

Asian Development Bank

A PRIVATE SECTOR STRATEGY FOR CENTRAL ASIA

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ABBREVIATIONS

CAAEF	-	Central Asian-American Enterprise Fund
DMC	-	Developing Member Country
EBRD	-	European Bank for Reconstruction and Development
EU	-	European Union
FDI	-	Foreign Direct Investment
FSU	-	Former Soviet Union
GDP	-	Gross Domestic Product
IBRD	-	International Bank for Reconstruction and Development
IFC	-	International Finance Corporation
IMF	-	International Monetary Fund
MDB	-	Multilateral Development Banks
MOU	-	Memorandum of Understanding
SME	-	Small- and Medium- Scale Enterprise
SOE	-	State-owned Enterprise
TACIS	-	Technical Assistance Program of EU for FSU and Mongolia

NOTE

In this Report, "\$" refers to US dollars.

I. THE NEED FOR MULTILATERAL ASSISTANCE TO THE PRIVATE SECTOR IN CENTRAL ASIA¹

1. The breakup of the former Soviet Union (FSU) initiated a difficult transition period for the newly independent republics of Central Asia as they make their way from a command-style economy to an economy that relies upon market-based institutions. This transition period has entailed major social and economic costs. The governments have responded to the challenge of transition with broad-based reforms designed to encourage the development of a viable and healthy private sector. Considerable progress has been achieved, especially in macrostabilization. Much, however, remains to be done in terms of structural reform, especially in those areas concerned with developing commercially viable firms and farms. Structural reforms for a transitional economy are, of necessity, an uncertain process entailing considerable experimentation, review, and revision. Thus an incomplete policy environment is likely to be present for the foreseeable future.

2. The situation presents a challenge to the multilateral development banks (MDBs). Traditional programs are based on the experience in economies with well-developed private and public institutions, often targeting repressed or distorted, but inherently viable, private sector enterprises. These traditional programs may well miss the real needs of Central Asian enterprises of mixed ownership and management structure operating in a gray region that is neither private nor public.

3. This paper argues that there is a call for the Bank to respond to the region's needs with a program that will

- (i) focus on private sector operations that would be directly complementary to public sector programs;
- (ii) develop programs in those sectors that can have a direct impact on reducing the costs of transition, particularly in the social sectors; and
- (iii) seek the maximum involvement of other investors or participants.

4. Given the existing programs of the Bank and other funding agencies, there are likely opportunities for the Bank to provide direct assistance to the private sector in (i) the financial sector, especially to encourage good corporate governance; (ii) infrastructure, especially in rehabilitation and operation projects; (iii) the difficult company towns; (iv) agriculture to encourage farm restructuring; (v) small- and medium-scale enterprise (SME) assistance; and (vi) social infrastructure to help create private sector service providers.

5. To illustrate the range of possible Bank activities, a set of appendixes is provided. Each appendix is a sketch of a project designed to support needed restructuring for farms and firms by addressing the complex of problems faced by the private sector in Central Asia. The projects include

1 The issue of possible Bank activities in the private sector in Central Asia was raised in the informal Board discussion on the Country Operational Strategy for Kazakhstan on 4 December 1996. Subsequently, an Economic Mission led by David Green, Senior Economist, PE3, with Mr. Makarand Dehejia, Consultant, was fielded to Kazakhstan on 12 August 1997.

- (i) An SME financing and business advisory service that will provide credit but also the business services to ensure that credit will actually be used to improve productivity and widen markets (Appendix 1);
- (ii) technical assistance in agriculture (Appendix 2), providing prefeasibility studies on a range of possible agriculture and agro-processing activities that can be presented to potential entrepreneurs, both domestic and foreign; these studies could potentially lead to new investment activities that could be supported by the Bank;
- (iii) a business format licensing and finance facility (Appendix 3) that could support small enterprises by providing for a transfer of technology through equipment, business advisory support, and financing; franchising support could take place, for example, for such activities as gasoline retailing or in the social services such as health clinics;
- (iv) a management services facility (Appendix 4) that could address the shortage of qualified managers in Central Asian enterprises by providing foreign managers on performance-based contracts, and training for local managers; and
- (v) a company town restructuring initiative (Appendix 5) that pairs public sector and private sector operations to provide for institutional strengthening and for a commercially viable private enterprise.

II. INDEPENDENCE AND REFORM

A. Independence and Economic Distress

6. The breakup of the FSU in 1991 led to independence for the Central Asian republics. Independence came without warning and brought the immediate need to develop new political and economic institutions. In all cases the countries have made formal commitments to developing market-based economic institutions and a political system based on representative democracy. In practice, institutional development varies considerably across the region and in the best of circumstances will demand a long process of uncertain experimentation.

7. The disruption to the economy represented by independence resulted in a sharp contraction in output in most sectors. Firms in the Soviet Union were designed to satisfy the needs of the autarchic command economy in isolation from world markets and world prices. Energy products, capital goods, and transport services were heavily subsidized, resulting in widely dispersed, capital intensive facilities that were inefficient by world standards.¹ This complex system was severely disrupted with the general decline in FSU trade, the breakdown in the interrepublican payments systems, and the opening of domestic markets to competition from non-FSU countries.

¹ "The old regime generated a peculiar industrial structure and a capital stock totally unsuited to a market economy." European Bank for Reconstruction and Development (EBRD). 1996. *Transition Report*. London: EBRD, p. 3.

8. A complex of problems hinders a rapid restructuring of the farms and firms in Central Asia:

- (i) capital equipment is old, poorly maintained, and inefficient;
- (ii) there is nearly a complete absence of financing for new investments (para. 24);
- (iii) infrastructure facilities are in need of rehabilitation and policy reform, the recurrent electricity outages in different regions particularly hamper operations;
- (iv) as a result of Soviet central planning, there has been little opportunity to develop modern business skills such as marketing; and
- (v) information on markets for either sales or purchases is often hard to obtain.

9. The aggregate decline in gross domestic product between 1990 and 1995 ranged from 52.3 percent in Kazakhstan to 49.2 percent in the Kyrgyz Republic to 18.8 percent in Uzbekistan.¹ Table 1 provides the basic macroeconomic statistics for the Bank's three Central Asian developing member countries (DMCs). There does appear to be an end to the output contraction, and positive growth was recorded for 1996 and 1997 in all three countries; however, sustainable growth of a magnitude to redress the recent fall in personal income remains uncertain.

10. The social costs of this transitional period have been exceedingly high. The incidence of poverty has increased in all countries, although less in Uzbekistan than in Kazakhstan and especially in the Kyrgyz Republic. Rural areas have been extremely hard hit, and in the areas near ecological disasters such as the decaying Aral Sea, more than two thirds of the populace is living in poverty.

B. Significant Progress in Macrostabilization

11. Achieving macrostabilization proved to be one of the most difficult, but important tasks of the newly independent republics. Evidence from Eastern Europe as well as the FSU suggests that output can recover from the shock of initial contraction only several years after the determined stabilization measures are in effect.² Because the Central Asian republics lacked most of the necessary institutions to conduct appropriate monetary and fiscal policy, their quick recovery was inhibited. It was not until 1993 that the countries adopted their own currency, opting in the interim to continue to use the Russian Federation's ruble. As a result, until firm policies took effect, the countries had to contend with hyperinflation in addition to other macroeconomic problems common to all countries using the Russian ruble.

¹ The output contraction in Uzbekistan was cushioned by the ability to market cotton and gold in Western European markets and increased domestic oil production. For a more detailed discussion of the economies in the Bank's Central Asian developing member countries, see STS KAZ 96031: *Country Operational Strategy: Kazakhstan*, December 1996; CER:KAZ 97027: *Country Economic Review: Kazakhstan*, October 1997; STS KGZ 96029: *Country Operational Strategy: Kyrgyz Republic*, December 1996; CER:KGZ 97007: *Country Economic Review: Kyrgyz Republic*, July 1997; and CER: UZB 97024: *Country Economic Review, Uzbekistan*, October 1997.

² EBRD. 1996. *Transition Report*. London: EBRD, p. 7.

Table 1: Selected Economic Indicators:
Kazakstan, Kyrgyz Republic and Uzbekistan, 1991-1997

	1991	1992	1993	1994	1995	1996	1997
GDP Growth (% , in constant prices)							
Kazakstan	-14.9	-14.0	-12.9	-17.7	-9.1	1.4	1.5
Kyrgyz Republic	-7.8	-13.8	-15.5	-20.2	-5.3	5.6	10.4
Uzbekistan	-0.5	-11.1	-2.3	-5.2	-0.9	1.6	3.5
GNP Per Capita (\$, in current prices)							
Kazakstan		1900.0	1560.0	1160.0	1330.0		
Kyrgyz Republic		1020.0	850.0	630.0	690.0		
Uzbekistan		1000.0	980.0	950.0	970.0		
Inflation (annual percentage change)*							
Kazakstan	90.9	1381.0	1658.7	1878.3	175.8	39.1	20.4
Kyrgyz Republic	85.0	854.6	1208.7	278.1	42.9	30.3	25.0
Uzbekistan	82.2	635.9	481.9	1522.5	515.8	55.7	60.6
Government Budget Balance (% of GDP)							
Kazakstan	..	-6.8	-1.3	-7.2	-2.0	-2.5	-4.2
Kyrgyz Republic	4.0	-9.5	-7.4	-7.7	-11.5	-5.6	-4.8
Uzbekistan	-2.6	-18.5	-10.4	-6.1	-4.1	-3.3	-3.4

GDP - Gross Domestic Product

* Refers to year average.

Sources: Staff estimates

12. Price liberalization was an initial factor in the inflationary experience in the FSU; Soviet planners had kept the prices for many goods (especially energy related products) and services (especially urban services) below international levels. Price adjustments, however, were not the major factor behind the hyperinflation. Hyperinflation is a monetary phenomenon, and the growth in credit extended to loss-making enterprises was a major factor in the inflation.

