

Dear Sir,

Please find in the enclosure the report of Mr. Jürg Frieden who accompanied the World Bank Vice-President Thalwitz to Kyrgyzstan and Uzbekistan last week. I would highly recommend you to read this report. It shows the difficult situation in which Kyrgyzstan finds itself. The Government must now determine its course of action: either it pursues vigorously the reforms began a year ago and faces the strenuous parliamentary opposition or it reverts back to the old methods of centralized planning, prolongs the economic decline and jeopardizes the external assistance.

It appears from the report that the Kyrgyz Republic will have major difficulties in using the Swiss balance of payment support, if our aid remains tied. The lack of disbursements experimented so far reflects not only procurement problems, but the insolvency of many established enterprises, that cannot be compensated by State subsidies. The World Bank has taken this evolution into account, shifting the allocation of its Rehabilitation Credit in favor of not earmarked expenditures. Our country should consider following this example, comforted by the fact that Kyrgyzstan already spent in Switzerland a sensible share of the money provided by the World Bank.

The Uzbek authorities have not yet completely understood what a reform process really implies, especially on the monetary and fiscal front. The economy remains to a large extent State controlled and crucial institutional and structural changes are constantly delayed. Contrary to Kyrgyzstan, Uzbekistan has the means to persevere such a policy for a longer time. But the hour of verity will inevitably come. In the meantime the WB remains ready to support actively and substantively Uzbekistan if the country should decide to use the proposed assistance.

As you know, Vice President Thalwitz, one of the most outspoken and best knowledgeable man on the Eastern European situation, will visit Switzerland on November 23. This will constitute an excellent opportunity to continue the discussion not only on Central Asia but Central and Eastern Europe in general.



11.2 and 11.5 / FJ 26.10.93

**VISIT TO CENTRAL ASIA BY MR. THALWITZ, VICE-PRESIDENT OF THE WORLD BANK**

Mr. Wilfried Thalwitz, vice president of the World Bank for Europe and the FSU, visited the Kyrgyz Republic and Uzbekistan from October 17 to October 22, 1993. The other members of the delegation were Mr. Kadir T. Yurukoglu, Division chief responsible for Central Asia, Mr. Paved Hasad, resident representative of the World Bank in Tashkent and Jurg Frieden, assistant to Mr Jean Daniel Gerber.

**KYRGYZ REPUBLIC**

**The general situation at the outset of the discussions.**

1. The Kyrgyz Republic (KR) finds itself at a crossroad on its way to an independent State: either major structural reforms are introduced or the important results achieved in the stabilization of the economy, which find expression in the circulation of the national currency, will be wiped away, bringing the country back to the collective economic disorder of the ruble zone.
2. The problem has two main dimensions:
  - a) To keep functioning the inherited, inviable productive organization, massive financial transfers must be decided upon - in the case of budgetary allocations to the enterprises, marketing boards etc. - or tolerated - in the case of the accumulation of debts between State enterprises or from the latter toward the banking system, ultimately refinanced by the Central Bank. These expenditures and the related credit expansion nourish the inflation and undermine the new currency (since its introduction, the price of a Som has decreased from .25 dollars to .125 dollar);  
*1\$ = 4 Som 1\$ = 8 Som*
  - b) Allocating the financial resources primarily to the existing enterprises, mainly in function of their bargaining power, the authorities waste precious income - for instance in the accumulation of stocks that cannot be sold - and constrain the medium term growth perspective of the economy, because they delay the emergence of a private sector oriented by the new, more realistic macro and micro prices.
3. The government tends to see in the insufficient flow of external financial support one of the principal causes of its difficulties. However, although it is undeniable that the slow disbursement of grants and credits puts the budget under additional strains, the heart of the matter is the lack of demand for inputs and investments generated by a viable, unsubsidized productive sector. This means that the internal allocation of credit is the crucial problem, the inexperience in the management of foreign aid and in the operations on the international markets being just a complicating factor. As an evidence of this, one has to consider that to allow illiquid enterprises to have access to the donated imports does not generate counterparts funds, has no positive effects on the fiscal deficit but unproductively destroys the resources coming from abroad.
4. The World Bank finds itself in a difficult position. Convinced by the serious commitment shown by the government, the institution would like to proceed speedily toward a second adjustment loan, aimed at the structural deepening of the economic reforms. This operation would be complemented by a WB/IFS/EBRD project supporting the restructuring of the industrial sector and by a program of institutional strengthening of the administrations in charge of the social programs. Yet, as per end

of August 1993, the main conditions of the Economic Rehabilitation Credit having a structural character had not been fulfilled. This should logically induce the Bank to slow down its lending program.

