders will be central to the SCD.** The SCD was launched at a two day event for the Kyrgyz Country Office (Bank and IFC) where the process and initial storyline were drafted in a participatory process. Subsequently all GPs and CCSAs have assigned focal points to provide pre-PCN inputs on the storyline and constraints. Following the PCN, more detailed consultations will take place with all GPs and CCSAs structured along the lines of interdisciplinary discussions on key themes of the SCD. Some particularly critical issues such as informality, jobs, and governance will be further developed with dedicated support from GP and CCSA staff.

VIII. Team, Milestones

95. **The SCD team represents a blend of knowledge and experience relevant to the diagnostic.** The core team is led by co-TTLs representing both IBRD MFM GP and the joint IFC/IBRD T&C GP and includes the Country Economist and a poverty economist. The World Bank Country Manager and IFC Country Officer advise the core team. The extended core team brings in the three CMU Program Leaders and focal points have been identified in each GP/CCSA. (See below)

96. **The schedule of milestones for the SCD is as follows:**

a. PCN: The PCN will take place in November following the first round of inputs from the GP and CCSA focal points.

b. Consultations: January through March leading up to a presentation of the draft SCD to counterparts in the Kyrgyz Republic.

c. Board Review: Tentatively targeting early Q4 FY17. This is well aligned with the timeline for the new National Development Strategy as well as the timeline for preparation of the CPF.

GPs	Manager	PL	Focal point
Agriculture	Julian Lampieti	Animesh Shrivastava	Sandra Broca
Education	Cristian Aedo	Janssen Teixeira	Dingyong Hou / Jason Weaver / Gulmira Sultanova
Energy and extractives	Ranjit Lamech	Paul Valley	Kathrin Hofer / Katharina Gassner / Zamir Charynov
Environment and natural resources	Kulsum Ahmed Valerie Hickey Emilia Battaglini	Animesh Shrivastava	Gillian Cerbu, Tolkun Jukusheva, Gayane Minasyan, Craig Meisner
Finance and markets	Rolf Behrndt	Animesh Shrivastava	Cevdet Unal / Coleen Mascenik
Governance	Adrian Fozzard	Paul Valley	Nataliya Biletska / Zhanybek
Health, Nutrition, and Pop	Enis Baris	Janssen Teixeira	Ha Nguyen / Ana Milena Aguilar Rivera / Asel Sargaldakova
MFM	Maria Gonzales	Christos	Aurélien Kruse / Bakyt Dubashov
Poverty	Carolina Sanchez	Janssen Teixeira	Saida Ismailakhunova / Sarosh Sattar
SP and Labor	Andrew Mason	Janssen Teixeira	Ishan Ajwad / Sherzod Akbarov / Oleksi Sluchynskyy
Social, Urban, Rural	David Sislen / Nina Bhat / Jorge Munoz	Paul Valley	Janelle Plummer (Social) / Joaquin Toro (DRM) / Ana Corsi / Kremena Ionkova
Trade and Competitiveness	Lisa Kaestner	Animesh Shrivastava	TBD
Transport and ICT	Binyam Reja	Paul Valley	Cordula Rastogi / Juan Navas-Sabater
Water	Michael Haney	Animesh Shrivastava	David Meerbach / David Lord / Richard Damania / Jason Russ
CCSAs			
Climate change	James Close	Animesh Shrivastava	Philippe Ambrosi

Fragility and Conflict	Amara Konneh / Kanthan Shankar	Janssen Teixeira	Janelle Plummer
Gender	Stefano Mocci	Janssen Teixeira	Bénédicte de la Brière / Emcet Oktay Tas / Ursula Casabonne / Janelle Plummer
Jobs	Andrew Mason	Janssen Teixeira	Ishan Ajwad
PPPs	Clive Harris	Paul Vallely	Jyoti Bisbey