13. The establishment of national currencies (the tenge in Kazakstan, the som in the Kyrgyz Republic, and the sum in Uzbekistan) in 1993, and the development of the tools of monetary control by the respective central banks, offered the governments the opportunity to target a reduction in inflation. By 1995, serious anti-inflationary action began to show results. In 1996, annual inflation had fallen to between 30-40 percent in Kazakstan and the Kyrgyz Republic, and to 56 percent in Uzbekistan. Anti-inflation activity is a continuing aspect of both countries' stabilization programs, which were developed and continue to be supported by the International Monetary Fund (IMF).¹

¹ In Kazakstan, the IMF's program uses an Extended Fund Facility. The Kyrgyz Republic's program is based on an Enhanced Structural Adjustment Facility. In Uzbekistan, the program is based on a Stand-by Arrangement approved in December 1995.

14. The development of the tools of fiscal policy has similarly offered considerable challenges to the Governments. Prior to 1991, fiscal policies and operations were largely determined by Soviet Union authorities in line with the State Economic Plan. Local officials had little input into decision making and little real authority. Expenditure needs of each FSU republic were covered by transfers from the central budget. For example, in 1989 in Kazakstan, Union transfers accounted for about 10 percent of GDP. The breakup of the FSU meant the loss of these subsidies but also other severe impacts on the fiscal balance. The generation of adequate Government revenues became difficult as output at state-owned enterprises (SOEs) declined. At the same time there were increased calls upon public sector resources due to the need to provide for social assistance to those affected by the economic depression and to provide for the basic needs of the new countries such as defense that had hitherto been provided by the FSU Government.

15. By 1995, significant progress had been made in improving fiscal performance in all three countries. This was largely as a result of expenditure control as increasing tax revenues proved difficult. The situation was less difficult in Kazakstan which drew on nontax revenues including those from privatization, and in Uzbekistan where the economic depression was relatively mild; than in the Kyrgyz Republic, which struggled with sharply constrained fiscal resources. In all countries, considerable efforts were made to rationalize the tax system through, for example, introducing value-added taxes.

C. Structural Reforms were Initiated

16. The programs and policies regarding structural reform will be key elements in determining the nature of this transition period for the countries of Central Asia. New institutions must be created, old institutions restructured, and a new policy environment designed. The process is neither simple nor quick. Institutional change is necessarily uncertain, and all previous steps must be continually reviewed and judged as to their suitability under current conditions. An analysis of the policy environment should consider three basic conditions: (i) reforms to encourage the creation of free markets; (ii) reforms to encourage competitive forces to develop; and (iii) programs to provide social protection. The following provides a comparative discussion of the extent of structural reform in the three Central Asian DMCs.

1. Reforms to Encourage the Creation of Free Markets

17. The development of markets is encouraged by the provision of some basic property rights including those related to use and ownership, transfer or sale, price determination, and market entry and exit.

- (i) Although ownership of land is generally not permitted, use-rights are technically available through long-term leases. In some cases, these use-rights are transferable, encouraging the development of land and property markets.
- (ii) The practice of mandatory sales to the Government at administered prices, especially for agriculture goods, is largely dismantled, at least in Kazakstan and the Kyrgyz Republic, allowing firms and farms to market as they choose. In Uzbekistan, the system of mandatory sales still exists for the important cotton and grain crops, although prices have been raised to roughly one half of world prices. The Government has committed to ending these mandatory sales requirements for grain in 1997 and for cotton in 1998.

- (iii) Price liberalization is generally complete allowing the development of prices as market signals. Exceptions to this include some urban services and energy product prices. In Uzbekistan, price controls still exist for bread and flour at the retail level, and for cotton and grain at the producer level. Foreign exchange markets are developed, and the Kazakstan and Kyrgyz currencies trade in relatively unrestricted markets.¹ The Uzbekistan Government maintains restrictions on foreign currency exchange prompting a wide divergence between official rates and unofficial street rates.
- (iv) The development of markets was aided by liberalizing the entry rights to markets, particularly the replacement of most licensing requirements by a registration process. Exit procedures were similarly reformed through the introduction of laws governing bankruptcy; however, few registered firms have actually failed. Export and import restrictions and tariffs were greatly eased after their introduction in the early 1990s. The countries in the region have applied to join the World Trade Organization.

2. Reforms to Encourage Competitive Forces

18. The development of competitive markets is a formidable, however, necessary task. Noncompetitive markets reduce efficiency and may result in inequitable distribution of income and wealth. Efforts to develop competitive market structures have focused on transferring assets to nonstate ownership.

19. In all three countries, the most significant progress is in the transfer of relatively small-scale assets to private sector ownership. Most of the countries' housing stocks, for example, are now transferred to private ownership. The privatization of other small assets, trade outlets, small farms, and service establishments is similarly largely complete.

20. Formal progress has also been made in medium- and large-scale enterprises in that many of these enterprises were reorganized on the basis of a joint-stock company (corporatized). However, substantive change i.e., change that results in commercially oriented behavior by firms, is lacking. Large-scale enterprise privatization has been the most problematic; only a small number of enterprises have been fully transferred to private sector ownership and control. Actions have taken place through procedures that lack transparency and sometimes accompanied by allegations of malfeasance. Most large enterprises remain subject to considerable government influence concerning employment and production; access to credit; and marketing and pricing.

21. The failure to successfully transform the large state-owned or controlled enterprises into viable private sector operations has a number of deleterious implications. The lack of efficient use of existing resources, both capital and labor, by these large firms has prolonged the output recession and inhibited the development of trade in both domestic and international markets. The firms often operate at a loss, which is covered by running tax, wage, or other payment arrears, and, in some cases through public subsidies. The large interenterprise payment arrears weakens efforts to control credit and inflation, and discourages

¹ Both Kazakstan and the Kyrgyz Republic subscribe to Article VIII of the IMF Articles of Agreement limiting the restrictions on foreign exchange transactions.

a commercially oriented financial sector. Tax arrears and public subsidies undermine fiscal management and inhibit macrostabilization efforts.

3. Reforms to Provide Social Protection

22. Social protection is an essential element of successful transition. If the transition period is perceived as failing to provide for social equity and justice, then governments risk the loss of popular support for reform. Similarly, the lack of widespread participation in the benefits of transition or in the equitable sharing of the costs will ultimately limit economic performance and policy sustainability.¹ As a result of the output contraction and the loss of Soviet subsidies for social assistance there has been a widespread increase in poverty. Public assistance is especially needed to reduce the impact of the transition on the most vulnerable including children in poor families and elderly women pensioners.² This is an essential element of good governance. Comprehensive social support needs to be provided through reformed social insurance programs, increased social assistance payments to the truly needy, and adequate levels of public support for social services such as health and education. Reform of these systems requires improved beneficiary targeting and increases in efficiency.

23. A particularly difficult problem in improving the delivery of social services stems from the ongoing privatization program. Under the FSU system, medium and large firms had the responsibility to provide many social services through kindergartens and health clinics. These services were provided through the complex system of subsidies characterizing Soviet central planning. With the breakdown of central planning and as firms face increasingly competitive market tests under conditions of hard budgets, these social services are being either closed or transferred to local governments. There is scope for private sector provision of many of these services, however, the policy environment is at present ill-defined and the weakness in family income discourages prospective entrants.

D. A Severely Limited Financial Sector

24. The financial sector in all three countries is heavily dominated by the handful of successor banks of the FSU banks. In Uzbekistan, for example, two of these (the Agroprombank and the Promstroibank) account for 90 percent of all lending to enterprises. These successor banks as well as the newly created banks typically lack expertise in commercial banking practices and have large portfolios of nonperforming loans to former or current SOEs.³ There is widespread lack of confidence in the commercial banking system, weakening incentives to use the system. Nascent nonbank financial enterprises and capital

¹ From the standpoint of providing for political support for the reform process, the issue of social protection becomes more important, because, at least in some significant respects, those groups that have benefited from the reforms thus far have sometimes done so from inequitable manipulation of the process of transferring formerly public assets to private hands (EBRD 1996, p. 29).

² The issue of the social costs of transition was discussed in two recent Bank publications: ADB. 1997. *Women and Gender Relations: The Kyrgyz Republic in Transition.*; and ADB. 1997. *Women and Gender Relations in Kazakstan: The Social Cost.*

³ The experience in Central Asia is typical for Euro-Asian transition economies, see for example Fries, Steven, ed. 1994. *Transition: Private Sector Development and the Role of Financial Institutions*, working paper no. 13, EBRD, London.

market institutions typically have little overall net impact. For the most part, credit is simply not available for farms or firms in Central Asia. Exceptions include some trade financing; limited informal sector financing; and public, directed credit programs.

25. The failure to establish viable financial sectors seriously limits the growth of the private sector and weakens macrostabilization efforts. The development of new markets, especially international markets, demands reinvestment in existing firms and support for the creation of new enterprises. The lack of loanable funds restricts this needed investment. The difficulties faced by SMEs in obtaining trade or investment credit are particularly severe. The dearth of commercially oriented lending by banks has contributed to the growth of payments arrears, delays the necessary restructuring of farms and enterprises, and weakens credit control by the monetary authorities.

E. Limited Development of Private Sector

26. The difficulties in establishing a market-based economy are particularly pronounced in the industry or enterprise sector. Industries in Soviet Central Asia developed as integral parts of the FSU's centrally planned economy. Enterprises provided their products to other Soviet firms and were highly dependent upon input supplies from the FSU. In many cases, industries were established as part of the Soviet military-industrial complex. This was particularly so in Kazakstan where manufacturing centers were concentrated in the northern cities (such as Karaganda, Pavlodar, and Semipalatinsk) and around the southern city of Shymkent. In addition, 40 to 50 company towns were developed in Kazakstan. These are isolated urban areas formed around large integrated industrial activities. In these towns, one enterprise provided nearly all employment in the area plus a whole range of social infrastructure, including schools, health facilities, and urban utilities.

27. A particularly difficult pattern of development is emerging as a result of the difficulties facing firms and farms: they are turning inward, producing with minimum inputs and limiting sales efforts to traditional markets in the FSU. Farms operate with no pesticides; factories make do with obsolete equipment. Central Asian goods from Soviet-era producers are characterized by low quality and inconsistent production. The goods can only be sold for low prices in markets with limited effective demand. Low prices constrain revenues and the firms and farms are caught in a vicious circle that limits growth and restructuring.