5. The dilemma, ultimately, is political. Which forces would be strengthened by the Bank assuming a tough position? the reformist forces, which would dispose of an additional argument against the conservatives, or the latter, being then able to show that the western aid is not forthcoming and that the dependence from the International Financial Institutions (IFIs) has become unbearable?

#### The disbursement of the financial aid

6. So far, the country has received only a small fraction of the many millions dollars promised by the donor community in Paris last year. Disbursements amount, essentially, to the 52 millions SDR spent by the IMF to support the Som in the context of its STF, to 10 millions dollars out of the 60 millions rehabilitation credit of the World Bank and to 10 millions dollars food aid provided for by the American Government. Of these transfers, exclusively the World Bank contribution generates counterpart funds for the budget. Correspondingly, the Ministry of Finance collected only 32 millions Soms of "foreign aid", to cover a deficit estimated at 160 millions Soms for the second part of the year.

7. As mentioned above, at the origin of this stalemate there are the many unprofitable and some totally illiquid enterprises to which the bulk of the foreign assistance was allocated, "to rehabilitate the industrial sector". In fact, 33 millions dollar of the Bank Economic Rehabilitation Credit (ERC), the Japanese 60 millions dollars and the Swiss 7 millions francs were earmarked to finance the imports of enterprises which are often unable to pay for them. In the short term, this means that either the State transfers the official grants to these enterprises, expanding its expenditures and maintaining at the same level the budget deficit after grants, or that the imports are not realized.

8. Until the end of the year, about 80 millions Soms could be additionally collected, as countervalue of the 10 millions dollars that the Bank is providing out of the exchange market component of the Economic Rehabilitation Credit. As this amount would not be enough, the Bank is ready: to shift 10 millions dollars from the pre-identified goods part of the ERC to the exchange market part of the latter (this will therefore go from 20 to 30 millions, of which 20 undisbursed); to include 5 millions dollars of gas import in the list of the goods to be imported under the pre-identified segment of the ERC. This flexible reaction of the Bank, decided on the spot by the Vice-President Thalwitz when confronted with the difficulties met by the government, could allow to close this year budgetary gap, if the liquid demand for imports to be documented under World Bank procedures will remain strong enough during the next weeks and if the administrative steps are readily implemented.

9. The Swiss balance of payment support must be situated in this global context, to understand its real implications and the difficulties of its implementation.

a) It is likely that many of the enterprises identified as potential beneficiaries of the Swiss grant will not have the Soms necessary to purchase the imported goods. In most cases, this would not reflect a liquidity problem, but a solvency crisis which questions the opportunity of the industrial rehabilitation itself. To be coherent with the logic of the adjustment process and support an efficient allocation of the foreign resources, Switzerland should nevertheless maintain its request that the goods provided are fully paid for in Som, eventually through a normal, unsubsidized bank credit. Unfortunately, this could delay substantially the disbursement of the available funds, reducing the relevance of the Swiss aid to the Kyrgyz government, which is especially under pressure now.

b) In this difficult economic context, the best manner to support the monetary stability, to finance the State budget and to accelerate the structural transformations is to supply convertible currencies to profitable enterprises, able to finance in Soms their imports, expand their activities and prosper. Unfortunately, these economic units cannot be identified by administrative procedures; it is therefore almost impossible to make them benefit from a tied external financing. The only way to reach them is through the foreign exchange market, which should receive an increased share of the external transfers in the form of untied contribution. To be consistent with its development policy and respond to the particular commitment entered into with Kyrgystan as ("model") member of its constituency, Switzerland should consider **untying** its balance of payment support - as the Dutch already did - at least for 1994 and 1995. This decision should be facilitated by the large share of the not earmarked World Bank financing which has already been spent in Switzerland.