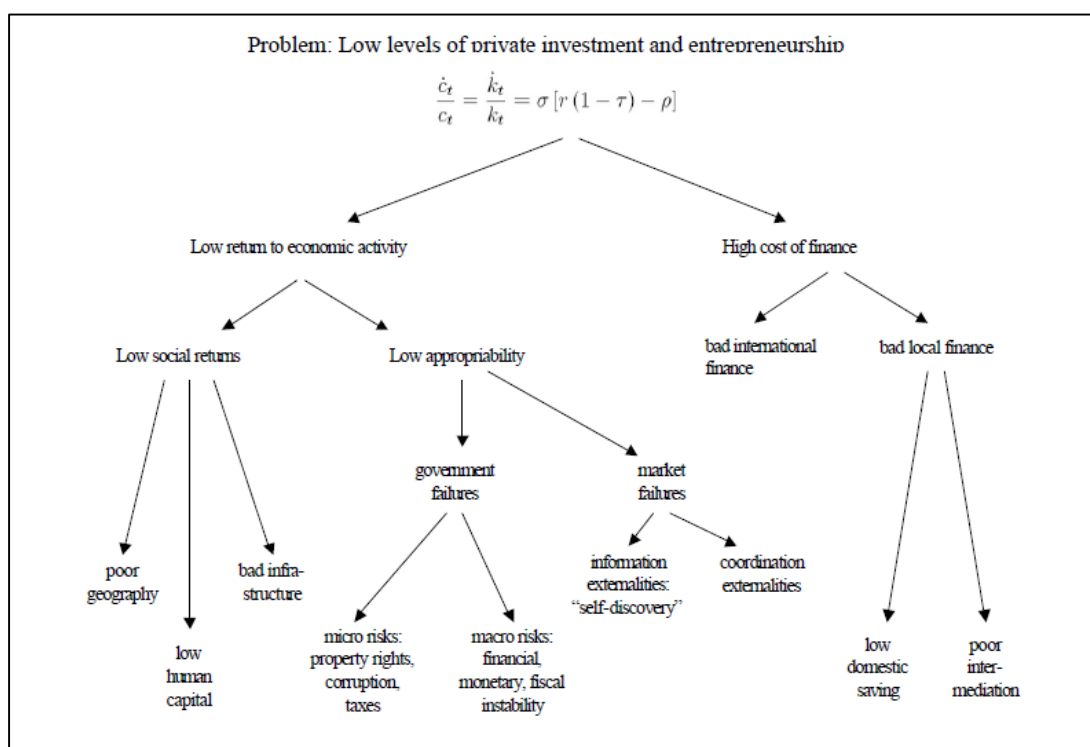
Annexes

Annex 1: Special Focus topics for the SCD

Focus Area	Lead GP(s)
<p>Preserving a high level of shared prosperity in future growth</p> <ul style="list-style-type: none"> • The Kyrgyz Republic ranks in the 90th percentile with respect to share of total income held by the bottom 40 percent • How has the Kyrgyz Republic been able to achieve such high levels of equality? • What would it take to maintain this distribution as growth increases and the drivers of that growth change? 	<p><u>Lead GPs:</u> POV</p>
<p>Characterizing the bottom 20</p> <ul style="list-style-type: none"> • Despite strong results in poverty reduction over the past 15 years, the bottom quintile remains characterized by entrenched poverty • The special focus will look at the characteristics of these households – spatial factors, LM outcomes, access to services, etc. • What last mile policy measures could impact poverty eradication? 	<p><u>Lead GPs:</u> POV, SPL, SUR</p>
<p>Making the most of migration</p> <ul style="list-style-type: none"> • The Kyrgyz Republic ranks second in the world in remittances as a share of GDP • What global examples could be applicable to the Kyrgyz Republic as the country moves up the migration value chain • How can remittances be better channeled into investment 	<p><u>Lead GPs:</u> SPL, (with DECMR)</p>
<p>Informality and productivity: links and constraints to formalization</p> <ul style="list-style-type: none"> • The Kyrgyz Republic has rates of informality unique in ECA and more typical of low income SSA countries • Are firms informal because of low productivity and/ or unproductive because of informality? • What are the main constraints to formalization? What are the costs and benefits of informality? 	<p><u>Lead GPs:</u> T&C, SPL</p>
<p>Leveraging EEU Integration</p> <ul style="list-style-type: none"> • What the constraints limiting Kyrgyz exports from accessing the common market? • What specialization opportunities exist for the Kyrgyz Republic within the common market? • What other markets could present opportunities for Kyrgyz producers – China, EU, etc? 	<p><u>Lead GPs:</u> T&C, MFM</p>
<p>Jobs and Skills</p> <ul style="list-style-type: none"> • The special focus will explore key findings and lessons from the jobs strategy around the alignment of skills with market needs, returns on education, quality of education, etc 	<p><u>Lead GPs:</u> SPL, GED</p>
<p>Closing the spatial divide</p> <ul style="list-style-type: none"> • The special focus will address targeted policies to develop access to market; infrastructure investments, particular focus on agricultural growth, natural resources/forestry and value chains creation 	<p><u>Lead GPs:</u> AG, T&C, Tr ICT, GENDR</p>