28. Recovery of the industry sector will then require the general rebound of aggregate demand in the country and the region. More importantly, however, sustainable recovery will require a thorough restructuring. The restructuring must move production techniques and products away from that designed for the Soviet command economy and toward responding to newly emerging market demands. As noted, in this activity the lack of a viable financial sector presents particular barriers. The development of a viable private sector must also deal with the legacy of more than 70 years of the Soviet system that actively discouraged entrepreneurial behavior and the development of business-related skills.¹ Firms and farms in Central Asia face increasingly competitive markets with managerial and labor skills developed to meet the requirements of a command economy. Retooling capital equipment must be accompanied by labor retraining at all levels.

¹ Borton, Nan, et al. 1992. Supporting Private Enterprises in Uzbekistan: Challenges and Opportunities, GEMINI, Bethesda, MD., p. 12.

F. Need for Continued Reform and Assistance

29. The unfinished reform agenda is a critical element in determining the prospects of the Central Asian economies in general, and the development of the private sector in particular. In this regard, much of what could be done easily, by administrative fiat or other action by the central government, is done. In addition, many difficult reforms with a clear focus, such as stabilization policies to reduce inflation, are implemented. What remains to be done is neither simple nor clearly defined. Many needed actions require considerable institution building, for instance the development of viable tax collection systems. The process of significantly reducing the unfinished reform agenda will require considerable time and is inherently one of uncertain experimentation. In the near term, three broad areas must receive attention: (i) the delineation of the proper role of the public sector; (ii) development of legal and regulatory institutions; and (iii) the strengthening of the financial sector.

1. Public Sector Must Be Confirmed in its Proper Sphere

a. Privatization Must Move Assets to the Private Sector

30. Without new investment to clear accumulated arrears and provide for technology transfer and working capital, and without assistance to develop new managerial skills, such as marketing, many old Soviet-era enterprises face limited futures, if not liquidation. As a result of a concern with the social impact of liquidation, unreconstructed enterprises may well remain wards of the state, operating for little economic purpose and supported by subsidies.

b. Divestiture Must Move Assets to the Public Sector

31. In many instances, former state-owned enterprises had responsibility for a number of public sector regulatory, administrative, and service functions. These must be divested and given proper support within a strengthened public sector institutional framework. The problem has serious welfare implications in the service sector: many local health posts or schools, especially preschools, were maintained by the state-owned enterprises and, in the absence of the former budget subsidies from the Soviet Central Government and in a new and harsher competitive environment, many of these facilities have been closed. This reduces the availability of social services and reduces employment possibilities. The impact of these closings has been particularly harsh for children who miss the human resource development provided to earlier generations and for the employment of women who formerly staffed these facilities. In the context of widespread and growing poverty, these are particularly serious issues.

2. The Development of Legal and Regulatory Institutions

32. Economic recovery on a sustainable basis will require a thorough restructuring of farms and firms, and the establishment of a new system of market-based incentives. Production techniques and products must be moved away from those designed for the Soviet command economy and toward newly emerging market demands. This will require substantial completion of the unfinished reform agenda, particularly for (i) improvement of the legal environment, and (ii) the creation of regulatory institutions.

a. A Legal System Must be Developed

33. To create a responsive and well-established legal system that is supportive of private sector operations, a systematic approach to legal reform must be adopted. This implies a move away from a purely reactive approach to specific problems toward an approach that seeks to understand and take into account the working of the legal system as a whole. A systematic approach to law reform involves shifting the focus of the law reform efforts away from normative law reform, i.e., writing up new laws, though it must still be maintained, towards strengthening the institutional capabilities of the judiciary and government agencies through training, including continuing legal education for existing professionals. In addition to training, comprehensive judicial reform programs will have to be undertaken, including the introduction of modern court management systems, training for judges and other judicial personnel, improving court management information systems, and improving physical and technical facilities supporting the judiciary.

b. Regulatory Bodies Must be Created and Strengthened

34. Complementary to the development of a modern legal system, the regulatory structure of the government must be created and modernized. The shift to reliance upon the private sector for goods and services previously supplied by public enterprises demands, in many instances, the creation of a regulatory environment. Environmental or safety standards, in particular, were previously the responsibility of Soviet firms. These must now be established in accordance with market-based norms and defended by public institutions. Prices that were once simply accounting conventions by central planners must now be brought into existence in such a way as to guide the operations of public utilities presently being shifted to private sector control. The absence of well-functioning regulatory bodies risks leaving vital economic decisions either to undeveloped markets or to the political arena with concomitant costs for the development of the nation. The need for adequate regulatory bodies is apparent in a wide range of sectors including transportation and energy. These bodies require support by legal institutions; support that would discourage a continuation of administrative interference in developing market institutions.

3. The Financial Sector Must be Strengthened

35. The absence of a well-functioning financial sector is impeding enterprise restructuring and macrostabilization. Central to a strengthened sector are banks that act as true financial intermediaries, provide loanable capital to borrowers on market-based conditions, and encourage savings particularly by the household sector. During the first few years of this transition period, banks simply acted as conduits for directed or subsidized credit without expectations that loans would be repaid. Banks must be restructured, relieved of their portfolio of nonperforming loans, and provided an incentive structure that encourages proper credit extension and savings mobilization. Initial programs are established in all countries and some of the more politically difficult decisions made: in particular some banks were allowed to fail or were administratively restructured. This must continue, but without foreign participation—without outside investment in the sector—bringing modern banking skills, the development process may be slow. Public sector programs, for example to provide lines of credit, are also important, especially to prevent a return to the earlier conditions of a downward spiral in output.

III. THE ROLE OF FOREIGN DIRECT INVESTMENT

36. There is widespread recognition of the benefits of foreign direct investment (FDI) in private sector enterprises in Central Asia. Foreign investment provides the funds for capital equipment, the contact with international markets, and the skills necessary to compete in these markets. One important element that foreign investors can bring is an emphasis on good corporate governance, through demonstration as well as active partnership in projects. All three DMCs in the region have taken considerable efforts to create conducive climates for FDI.

37. In some sectors there has been signal success in attracting FDI. In Kazakstan, for example, in 1996 FDI was estimated to be \$859 million, approximately the same as the average recorded for the past three years. The funds from FDI were often concentrated in a relatively few sectors: in mining; oil and gas; and agriculture, specifically in tobacco.¹

38. The FDI activity in these sectors, especially oil and gas will play an important role in the medium- and long-term prospects for the country. However, in Kazakstan, as in much of the rest of the world, oil and gas reserves can be developed as enclave industries, independent of the existing economic structure and having little direct development impact. Unless current conditions change, much of the planned FDI will play little or no role in transforming existing enterprises and farms, and will have no direct impact on the development of SMEs.

IV. ASSISTANCE FROM MULTILATERAL AND BILATERAL SOURCES

39. The World Bank has recognized the importance of multilateral assistance to the private sector. In its most recent Country Assistance Strategy for Kazakstan, for example, a joint product for both the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), two strategic priorities were adopted to guide the program for the next three years: private sector development and social protection. This is somewhat more narrow strategic focus than previously adopted, however, it can support a fairly broad program. For instance, policy and legal reforms, infrastructure investment, and strengthening of the banking sector are correctly identified as inherent parts of providing assistance to the private sector; as important as direct investment.

40. Within the World Bank group, direct support to the private sector (nonpublic guaranteed resource provision) is the responsibility of IFC. The potential program of IFC covers a wide number of sectors: "investments in selected nonextractive activities, small- and medium-sized industrial enterprises, and financial institutions; participation in certain large-scale oil or gas and minerals activities and in the post-privatization restructuring of large enterprises" ² The program to date, however, has been rather more focused. As of May 1997, the IFC had approved seven projects, six in finance and one in oil field development.

41. By sector, the prospective program of the World Bank group targets (i) postprivatization restructuring of large enterprises; (ii) support for SMEs including financing and business skills development; (iii) financial market support including continuing their strong

¹ The data on FDI are on a disbursement basis. On a commitment basis, by the mid-1990s, Kazakstan attracted upward of \$45 billion in FDI. Chevron Corp. alone committed approximately \$20 billion [EIU 1996-Q4, p. 51].

² World Bank. 1997. Country Assistance Strategy: Kazakstan, July, p. 15.

program in commercial banking; and (iv) continued work on improving the policy environment. Consistent with the arguments given earlier in this paper, one key element in the World Bank program, is the recognition that assistance to the private sector requires an integrated approach, bringing together a number of World Bank instruments. One program will specifically focus on (i) extending IFC's Reach Initiative, which brings IFC resources to bear on relatively small projects; (ii) establishing backward linkages from large enterprises to the SMEs through, for example, business advisory services; and (iii) supporting financial market development.

42. The European Bank for Reconstruction and Development (EBRD) has an explicit mandate to target the major portion of its lending to the private sector. The strategy of EBRD in Kazakhstan, for example, provides for broad assistance to the country, emphasizing (i) the financial sector; (ii) SME assistance; (iii) oil and gas investments; (iv) mining, processing, and manufacturing projects; and (v) infrastructure, including transportation and power. As part of this program, EBRD has an active program of technical assistance to the Government to assist in legal reform supportive of the private sector. A major aspect of EBRD work, however, is credit provision. In Kazakhstan, for example, EBRD has focused thus far on providing lines of credit for SMEs and for a postprivatization support fund. The SME lines are being restructured to focus more on microcredit. Prospective projects range across the above strategic spectrum but in practice there appears to be an emphasis on energy projects.

43. The postprivatization fund of EBRD is operated with technical assistance provided by the European Union's TACIS program. This fund is similar to those EBRD has established in other FSU republics. In Kazakhstan the fund is managed by a private investment firm, the Belgium GIMV. The fund targets medium-size enterprises, providing equity investments supported by business-oriented technical assistance. The fund is designed to operate for ten years and exit procedures are an important part of any project. The \$40 million investment fund is supported by approximately \$2-3 million per year in technical assistance, from European consultants. Although operating only for one year and having approved only three projects, EBRD and TACIS believe that this project structure fills a definite transition need for the region and are reviewing plans to establish a second parallel fund. Staff at the postprivatization fund emphasize that they have concentrated their efforts primarily in the Almaty region, and that there is considerable need for their type of service throughout Central Asia.