### Discussions with the Kyrgyz authorities

10. Mr. Thalwitz met at length with President Akaev, with the Prime Minister Chyngyshef, with the Minister of Economy and Finance Shakirov, with the Chairman of the National Bank Nanaev and with the Speaker of the Supreme Soviet Sherimkulov. He also visited two provinces (oblast) - Issuk-kyl in the North and Osh in the South - and had exchanges of views with the respective governors.

a) The political situation is influenced by the imminent session of the Supreme Soviet, due for the first half of November. The legislative - which was still elected under Soviet rule - is likely to challenge the reform policy of the government. The President, probably to stress the difficulties he is meeting, mentioned even the possibility that the "parliament" induces the resignation of the present cabinet of ministers. Even if this threat is remote, it became apparent in many exchanges that the men in power fear the opposition of the conservative and hesitate when it comes to implement the necessary drastic measures in the restructuring of the economy (for instance the closure of many of the 25 enterprises - employing 75'000 people - which had to suspend their production many month ago, having lost their captive market in the FSU).

b) Uzbekistan continues to exercise pression on its Eastern neighbor, having accepted with difficulties the introduction of the Som and regretting the strong willingness of independence continuously manifested by the Kyrgyz Republic. Tashkent accepts only barter trade or payments in hard currency. In particular, it threatens to cut, just before the winter season, the provision of gas if Kyrgystan does not settle in dollars an outstanding bill of 9.5 millions USD.

c) The government would like to combine the next painful steps of structural reforms with the announcement of positive measures supported by the international community and by the World Bank in particular. The introduction of a law regulating bankruptcies and the suspension of the subsidies allocated to unprofitable ventures should be accompanied by the constitution of a restructuring fund and by the extension of the social safety net. The restructuring fund would have two component: one would support viable enterprises, private or to be privatized, in their reorganization; the other would make easier the down-sizing, the divestiture or the closure of the production units which do not have a future. The social safety net would be expanded in two directions: the direct subsidies that the State is providing, for instance to reduce the price of bread, will be better targeted to the poorest segment of the population; the unemployed will have access to a special fund supporting them during the search of a new activity. The World Bank has been involved in the preparation of these actions for many months and the three corresponding projects supporting the reforms should be presented to the Board in spring and summer 1994. In terms of financial flow, this timing is appropriate, because large amount of multilateral and bilateral resources

committed in 1993 are still available for the first semester of next year. Major difficulties could nevertheless appear if the implementation capacity of the Kyrgyz administration delays the establishment of the institutions in charge of these programs.

### Conclusion

The Kyrgyz leadership continue to see in the establishment of a market economy based on a stable national currency the best strategy to assert its independence and promote the development of the country. However, the principal structural obstacles on the path of transition have not been overcome yet and menace now to reverse the successes already achieved. The conservative opposition is asserting itself and is ready to launch its counteroffensive. The next six months will be crucial for the future of the reforms. The support of the bilateral donors at the Paris Consultative Group Meeting scheduled for February 1994 will be critical to strengthen the internal position and the confidence of the government. In this phase, Switzerland could play a useful role, accelerating the implementation of its cooperation program, untying its future balance of payment support and advocating the case of the Kyrgyz Republic with other potential donors.

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UZBEKISTAN

### General situation

a) The Uzbek economy has been kept afloat through inflation and external indebtedness, but resources have been ineffectively used and a serious crisis is to be expected in the next 12 - 24 months if the economic and the sectorial policies do not undergo major corrections. However, few persons in government seem to have understood the gravity of the situation. The majority apparently rely on the abundance of mineral wealth, on the prompt implementation of the government orders and on the reconstitution of a regulated barter and monetary space with Russia and other FSU Republics to reach macroeconomic stability and further growth. This does not exclude the piecemeal introduction, without a clear strategy, of some elements of a market economy: the privatization of housing and small enterprises; the economic autonomy of the largest economic units; the welcoming of foreign investors. However, the system remains essentially State controlled: not surprisingly, the authoritarian character of the regime translates itself into its economic visions.

b) As long as this attitude prevails, as long as the country can delay a financial crisis, the role of the IMF and of the World Bank will continue to be modest. The international financial institutions are perceived as provider of useful analysis and of interesting advises to be selectively discussed and followed. They are also accepted as a vehicle of Western support in some important areas, like the reorganization of the Central Bank, the response to the Aral see disaster or the strengthening of the social sectors. Nevertheless they are not considered as partners in the discussion of the economic policy. Even in the preparation phase of the Bank investment projects, the government is reluctant to enter the discussions on policy matters and to commit itself to a specific course of action.

### The discussion with the Uzbek authorities

c) The principal purpose of the discussions was to define what role the government would like the World Bank to play in Uzbekistan. In particular, it was necessary to determine if the Uzbek authorities wished to enter in an intensive dialogue with the Bank (and implicitly with the Fund) on