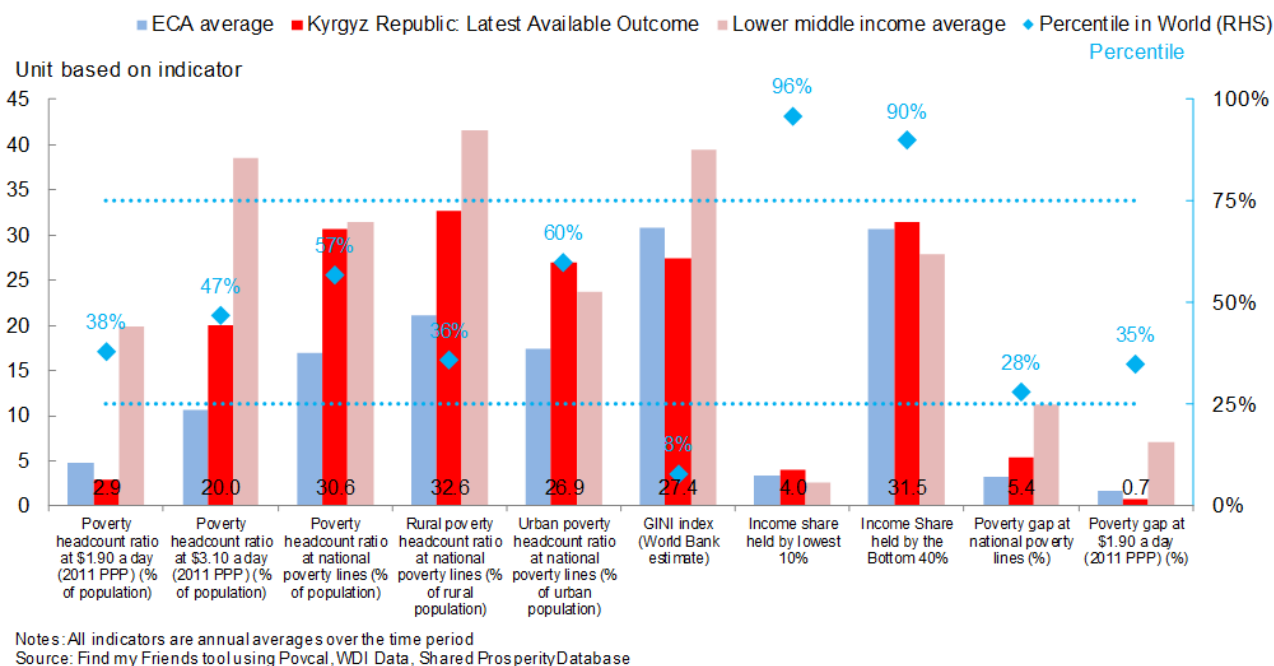
<p>Patterns of exclusion, and exposure to risk</p> <ul style="list-style-type: none"> • The special focus will analyze the particular challenges faced by disenfranchised populations including <ul style="list-style-type: none"> ○ Minority populations in Southern Kyrgyzstan ○ Internal migrants in cities • It will look at socio economic dimensions of exclusion (access to labor market opportunities, services) and at voice, agency and governance challenges to participating in public life. • It will assess exposure of specific populations to climate change risk 	<p><u>Lead GPs:</u> POV, SUR, SPL, GENDR, CCCCSA</p>
<p>The future of gold production</p> <ul style="list-style-type: none"> • Kumtor has an estimated remaining life of approximately 10 years, creating a major risk to the fiscal stability of the country given the large dependence of the economy on this single mine. • What steps could the government take to prepare a new pipeline of projects to sustain exports post-Kumtor? What scale of projects would be necessary and to what extent is there a sufficient resource base in the country to support such a pipeline? • How can the sector drive linkages to the wider economy and spur job creation in upstream services? • How can persistent environment, governance and community challenges be sustainably addressed to improve the perception of the country among potential investors? 	<p><u>Lead GPs:</u> E&E, T&C, MFM, GENDR</p>