44. The United States (US) provides considerable assistance to the private sector through technical assistance to the Government for policy review and reform, and through direct support to private sector enterprises. The former encompassed a wide range of areas and been supportive of Bank activities in a number of specific projects, most recently in the processing of Bank loans to the Kyrgyz Republic to further institutionalize corporate governance, and in Kazakhstan to advance pension reform. US direct support to private enterprises has also taken a large number of directions, the most notable being the Central Asian-American Enterprise Fund (CAAEF). CAAEF has operated since 1995 to provide equity and loan funds to SMEs. With offices in all five Central Asian republics, CAAEF has committed \$50 million, and disbursed \$30 million to 25 enterprises. A smaller program to specifically target small enterprises has provided 50 loans. Staff of CAAEF note that there is a great demand for their services but they are restricted to a somewhat passive selection of business projects in that their ability to provide business-oriented technical assistance is limited.

V. A ROLE FOR THE BANK

A. Bank Programs in Central Asia

45. The three DMCs from the region joined the Bank in 1994 and 1995.¹ The Bank's programs in Kazakhstan and the Kyrgyz Republic developed from relatively noncomplex special assistance loans to policy based-lending and investment activities in both infrastructure and the social sectors. The relatively newer program of assistance in Uzbekistan focuses more on project assistance.

46. Bank strategies were developed for Kazakhstan and the Kyrgyz Republic, and an interim strategy drafted for Uzbekistan in the context of the first economic report for the country.² Even though the countries differ greatly in the size of the economy and their resource base, owing to similarities in their transition experience and the presence of other funding agencies there are common elements in the Bank strategies across the region. (Box 1 provides a summary of the main elements of the Bank's strategies for the three Central Asian DMCs.) In all three countries the Bank is committed to providing assistance in transport, and is the lead funding agency in road transport. The Bank is similarly committed to providing assistance in agriculture in all three countries, and has provided program loans in Kazakhstan and the Kyrgyz Republic to support reforms in the sector. In the social sectors, the Bank is the lead funding agency providing assistance to the governments in education. Of most relevance to the discussion in this paper, the Bank is committed to assisting SMEs in Kazakhstan and Uzbekistan, and to supporting the overall reform program for enterprises in the Kyrgyz Republic. Table 2 provides a list of Bank projects in enterprise development.

¹ Kazakhstan joined the Bank on January 1994; the Kyrgyz Republic on April 1994; and Uzbekistan on August 1995.

² ECR:UZB 96019: *Economic Report on Uzbekistan*, September 1996.

Box 1: Bank Strategy and Sector Concentration in the Central Asia DMCs

Kazakhstan

Strategic Focus

- Support the Government's reform agenda, encouraging institutional change, and strengthening the provision of public services.
- Promote the rehabilitation of the environment.
- Strengthen the long-term potential for the country by investing in physical infrastructure and in human resource development.
- Encourage the creation of a new structure of output and new production capacity through private sector investment.

Sectoral Concentration

- Strengthen management of reform at the level of the Central Government and local government
- Infrastructure, especially rehabilitation projects
- Education and training
- Industry, focusing on the problems of medium-sized enterprise reform
- Agriculture

The Kyrgyz Republic

Strategic Focus

- Support the Government's reform activities and strengthen development management
- Encourage the creation of a new structure for output and capacity by the private sector through investment and job creation.
- Arrest the rapidly deteriorating long-term potential of the country by investing in physical infrastructure and human resource development, but also by selective interventions to protect the environment.

Sectoral Concentration

- Improvements in the provision of public services
- Agriculture, including rural finance
- Human resource development, especially education
- Infrastructure, especially rehabilitation projects

Uzbekistan

Strategic Focus

- Support policy reform, capacity building and institutional strengthening
- Improve efficiency and support cost-effective investments in rehabilitation
- Support reforms directed at private sector development, enterprise restructuring and post-privatization issues.

Sectoral Concentration

- Agriculture and agro-industry, especially small and medium enterprises, and water management
- Transport infrastructure, particularly the railway subsector
- Education

B. A Division of Labor with EBRD

47. Previous even to the start of Bank operations in Central Asia, discussions between the international funding agencies focused on the need to coordinate activity. In particular the unusual circumstance of countries eligible to join two regional MDBs had to be addressed: surviving republics of the FSU, which had been a member of the Economic and Social Commission for Asia and the Pacific, are formally eligible to join both the Bank and the London-based EBRD. To reduce unnecessary duplication of effort, a Memorandum of Understanding (MOU) was signed between the Bank and EBRD, such that it was understood that the Bank would take the lead in public sector areas, particularly the social sectors and infrastructure projects, while EBRD would take the lead in private sector projects and those public sector projects that would generate foreign exchange. The MOU was expected to be “interim in nature and subject to a review after the completion of the first programming cycle of ADB’s operation in each Central Asian Republic (CAR).” (Appendix 6)

Table 2: Bank Projects in Support of Enterprise Development in Central Asia (1995-1997)

TA/Loan Name	TA/Loan Amount (\$'000)	Date of Approval
Kazakstan		
Industry and Enterprise Sector Reform (TA)	600	20 Mar 1995
Financial Sector Advisory (TA)	600	11 Oct 1995
Pension Reform (Loan and TAs)*	101,880	16 Dec 1997
Kyrgyz Republic		
Industry and Trade Sector (TA)	600	3 Feb 1995
Preparation and Implementation on Best Practices in Corporate Governance (TA)	100	13 Dec 1996
Corporate Governance and Enterprise Reform Program (Loan and TA Loan)	44,000	25 Sept 1997
Pension Reform (TA)	680	23 Dec 1997
Uzbekistan		
Institutional Strengthening of the National Bank of Uzbekistan	830	17 Dec 1996
Rural Enterprise Development (TA)	100	17 Dec 1996
Rural Enterprise Development (Loan)	50,000	17 Dec 1996

TA = Technical Assistance.

* Loan approval date

48. The MOU helped the Bank focus its activities in the countries and develop expertise in what was then a new region of work for Bank staff. However with the evolution of Bank assistance and with the increasingly difficult circumstances accompanying transition, the respective governments asked for a reconsideration of the division of labor implied by the MOU and for the Bank to become active in direct assistance to the private sector.

49. There is a clear need to provide more flexibility in Bank assistance programs. The Bank, for example, has become active in promoting privatization, policy reform, and even financial assistance through public sector financial intermediaries. However, the long-term

impact of these programs and the ability of the Bank to directly follow up on its first efforts will be severely limited unless it begins to directly conduct private sector operations.¹

50. The need is most obvious in those programs that have promoted privatization. In the agriculture program loans, for example, to Kazakhstan and the Kyrgyz Republic, the Bank encouraged the Government to initiate privatization exercises for state enterprises.² As seen in all FSU transition economies, privatization is a difficult and uncertain process. Most initial exercises accomplish little more than formal or legal restructuring and do not in fact lead to substantive differences in organizational behavior. Under current guidelines, the Bank can provide assistance to remove an enterprise from Government control, but not then directly provide support for the needed restructuring or movement into new markets. Funding exercises that only work for or through public sector entities would defeat the major goal of reform to develop appropriate market-based institutions.

51. The current operating guidelines restricting Bank assistance to the public sector limit Bank assistance in Central Asia in the large gray area of enterprises that are neither truly private nor public, within markets that lack many of the necessary supporting institutions. Moreover, in some sectors there are definite advantages to developing a mixed ownership and management system. For instance in the social sectors it is not unknown to find a diverse mixture of public, semipublic, or private ownership and management structures existing. In countries with well-developed private and public sector institutions, this range of structure evolved over considerable time. In Central Asia the need to hasten the evolution of appropriate ownership and management structure is great. As with most reform activities, initial efforts must be followed up, to respond to the unmet need and the changing economic environment.

C. Guidelines for Bank Private Sector Operations in Central Asia

52. The Bank can respond to the needs of the region by introducing the flexibility within its programs to provide direct support to the private sector. The operations should not seek to duplicate those of other funding agencies. There would be little need for the Bank to undertake extensive support for the purely commercial investments that can be fully supported by EBRD or IFC. Rather the Bank should actively support private sector operations by following these guidelines:

- (i) Focus on private sector operations that are directly complementary to public sector programs.
- (ii) Develop programs in those sectors that can have a direct impact on reducing the costs of transition, particularly the social sectors.
- (iii) Seek the maximum involvement of other investors or participants.

¹ The difficulty in ensuring the development of the private sector in the Central Asian republics was implicitly noted in the *Strategy for the Bank's Assistance for Private Sector Development*, which emphasized the special needs of transition economies. R56-95, 17 February 1995, paragraph. 41.

² Loan No. 1406-KAZ: *Agriculture Sector Program*, for \$100 million, approved on 23 November 1995 and Loan No. 1407-KGZ: *Agriculture Sector Program*, for \$40 million, approved on 23 November 1995.

1. Build on Public Sector Programs through Complementary Private Sector Activities

53. This guideline echoes the theme established in the Bank's Strategic Directions for 1995-1998, of the importance of providing "an integrated package of policy support, capacity building and investment services..."¹ The strength of the Bank is that it has well-developed public sector programs and that private sector operations can be conducted by the same units within the Bank that are doing the public sector operations. Potentially this provides for close coordination and, equally important, the ability to incorporate lessons learned from one operation into the design and implementation of another. It will be particularly important to actively participate in private sector projects so as to judge the actual progress of many public sector reform programs. Knowledge gained in private sector operations will be of considerable use in the ongoing policy dialogue with the governments regarding the pace and direction of reform in a number of different sectors.

54. In this respect, the Bank may be able to develop a comparative advantage with respect to the other MDBs. The World Bank Group, for example, conducts private sector operations through IFC not IBRD or International Development Association (IDA), which are responsible for public sector operations. Although there is close coordination between the agencies, there is considerable potential for the Bank, working within the same division for complementary activities, to develop true synergy between public and private sector operations. EBRD, although involved in some public sector investment projects, does not attempt to provide extensive support for policy reform.

2. Target Sectors that can Directly Reduce the Costs of Transition

55. The serious output contraction accompanying independence has resulted in widespread poverty and unemployment. The accompanying fiscal crisis exacerbated this by limiting public support, especially in the social sectors. The Bank's program seeks to support the governments' efforts to redress this situation by providing technical assistance and loan funds especially in education where there is limited support from other funding sources.

56. The potential for private sector provision of social services varies considerably across the sectors. In some countries, for instance, health and education facilities can be found that are publicly owned and managed; facilities that are privately owned and managed; and facilities that offer mixed public or private ownership or management structures.² The Central Asian countries are moving away from complete public ownership and management, however, the restructuring has often been conducted in the midst of a crisis and with little institutional capacity, especially at the local level. Thus social service facilities, once operated by state enterprises, have been divested to local governments without the financial capacity to maintain

¹ Asian Development Bank. 1995. The Bank's Medium-term Strategic Framework. Manila, p. 8. This is in the context also of the recognition of the need for the Bank to act as a catalyst to "greater private sector investment."

² See the discussion in Torres, Gerver and Sarita Mathur. 1996. The Third Wave of Privatization: Privatization of Social Sectors in Developing Countries, First Steps, The World Bank, October.

them. The massive closure of kindergartens in the Kyrgyz Republic, for example, is one example of this process.¹

57. The existence of private sector, social service facilities in other countries, particularly for kindergartens and health posts, suggests the potential for this in Central Asia.² However, without external support the development of private sector, social service facilities is likely to be slow. Field work suggests, for example, that the tax structure and regulatory environment discourages the opening of private schools. Moreover, the same lack of managerial skills and working capital that exists in other sectors limits domestic social sector entrepreneurs. This is a sector in which outside funding may admittedly not yield a high rate of financial return, however, the economic return including the lower social costs of transition may indeed be high.

3. Seek the Maximum Involvement of Others

58. The demonstration impact of Bank investment in the private sector and obtaining the highest impact of relatively scarce staff and budgetary resources, can be ensured by seeking maximum involvement of other participants. In part this is simply the normal policy of the Bank in private sector operations. However, given the need to encourage the development of new ownership and management structures, the need to widen project participation from both domestic and foreign sources is greater in Central Asian operations than in other countries. The encouragement of FDI through this activity is particularly important.

D. A Prospective Sectoral Approach

59. The potential for active support to the private sector by the Bank in Central Asia varies across countries and sectors. The discussion following provides some direction for future programming in the financial sector, infrastructure, industry, agriculture, SME assistance, and social infrastructure.

1. Financial Sector Support

60. Direct support for the financial sector may be needed to encourage the development of financial intermediaries. Investment in and managerial support for commercially oriented financial institutions will directly aid the development of this important sector. The involvement of the Bank would ensure that good corporate governance is practiced, providing a demonstration effect for the sector. Involvement in private sector financing will provide feedback on the state of the evolving policy environment, contributing to the Bank's policy dialogue with the governments. The Bank's activities should not seek to duplicate other efforts by multilateral or bilateral funding sources. Rather they should be directed toward specific sectors or regional locations where the impact of the investment would be the greatest.

¹ In the Kyrgyz Republic, the number of kindergartens fell from 1,604 in 1991 to 449 in 1996.

² The issues in health are discussed in the recent Newbrander, W. ed. 1997. *Private Health Sector Growth in Asia, Issues and Implications*. Chichester: John Wiley and Sons.

2. Infrastructure

61. The Soviet economic system was characterized by a predilection for capital-intensive activities. This included the extensive development of infrastructure systems in energy, transport, irrigation, and urban water and sanitation. These systems suffered from inefficient design, construction, operation, and maintenance. Thus, unlike many other DMCs, except in some specific sectors or locations, there is less of a need for new infrastructure investment than a need to rehabilitate existing systems and ensure that the operations are on a sustainable basis. Rehabilitate and operate (Rehab-Op) projects are needed more than build-operate-transfer projects.

62. Kazakstan in particular has aggressively initiated rehabilitate and operate projects in public utility sectors. The long-term prospects for some of these experiments are in doubt owing to weaknesses in the public sector, as well as inexperience and lack of resources in the private sector. The public sector often lacks the core regulatory, legal, and administrative institutions needed for efficient and equitable provision of private sector utility services on a long-term basis. The private sector is similarly hampered, especially by the lack of a broad, well-functioning capital market that would provide an independent measure of performance as well as investment funds.

63. Bank initiatives in private sector rehabilitate and operate projects will be a source of confidence and provide comfort for other lenders and investors, particularly foreign enterprises that can provide for a transfer of technology and managerial skills. Companion or parallel public sector policy-based operations could help ensure the continued development of the policy environment. Bank participation in infrastructure projects could also help to encourage the development of good governance practices such as the use of competitive bidding and contracting in construction and maintenance activities. This could be particularly important in encouraging the development of competitive markets in the energy and transport sectors.

3. Company Towns

64. The industry sector, especially energy, has received considerable attention from external funding sources. The Bank must carefully target those areas of the greatest potential development impact, to avoid duplicating the efforts of others. The very serious issue of company towns, for example, may be a target for Bank activities in Kazakstan. These localities need a coordinated program of support both on the public side and the private side. On the public side, local-level government services need to be strengthened; their efforts made more productive, supported by a sustainable level of financing, and more closely targeted to the needs of the community. This will involve programs of institutional strengthening, infrastructure investment, and policy reform. At the same time, large enterprises must be restructured: new business plans adopted, investments made, management practices improved, and the labor force rationalized. The Bank potentially has the ability to provide this integrated program of assistance. One possible program is described in Appendix 5.

4. Agriculture

65. The Bank has provided policy-based assistance in agriculture in both Kazakstan and the Kyrgyz Republic; and is processing public sector investment projects in all three Central Asian DMCs. For instance, the Bank has been encouraging the development of private sector farming by supporting the privatization of farms and farm equipment, and of SOEs involved in agro-processing; by supporting the restructuring of farm services such as irrigation; and by

helping establish an enabling environment with nondistortive tariff structures. This work has provided some impetus to the development of private farming, most notably on small farms or garden plots. However, substantive reform is inhibited by a general lack of postprivatization support including credit. Those private sector investments undertaken by foreign firms tend to be somewhat conservative, limited mainly to contract farming projects.¹ The restructuring of the large farms in Kazakhstan is especially problematic, involving many of the same issues as found in large-scale industrial privatization.

66. Complementary to public sector projects, private sector operations in agriculture could provide vital postprivatization support. The Bank could act, for example, through equity investment, to encourage foreign agriculture enterprises to invest in farms providing for a transfer of skills such as marketing. The Bank is extremely well placed to support such activities with public sector projects such as infrastructure rehabilitation in irrigation or farm-to-market roads. The complementarity would increase project quality in both the public and private sector operations. One possible program is described in Appendix 2.

5. SME Assistance

67. The development of viable SMEs is a key challenge for the governments in Central Asia. The Soviet economy was based on horizontal and vertically integrated monopolies of unprecedented scope. The collapse of this system has left a vacuum in those areas, such as services that are in most market-based economies filled by SME activity. Viable SMEs would improve the efficiency of the economy, lower costs for larger firms, widen employment prospects, and increase the tax base.

68. The development of SMEs is hobbled by many of the same problems limiting restructuring in existing firms: lack of capital and market-based skills. Existing government programs of assistance to SMEs are small in relation to the need in the economy. Although they can provide valuable support to the sector, they should be supplemented by nongovernment credit programs. Among the many avenues of possible assistance are the provision of licensing facilities (Appendix 3) and managerial services (Appendix 4). Programs such as the EBRD/TACIS postprivatization support fund offer models for possible Bank activities. The Bank can in particular make a contribution by bringing to the region the experience of its Asian DMCs in dealing with enterprise development. This could be done through technical assistance using consultants with experience in Asian countries and through training programs for Central Asian business people in member countries. A possible Bank project is in Appendix 1.

6. Social Infrastructure

69. The breakup of the FSU resulted in a severe shock to the social services sectors. Previously, widespread health, education, and communal (housing, urban infrastructure) services were provided by state enterprises or public agencies, supported through generous subsidies from the budget of the Central Government. The Bank has taken the lead role among international funding agencies in supporting the education sector in all three Central Asian DMCs. Thus the Bank may be the only major funding agency that can address the policy issues, provide comprehensive public sector support, and encourage the private sector in this vital

¹ See for example, the short listing for Uzbekistan in Borton, Nan et al., 1992. Supporting Private Enterprises in Uzbekistan: Challenges and Opportunities, GEMINI, Bethesda, MD. p. 25.

sector. In some cases, private sector social service provision may be encouraged through business licensing or franchise operations that provide financial support, technology transfer, training, and market development support. See the general discussion in Appendix 3.

70. The five appendixes provide further illustration of possible bank activities, the programs described are

- (i) An SME financing and business advisory service that will provide credit but also the business services to ensure that credit will actually be used to improve productivity and widen markets (Appendix 1);
- (ii) technical assistance in agriculture (Appendix 2), providing prefeasibility studies on a range of possible agriculture and agro-processing activities that can be presented to potential entrepreneurs, both domestic and foreign; these studies could potentially lead to new investment activities that could be supported by the Bank;
- (iii) a business format licensing and finance facility (Appendix 3) that could support small enterprises by providing for a transfer of technology through equipment, business advisory support, and financing; franchising support could take place, for example, for such activities as gasoline retailing or in the social services such as health clinics;
- (iv) a management services facility (Appendix 4) that could address the shortage of qualified managers in Central Asian enterprises by providing foreign managers on performance-based contracts; and
- (v) a company town restructuring initiative (Appendix 5) that pairs public sector and private sector operations to provide for institutional strengthening and for a commercially viable private enterprise sector.