Annex 2: HRV Growth Diagnostic tree

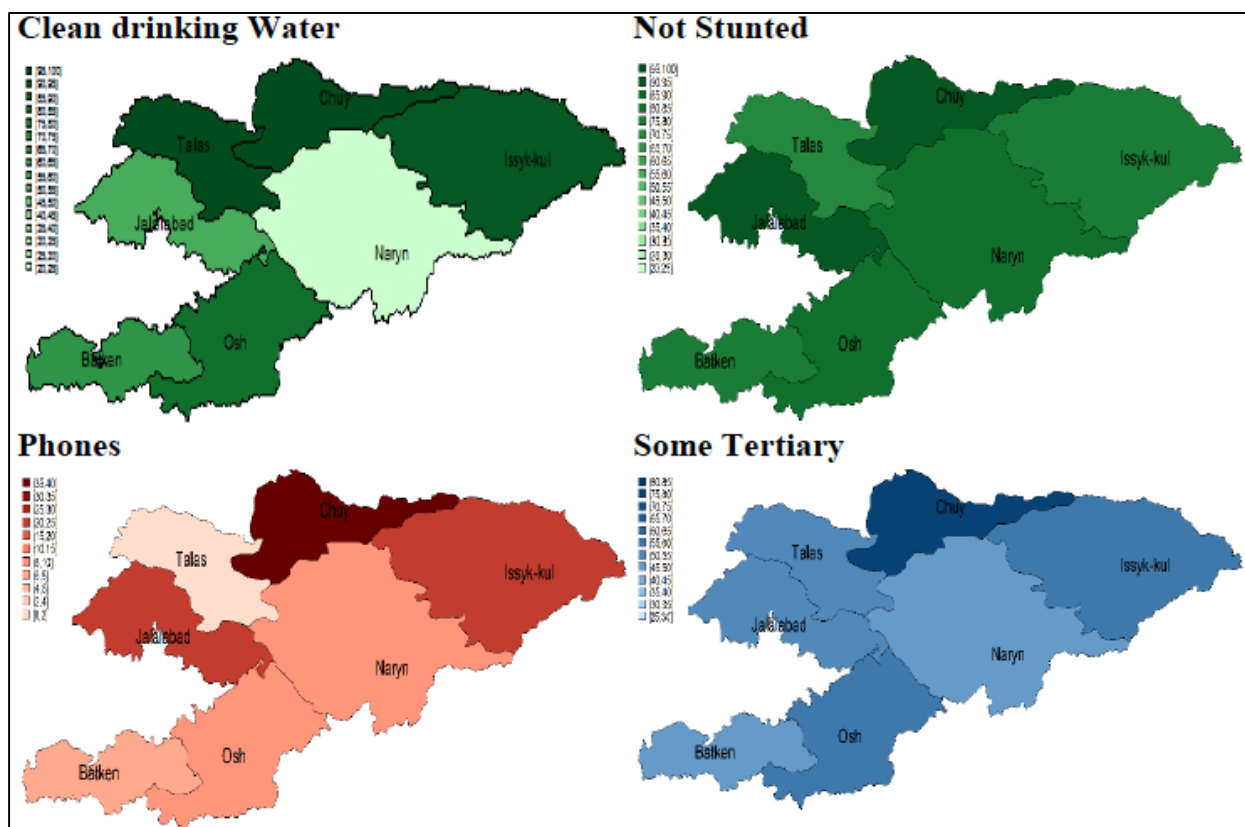


Source: Hausmann, Rordrik, Velasco (2005)

Annex 3: High poverty / low inequality (poverty indicators and percentile comparison to the world)



Annex 4: Human Opportunity spatially concentrated (HOI selected opportunities)



Source: Tiwari and Mitra (2012)