VI. THE IMPLICATIONS FOR THE BANK

71. Direct support for private sector enterprises in Central Asia, given the difficult policy and market environments, may well entail relatively high administrative costs, unless innovative management techniques are adopted. The recent IFC initiative to set up a Small Enterprise Fund is an example of what can be done. The Fund commits \$40 million in loan and equity resources to be directly provided in investments as small as \$100,000. Project identification and appraisal are designed to be managed without need of Board approval.¹ The EBRD/TACIS postprivatization support fund discussed earlier is another example, committing \$40 million in investment credit, supported by \$2-3 million per year in technical assistance.

72. The implications for the Bank, in terms of budget or staff, depend on the commitment to action. At a minimal level of operations, some private sector activities could be folded into public sector projects as components. For example, the technical assistance project in agriculture, described in Appendix 2 could be processed as a normal project preparatory

¹ Miller, Stephanie and Richard Rutherford. IFC's Small Enterprise Fund Reaches Out. *Transition*, November-December 1996, (7/11-12), pp. 20-22.

technical assistance in the course of regular project processing. This would still involve additional staff work and some additional administration costs including consultants. At the other extreme, some projects should not be undertaken without specific dedication of staff and will require substantial technical assistance and loan fund commitment. The operation of an SME Financing and Business Advisory Service, for example as described in Appendix 1, would benefit from a high level of staff commitment, ensuring that activities are carried out in a fiscally responsible fashion in line with the Bank's philosophy on development. In addition, some activities would involve the joint participation of more than one department, and may be administratively cumbersome.

**POSSIBLE BANK PRIVATE SECTOR INITIATIVE IN CENTRAL ASIA:
CENTRAL ASIAN FACILITY FOR SME FINANCING & BUSINESS ADVISORY SERVICES**

1. The steady progress of privatization programs in the region is creating two broad types of issues that need resolution. On one hand, the privatization of large enterprises is causing serious unemployment, particularly in single company towns. Mass privatization, on the other hand, has created a new class of business owners who are generally unfamiliar with techniques of corporate finance and business strategy. Operating, as they are, with outmoded capital assets they are unable to take advantage of growing potential markets, both domestic and foreign, for competitively priced, better quality goods. Unless the owners of these newly created small- and medium-scale enterprises (SMEs) are able to improve their operations, they are likely to find themselves trapped into producing relatively low quality goods for sale in weak markets, unable to develop revenues to support growth and productivity improvements.

2. The problem of weak SMEs is compounded by the fact that the governments in the region are trying to combat unemployment—particularly the major dislocations caused by privatization of the larger enterprises by encouraging newly unemployed workers to set up their own businesses through devices such as the creation of small business incubators, without having in place the rest of the supportive environment necessary for SMEs to flourish. Such policies run the risk of exacerbating the problems by creating more nonviable enterprises. While the creation of a strong, vibrant SME class is a commendable objective—after all, more than 50 percent of the gross domestic product (GDP) in Western economies is accounted for by the SME sector, and that sector creates not only jobs but the hope and confidence to build a democratic society—the creation of a second-rate SME sector would be a permanent drag on the well-being of the economy.

3. Governments, as well as donors and multilateral institutions, are making available some funding for developing SMEs. In Kazakhstan, for example, several credit facilities are available at the national, oblast, and city municipal levels, through public and private institutions. According to the Ministry of Finance in Almaty, more than \$350 million are currently earmarked for SME support. However, investment institutions complain about the lack of good financeable projects and the entrepreneurs say that they do not have access to appropriate funds.¹ There is a need for additional sources of trade financing but also for support of new investment for venture capital.

4. Better knowledge of funding availability will of course enable greater utilization of the earmarked funds. However, a much larger impact will occur if entrepreneurs in the region have access to business advisory services that will help them prepare better and more “bankable” business plans, but also help them to think through their business strategy suggesting technology, design, manufacturing, and marketing alliances—both domestic and foreign, as appropriate. This would increase the use of available lines of credit and reduce the risk of project failure after funds have been committed. This type of assistance could be particularly important for potential entrants into the social service sectors, where there is little business experience to guide new operators.

¹ Local commercial financial institutions generally restrict their loans to trade financing for 90 days at interest rates of 30 to 40 percent per annum.

5. Business advisory services of this type are established and operated successfully by other multilateral agencies. The International Finance Corporation (IFC), for example, runs a very successful operation in sub-Saharan Africa, the Africa Project Development Facility (APDF). The success of APDF's work can perhaps best be judged by the fact that the concepts it has developed for its clients have often been copied by others. For example, with APDF's assistance a client in Nairobi, Kenya, successfully implemented and operates a rose-growing project for the export market. Not only do "Karen" roses command a premium price at the Amsterdam auctions, but the concept has been replicated by entrepreneurs in several other countries such as Uganda, Tanzania, and Zimbabwe. In the instance of the "Karen" rose project, APDF staff in the field helped the client develop a complete business plan, put together a feasibility study, and helped the client negotiate technology and marketing arrangements in addition to securing the necessary financing from private sector financial institutions.

6. IFC has operated similar business advisory services for countries in the Caribbean and South Pacific regions, and also in Poland. It has recently established a similar operation for the Mekong region.

7. The principal objective of these facilities is to provide investment and business planning assistance to private sector companies to enable them to access long-term debt and equity capital. The activities are grant funded for an initial period. Depending on the environment in which they operate, experience has shown that such facilities can transform themselves into self-supporting private sector enterprises themselves. IFC's Caribbean facility for instance has been spun off into two privately owned entities. The APDF is still grant funded but an increasing proportion of its budget comes from fee income.

8. The key to the success of any business advisory service operation is obviously the quality of the individuals on its staff. Not only should they have the missionary zeal to help fledgling entrepreneurs, but they should have the vision, based on past experience, to see how the client can be assisted to get the maximum potential from the resources they bring to the table. In the case of the Shymkent, Serkut sheepskin enterprise, for example, while the client could well be satisfied if the advisory service was successful in raising some money to enable the company to buy a piece of required equipment, a visionary staff member will urge the enterprise to think in more global terms by bringing in a well-known designer of leather garment, perhaps, and open up marketing channels in Western countries. The Bank is fortunate that many of the member countries have a large cadre of such individuals who could staff an operation in the Central Asian Republics at a reasonable cost. The knowledge and experience of these individuals can be supplemented, as required, by the use of consultants, preferably from the corps of retired executives.

9. For Central Asia, the Bank should consider an operation in Almaty with smaller outposts in Bishkek and Tashkent as business experience develops. In the first instance, the Almaty office should perhaps have 4 to 5 international staff with an equal number of domestic professionals. To ensure that the fiduciary responsibility of using grant funds is adequately discharged, it may be desirable to use Bank staff on secondment in the field offices.

10. As a rough approximation, the budget for such an operation would be approximately \$5.0 million for a five-year period. Such a sum could be raised from governments of economies that have a direct interest in the region. Germany, Japan,

Malaysia, Republic of Korea, Singapore, Turkey, the United Kingdom and the United States of America are likely candidates. In addition, countries like India and Pakistan could be persuaded to provide assistance "in kind" by, for instance, offering consultants free of cost. The Bank could usefully contribute the initial 10 percent or \$0.5 million.

11. The European Bank for Reconstruction and Development currently operates a fund in Kazakhstan that provides equity investment in SMEs, supported by \$2-3 million per year in European Union-Technical Assistance for Commonwealth of Independent States funded technical assistance to the client firms. The structure follows similar funds established in the former Soviet Union and Eastern Europe, and relies upon consultant services from the European Union. In the first year of operations, three projects have been signed for support.

12. A reasonable expectation of the output from such a facility would be, say, 100 projects over five years with each project requiring, on average, financing of \$250,000 or, \$25 million over the period.

13. While such an operation would be modest in financial terms, its economic impact in the region would be considerable.

**POSSIBLE BANK PRIVATE SECTOR INITIATIVE IN CENTRAL ASIA:
A PROSPECTIVE OPERATION TO IDENTIFY PRIVATE SECTOR
PROJECTS IN AGRICULTURE**

A. The Importance of Agriculture

1. Agriculture in Central Asia provides for a substantial fraction of national output and employment in all of the countries. The sector is most important in the Kyrgyz Republic, in 1996 agriculture provided for 47 percent of gross domestic product (GDP) and 43 percent of employment. Although most of the country is mountainous, much of the land supports animal husbandry and Soviet-era investment has given the country extensive irrigation facilities: nearly 80 percent of the crop production relies upon irrigation. In Kazakhstan, which has a relatively diverse resource base and a highly developed industry sector, agriculture provided for 13 percent of GDP and 23 percent of employment in 1996. There is extensive livestock grazing on the broad steppes but also an important crops subsector in the irrigated lands in the south. In Uzbekistan, the agriculture sector provides for more than one third of GDP and as much as 40 percent of employment. Nearly all of the crop production is based on irrigation. The important cotton crop accounts for as much as 60 percent of exports.

2. From the standpoint of the broader economy, the agriculture sector provides a potentially rich base for agro-industrial processing. Cotton and wool support textile and clothing industries; rice and flour feed into milling activities; and oil seeds and fruit sustain processing factories. Increased agricultural production would stimulate these industries and also an expanded service sector, including transport, retail, and wholesale activities.

B. Transition Demands a Difficult Restructuring

3. In all countries considerable restructuring is needed for farms and agricultural enterprises to compete in the new markets. The old pattern of production developed under the former Soviet Union was based on central planning, with few incentives to encourage an efficient use of resources. Overstaffing on the huge state and collective farms was common as was inefficient use of capital-intensive techniques. Agriculture production placed unsustainable demands on the environmental resource base, resulting in increasing soil and water pollution. The system survived on subsidies from the Central Government and protection from international marketplaces.

4. With the breakdown in the central planning system, output declined: in Kazakhstan agricultural production fell 45 percent between 1991 and 1996, and the Kyrgyz Republic 11 percent. Even in Uzbekistan, where output declines were sheltered by the ability to quickly shift cotton crops from Soviet markets to those in Western Europe, agriculture production declined 17 percent from 1991 to 1996.

5. Over the long term in the Central Asia republics, evolving markets will reveal international competitive advantage in some products; for example, by virtue of the existing irrigation networks in the Kyrgyz Republic or the extensive rangeland in Kazakhstan. However it is unlikely that there will be a quick or smooth recovery in output in the sector; given the necessity for (i) farm and enterprise restructuring, (ii) the weaknesses in the private sector, especially rural financial sector, (iii) the unfamiliarity of local farmers with market-based

production, and (iv) the land-locked location of the region far from the markets of industrialized countries.

C. Foreign Direct Investment and External Assistance to the Sector

6. Private sector operations in agriculture have received relatively little attention from external investors. Exceptions include the investment in tobacco in some of the countries by foreign investors. There has also been relatively little support provided by external funding agencies. One exception is a grain farming investment in the Kyrgyz Republic supported by the European Bank for Reconstruction and Development. In addition, EBRD, the International Finance Corporation, and the Central Asian-American Enterprise Fund, supported by the United States, have provided some support to agro-industries. A number of funding organizations, including international nongovernment organizations, have supported small-scale rural credit programs.

D. The Involvement of the Bank in the Sector

7. In all three Central Asian developing member countries, the Bank has committed itself to supporting policy reforms and development in agriculture. In Kazakhstan and the Kyrgyz Republic, the Bank provided policy-based lending to the governments to support the reform efforts and to encourage a reversal of the serious output decline since independence and the breakup of the former Soviet Union. In all three countries the Bank is processing investment projects focusing on such issues as water management, farm support, and rural credit.

E. An Initiative Towards Development of Private Sector Agriculture in Central Asia

8. Given the need to support the private sector in agriculture, the Bank should consider financing, through a regional technical assistance, a set of prefeasibility studies in different subsectors across the region. The prefeasibility studies could be undertaken after fact-finding identifies a list of likely candidate projects from discussions in the field with the private sector, governments, and other funding agencies. Possible candidates might include (i) contract fruit or vegetable farming, (ii) lease contracts for large-scale farm management, and (iii) commercial farm support services.

9. Under the technical assistance, these prefeasibility studies could then be the subject of Bank-sponsored investor conferences within and outside of the region, with the aim of identifying potential participants in specific investment projects. The potential audience would include international agriculture enterprises as well as other multilateral and bilateral funding sources.

10. The costs of the following feasibility studies would be undertaken jointly with identified investors and viable projects proposed for further processing.

**POSSIBLE BANK PRIVATE SECTOR INITIATIVE IN CENTRAL ASIA:
BUSINESS FORMAT LICENSING & FINANCE FACILITY**

1. In every economy there is scope for widespread, site-specific provision of goods and services of consistent quality by small, privately owned businesses. The Central Asian republics are no exception; the potential market for such enterprises is very large, particularly given the Soviet experience, during which small businesses were discouraged.

2. The retailing of gasoline is a good example of this kind of enterprise. Typically, a major oil refining enterprise sets up a handful of retail outlets (stations) and then encourages private entrepreneurs to establish their own outlets under license. Generally, the licensor would assist the licensee in finding a suitable location, provide specifications for buildings, equipment and utilities required, assist in having the buildings constructed and equipment purchased and installed, train operators, supply the gasoline and other products to be distributed through the outlet and, in some cases, assist in having the necessary financing provided. The licensee would pay an up front fee and an annual royalty based on sales volume. Businesses in a wide range of sectors can be promoted using similar principles ranging from the establishment of kindergartens and rural health clinics to agro-processing facilities and light manufacturing entities.

A. The Business Format Licensing System

3. The Business Format Licensing System (BFLS) is composed of three elements; (i) the licensor, (ii) the system, and (iii) the licensee. The licensor owns the trade name in the system; the system can expand rapidly because of investment by the licensees. The licensee is the business person or investor who purchases, in effect, a prepackaged proven business concept that is operated under contract with the licensor. The contract is the license or franchise agreement.

4. The BFLS represents an alternative to other channels of distribution available to a seller of goods and services: sale through company-owned outlets or sale to independent, unaffiliated retailers for resale. With the BFLS concept a number of advantages accrue to the licensor and licensee:

- (i) To the licensor: ease of capital formation, through the initial investment of the licensee; incremental income, usually in the form of royalty payments; relatively rapid expansion of the network; and a more motivated group of retail distributors; and
- (ii) to the Licensee: a degree of entrepreneurial autonomy; a proven concept, often with widespread brand recognition; and, extensive training with ongoing supervision. Because each unit is held to a similar level of quality, there is an additional benefit to every member of the system.

5. This rather simple set of factors has had a dramatic impact on the economy in countries where the BFLS has developed. In Western economies, particularly in the United

States, this method of promoting small business has become extremely popular. Consider that in the United States (US):

- (i) over one third of all retailing is BFLS related;
- (ii) it is estimated that a new BFLS type outlet is opened every 8 minutes of every business day;
- (iii) there are approximately 3,000 BFLS licensors in the US doing business in 60 different business sectors with an estimated 525,000 licensed outlets;
- (iv) one out of eight persons in the US workforce either operates a BFLS outlet or works in one;
- (v) the most conservative statistics show that the rate of success for a new licensee outlet during the first five years of doing business is, at least, twice that of an independently owned small business; and
- (vi) the greatly increased likelihood of success explains why financial institutions favor loans to and investments in BFLS companies

6. This method of promoting small business, a complete system of doing business that is immediately available to licensees, has much relevance to the CARs, encouraging the growth of small businesses and increasing their prospects for survival by providing the licensee with training, shared market plans, purchasing, and other services. Experience has shown that this technique can be

- (i) a significant generator of employment;
- (ii) a relatively simple vehicle to attract foreign investment at a lower risk in a difficult market;
- (iii) a speedy, low-cost method to transfer know-how, technology, training and management skills;
- (iv) a vehicle that joins new licensees to similar systems worldwide, bringing the benefits and improvements made throughout the global system to the new licensee; and
- (v) a way to lower business costs by creating a chain of independently owned business, decreasing the total investment costs for any one investor.

B. A Role for the Bank

7. The Bank can play a very important catalytic role in fostering a BFLS in the CARs because of its ability to provide both technical assistance as well as lines of equity and

course be carried out in a phased manner. Availability of technical assistance funds to establish such demonstration or pilot plants would be an asset.

C. Some Additional Factors

10. The legal framework necessary for the successful operation of such a scheme exists in Kazakstan. A mission funded by the United States Agency for International Development (USAID) has looked into this matter and is just completing a report on its findings. The USAID work builds on experience in similar initiatives in South Africa, Hungary, Romania, and other emerging economies.

11. There are several reputable consulting firms who can help the Bank do the groundwork for developing such a scheme.

**POSSIBLE BANK PRIVATE SECTOR INITIATIVE IN CENTRAL ASIA:
PROVISION OF MANAGEMENT SERVICES**

1. The shortage of qualified managers at the middle and upper levels of organizations in both the public and private sectors is a serious obstacle to development in developing member countries (DMCs). This problem is particularly acute in the Central Asian republics because of their long history as centrally planned economies. The implementation of current government policies, supported by the Bank and other multilateral institutions including the World Bank group, which seek to privatize public enterprises, including institutions that provide social services, present significant problems because of the lack of good, experienced management.

2. The shortage of qualified and experienced managers places current plans for the promotion of private enterprise at risk. In the long run, the solution to this problem lies in the educational system. However, existing problems have to be dealt with in the short term and solutions must be found to cover the shortage of managers.

3. The largest enterprises that are being privatized, such as the steel works at Karaganda or the aluminum-processing facilities at Pavlodac, are able to attract management expertise together with direct foreign investment. The problem lies with the small- and medium-scale enterprises, in the agriculture and industry sectors. The Bank is particularly well placed to take the lead in providing assistance:

- (i) Member countries of the Bank such as Australia, Japan, New Zealand, Republic of Korea, and Singapore as well as some DMCs such as Pakistan and India, have a large pool of seasoned executives who could be made available to the CARs, through a Bank-sponsored program.
- (ii) The Bank has a network of clients among its members which could be used to establish appropriate training programs. For example, someone from a wheat straw operation in Kazakhstan could be sent for training in Pakistan; a silkworm operations manager in Kyrgyzstan could get hands on training in the Republic of Korea; a small-scale garment maker could be sent to Indonesia to learn from their success in this export-oriented business.

4. The proposed concept is to create a Central Asian Management Services Company (CAMSCO) to (i) provide selected enterprises in the CARs with an immediate means of attracting and retaining qualified foreign senior executives; and (ii) to contribute to the training and development of indigenous senior management personnel. It is envisaged that CAMSCO will be established as a limited liability corporation in a Bank DMC and operate as a profit-oriented commercial enterprise with respect to its activities of providing foreign managers for firms in the CARs. The training program will likely need to be grant financed. Shareholders of CAMSCO would be internationally widespread with both institutional and private sector entities. Initial subscribed and paid-in equity would be a sum that could provide sufficient investment income to cover the expenses of the start-up period and an equity base sufficient to provide financial credibility to both potential clients and professional managers. In the case of a similar initiative launched by the IFC for sub-Saharan Africa, initial capitalization was set at \$7.0 million equivalent. Experience has shown that a larger base might have been more

prudent. Depending on the scope of services intended to be provided in the case of the CARs, and considering the volume of operations contemplated, an initial capitalization of between \$5.0 and \$7.5 million should be adequate.

5. Besides the Bank, shareholders would include bilateral development banks from Bank members (such as the Development Bank of Singapore) and private sector companies such as some of the large Japanese and Korean trading houses, European and North American multinational companies, as well as selected private companies from the DMCs (such as Packages Ltd. in Pakistan, TATA Ltd and Larsen & Toubro of India), that have potential commercial interests in the region.

6. CAMSCO services will concentrate principally on the provision of senior management, the training of indigenous personnel as eventual successors to international managers and the support of international management in the field. Prior to entering into contracts for supplying managers and training local personnel, CAMSCO would organize, through independent consultants, a thorough diagnostic review of the client company to identify its specific needs. One of the primary purposes of such a review would be to ensure that the prevailing business environment would be conducive to successful operation by the new management team.

7. CAMSCO would generate revenues from three sources: (i) contract fees for the secondment of experts; (ii) a fee for providing executives from CAMSCO headquarters as directors on client company boards; and (iii) an initial front-end fee for the diagnostic work. Income would also accrue from performance-related bonus provisions in the CAMSCO management services contract agreements related to the net improvement in the financial performance of the client company during the period of the contract.

8. The training component of CAMSCO's mandate will likely need to be entirely grant funded. In the African case, IFC was able to raise a \$7.0 million grant fund under the United Nations Development Programme (UNDP) umbrella with contributions from donor governments as well from the UNDP itself.

9. To establish CAMSCO, the following next steps are suggested:

- (i) With the establishment of an interdepartmental working committee, define broad parameters such as country and sector coverage, i.e., all CAR countries or one or two selected ones; identify which sectors, i.e. agriculture, industry, or social services; and establish responsibility for the implementation of the project.
- (ii) A staff consultant with experience in similar initiatives (e.g., with the African management company of the IFC initiative based in Amsterdam) could be engaged to draw up a detailed project design, including technical assistance terms of reference and "offering memorandum" to invite cofinancing.

POSSIBLE BANK PRIVATE SECTOR INITIATIVE IN CENTRAL ASIA: COMPANY TOWN RESTRUCTURING

1. Before independence, the Central Asian economy developed under the central planning system of the former Soviet Union. The basic unit for much of the organization of economic activity was the large state enterprises. These enterprises were tightly linked with markets and suppliers in the rest of the former Soviet Union. The Soviet-system did not encourage efficient or sustainable use of resources, and enterprises were highly wasteful of inputs. Extreme levels of environmental degradation were found associated with industrial activities. The enterprises performed many functions which, in market economies, are often regarded as belonging properly in the public sphere. Enterprises were often responsible for health, education, and social infrastructure facilities including housing and utility services. The operations of the firms were often subsidized either explicitly through budgetary transfer or implicitly within the protected economy of the autarchic Soviet Union.

2. With independence and the collapse of the Soviet economic system, many enterprises found themselves in dire economic straits:

- (i) Their operating subsidies ceased, and the end of explicit protection offered by the Soviet Union's Council of Mutual Economic Assistance revealed adverse terms of trade for the inefficient, capital-intensive industries.
- (ii) Survival in the emerging market system demanded different skills for labor and management, such as marketing and finance, than those developed under state planning.
- (iii) The economic depression weakened even viable firms, burdening the loss-making enterprises with nonserviceable debts.
- (iv) A slowly evolving policy environment (reflected in high rates of inflation, weak financial markets, and incomplete legal protection for property in commercial transactions) presented the firms with inappropriate signals and a nonsupportive institutional structure.
- (v) Their continuing social obligations to workers and the surrounding community to provide social and infrastructure services became increasingly difficult to fulfill.

A. Company Towns

3. The situation of the company towns in Kazakstan presents an extreme example of these problems. The company towns are the 50 to 60 isolated urban areas centered around one or two industrial or mining enterprises. With the collapse of the old system, there were scant resources for the necessary restructuring, reinvestment, and training needed to overcome the legacy of problems, and to find a place in the new market economy.

4. In some cases foreign investors were awarded ownership or management of the industrial or mining enterprises with the goal of making them commercially viable. Typically, this was accomplished by divesting the firm of its social obligation and coming to an agreement concerning past debt and environmental problems. In most cases, however, the

divested social assets have either simply been closed or given to the local government, which lacks the resources to operate them effectively. In addition, the agreements concerning the firm's obligations toward past debts, the workforce, or the existing environmental problems have proved to be imprecise and unsatisfactory to guide operations.

5. A case in point is Tekeli, in south-eastern Kazakstan. Tekeli has a population of 31,700 people, the major economy activity was the mining and processing of lead, zinc, and other metals. The processing plant is seriously underutilized, and the mine sites require extensive investment to enable increased output at competitive prices. The company is insolvent, operating at a loss, and accumulating debts to suppliers, workers, and the government. The concern needs in excess of \$20 million in new investments to fashion a viable future. A management contract was awarded to a foreign firm, however, the enterprise had to apply for assistance from the National Rehabilitation Bank, which is providing some directed credit and debt relief. Both labor and management lack the skills needed to work in a commercially viable enterprise. The company had formerly been responsible for maintaining social assets and providing social services. At present, most of these are the responsibility of the local government, which suffers from a restricted local revenue base, and an increasing need for social protection and social assistance.

6. Company towns such as Tekeli face three interrelated sets of needs:

- (i) to provide for investment and restructuring of the principal enterprise: not all such enterprises can be made commercially viable, however, a preliminary study by United Nations Industrial Development Organization (UNIDO) in Kazakstan suggests that there are some company towns, such as Tekeli, that offer legitimate business opportunities;
- (ii) to encourage a diversification of economic activity, especially through the development of small businesses; and
- (iii) to strengthen the institutional basis of local governments.

7. The three problems should be addressed simultaneously. An active program, for instance, to encourage small businesses would provide attentive livelihood opportunities for people, easing resistance to restructuring efforts by the major local employer. In turn, new small businesses might well reduce the operating costs of the major enterprise by providing at lower costs some services previously provided in-house. Strengthened local government operations would also contribute to an improvement in the business operating environment: entrepreneurs frequently complain of inappropriate interference in business operations.

B. A Role for the Bank

8. The Bank is developing experience in strengthening local governments through ongoing technical assistance in Kazakstan. This work could be extended and focused on the public administration of a company town. The activity would require technical assistance but also could conceivably involve loan funds provided by way of the Central Government.

9. This activity could be supported by nongovernment guaranteed investment in the principal employer in the company towns. This investment could be accomplished in partnership with foreign firms. The Bank's presence would provide comfort to other participants

but also provide the Bank important information on developments in the locality and the effectiveness of the work with the public administration. This activity would have an important impact on the locality by restoring income and a market for local goods and services.

10. At the same time, a project encouraging small business development should be initiated. Projects described elsewhere in this report that provide technical assistance and financial support to small- and medium-scale enterprises would be assisted by other activities that improve the business and economic environments in the community.

11. The Bank's activities could start with a small-scale technical assistance project and could include a survey of the company towns, their problems, and the potential for successful restructuring.

**Memorandum of Understanding with regard to Cooperation between
the Asian Development Bank (ADB)
and
the European Bank for Reconstruction and Development (EBRD)**

1. In August 1993, three of the Central Asian Republics (CARs), Kazakhstan, Kyrgyzstan and Uzbekistan, were accepted as members of the Asian Development Bank (ADB). The remaining three Republics - Azerbaijan, Tajikistan and Turkmenistan - are expected to finalize their membership in the ADB in the near future. These six CARs are members of the European Bank for Reconstruction and Development. Consequently, in view of the dual membership of these republics in both ADB and EBRD, arrangements for cooperation between the two institutions with respect to their future operational activities are considered to be desirable.

2. Both institutions attach a high priority to responding to the developmental needs of the Central Asian Republics, particularly through mobilizing financial and other resources, promoting domestic savings and investment and for facilitating a greater flow of funds into the Republics.

3. Although the development needs of the CARs are vast and wide ranging, it is proposed that both institutions take all necessary steps to avoid overlapping and duplication of efforts in carrying out their respective operations in these countries. Both institutions will establish and maintain transparency in dealing with the CARs. To this end, the following approach has been agreed upon:

3.1 General understanding on all Central Asian Republics

3.1.1 Both institutions will meet periodically to exchange views on areas of common interest and exchange information and documents on a regular basis in those areas of work in the CARs which may be of mutual interest including loans, equity investments and technical co-operation (TC).

3.1.2 Both institutions will co-ordinate their efforts in assisting the CARs in funding technical co-operation and training in their respective areas of expertise, including institutional development, environment, development of infrastructure, and development of the private sector in the CARs. Lists of TC projects should be exchanged periodically and both institutions will co-ordinate their economic and sector work in the CARs.

3.1.3 Both institutions will develop country strategies and country programmes to ensure complementarity and enhance the development efforts of each institution for the benefit of the CARs.

3.1.4 Both institutions will assess the desirability of co-financing.

3.1.5 To facilitate the above, both institutions will consider mounting joint missions whenever feasible.

3.1.6 The country specific guidelines presented below are for purpose of setting internal priority operations to both institutions. They should, however, not prevent one institution to be active in an area not specifically described as its priority subject to consultations.

These guidelines are interim in nature and subject to a review after completion of the first programming cycle of ADB's operation in each CAR.

3.2 Country specific understanding for Kyrgyzstan (and for Tajikistan when it becomes a member of ADB)

3.2.1 Public sector activities:

- (i) ADB will cover social sector needs;
- (ii) EBRD will focus on public sector projects generating foreign exchange revenues sufficient to repay the Bank loan;
- (iii) ADB will take the overall lead in infrastructure projects once and if ADF resources are made available for use in the CARs, inviting EBRD involvement if cofinancing is needed.

3.2.2 Private sector and financial sector activities: EBRD will take the overall lead in private sector activities as well as in the financial sector, inviting ADB involvement if cofinancing opportunities arise. ADB will take up opportunities for policy reform based programme loans in the industrial and financial sectors in full consultation with EBRD, particularly when such programme loans will enhance the effectiveness of EBRD operations.

3.3 Country specific understanding for Kazakhstan and Uzbekistan (and for Azerbaijan and Turkmenistan when they become members of ADB).

3.3.1 Public sector activities:

- (i) ADB will cover social sector needs;
- (ii) both institutions will co-operate in the development of specific infrastructure projects, particularly when cofinancing possibilities exist or are desirable.

3.3.2 Private sector and financial sector activities: EBRD will take the overall lead in private sector activities as well as in the financial sector, inviting ADB involvement if cofinancing opportunities arise. ADB may take up opportunities for policy reform based programme loans in the industrial and financial sectors in full consultation with EBRD, particularly when such programme loans will enhance the effectiveness of EBRD operations.

3.4 **Technical Co-operation Projects:** both institutions will focus on areas of direct relevance to their respective lending activities. The results of all TC projects undertaken by one institution will be made available to the other upon request.

3.5 In the interest of facilitating close cooperation between the two institutions, the following contact persons have been designated:

EBRO

Joachim Jahnke
Deputy Vice President

ADB

Eiichi Watanabe
Director
Programs Department (East)