What Role Should State Development Bank Perform in Economic Development of the Kyrgyz Republic?

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CERTIFICATION PAGE

I, MURZALIEV Khanchoro (Student ID 52114606) hereby declare that the contents of this Master’s Thesis are original and true, and have not been submitted at any other university or educational institution for the award of degree or diploma. All the information derived from other published or unpublished sources has been cited and acknowledged appropriately.

MURZALIEV Khanchoro Amanturovich
2016/07/20
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SUMMARY

Idea of the study: To investigate the current state of affairs related to the provision of long-term finance in the Kyrgyzstan and provide recommendations regarding the further operation of the State Development Bank of the Kyrgyz Republic.

Research background: On the basis of stimulating GDP growth rates and the mobilization of international as well as domestic resources on August 9, 2012 the Kyrgyz Republic established the State Development Bank by adopting a special law. Initial capital was set up at the level of 2 billion soms (Kyrgyz national currency). Initial capital must be provided only through state budget. So far the state development bank is not in operation due to lack of state funds. The law defined the main provisions of the state development bank, such as the objectives, functions, powers, and regulations. Thus the main goal of the state development bank is to diversify and provide stimulus to the Kyrgyz economy. The State Development Bank’s investment policy would also include investments into big national projects.

Research questions:

• What role should the State Development Bank perform in the economic development of the Kyrgyz Republic?

• What are the market failures in the financial sector of the Kyrgyz Republic?

• What are the pros and cons of the State Development Bank in the Kyrgyz Republic?

• What are the alternatives to the State Development Bank in the Kyrgyz Republic?
Methods: in order to investigate long-term finance in Kyrgyzstan, this research used methodological triangulation. This triangulation consists of an analysis of Japanese development banking experience, analysis of secondary data about the financial market in the Kyrgyz Republic, and analysis of primary data gathered through interviews.

Conclusion: it was concluded that the current financial system has number of market failures and there is an urgent need in active state intervention. The perquisite in application of an instrument such as a development bank is presence of appropriate development strategy (program). Only the use of a development bank in relation to development strategy would lead to success. The current research suggests the feasibility of further work on the State Development Bank and proposes number of measures. The extension of the tenure of members of board of directors, ways to solve problems with filling up initial capital of the State Development Bank and possible sources of finance.
CHAPTER I: INTRODUCTION

Background of the problem

Classical Economic Theory states that national income, or GDP, is the sum of consumption, investment, government purchases and net exports (Mankiw, 2003). But, how can GDP grow in a sustainable manner? Prominent growth economists Arthur Lewis, Gunnar Myrdal argue that national governments could increase GDP by expanding investments in the economy. Because of low levels of investment, the Kyrgyz Republic had the lowest GDP growth rate among Central Asian countries during the years between 2000 to 2012. Its average GDP growth rate was 1.7% and gross capital formation (as percentage of GDP) in the same period was 21.6%. In contrast, other Central Asian economies such as Turkmenistan and Kazakhstan grew at 6.2% and 7.1% over same period, with a gross capital formation of 31.4% and 26.9% respectively. If comparing globally, for example, China, as a one of the fastest growing economies in the world, had an average GDP growth rate of 9.9% with average gross capital formation at 42.2% of GDP.

Figure 1 Selected economies’ average GDP growth rate 2000-12

Figure 2 Selected economies’ average gross capital formation 2000-12

![Graph showing average gross capital formation 2000-2012 (% of GDP)](image)


As investments are financed through the financial sector, it is important to look at the basic characteristics of the Kyrgyz banking system.

Table 1 Main Characteristics of Financial Sector of the Kyrgyz Republic

<table>
<thead>
<tr>
<th>Financial Institutions</th>
<th>2015 (number)</th>
<th>Assets (million USD)</th>
<th>Share in Fin. Sector (%)</th>
<th>Assets /GDP (%)</th>
<th>Credits /GDP (%)</th>
<th>Deposits /GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>24</td>
<td>2 640</td>
<td>88.4</td>
<td>42</td>
<td>22.2</td>
<td>21.1</td>
</tr>
<tr>
<td>Non-bank financial institutions (NBFI)</td>
<td>627</td>
<td>295</td>
<td>9.9</td>
<td>4.7</td>
<td>3.5</td>
<td>-</td>
</tr>
<tr>
<td>Other financial companies</td>
<td>29</td>
<td>1.7</td>
<td>1.7</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: NBKR, NSK KR

Exchange rate 4th of July, 2016 1USD = 67.4150 som (national currency)

As it is seen on the table 1 the Kyrgyz financial system is characterized as bank-based. 88.4% of assets of the financial system belong to banks. However, the level of
financial intermediation is low, only 25.7% of GDP delivered as credits to the private sector.

Table 2 Main characteristics of State-Owned Banks, 2015

<table>
<thead>
<tr>
<th>Name of the state bank</th>
<th>Assets (millions USD)</th>
<th>Credits (millions USD)</th>
<th>Deposits (millions USD)</th>
<th>GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aiyl Bank</td>
<td>243.9</td>
<td>149.3</td>
<td>112.8</td>
<td>6 284</td>
</tr>
<tr>
<td>RSK Bank</td>
<td>248.4</td>
<td>123.4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: www.ab.kg, www.rsk.kg
Exchange rate on 6th of July, 2016 1 USD = 67.4150

According to table 2 there are only two state-owned banks in the Kyrgyz Republic. Cumulatively state banks possess assets equal to 7.83% of GDP in the year of 2015. In terms of the possession of assets, cumulatively privately owned commercial banks hold 4.36 times more assets than state banks. It can be inferred that state role in the banking sector is not considerable.

One of the ways to increase investment in an economy is to use the instruments offered by a state development bank. Globally, there are around 750 national development banks (United Nations, 2005). The large amount of these financial institutions illustrates that national governments believe in their effectiveness in achieving economic policy objectives. The Government of the Kyrgyz Republic was no exception.

Kyrgyzstan’s first experience in development banking came with the establishment of Kyrgyz Agricultural Finance Corporation in 1996. The Agricultural Finance Corporation in its organizational form was a non-bank financial institution whose primary purpose was to fill a market gap in financing agriculture. At that time, the sole state financial institution designed to provide funding for agriculture, Agroprombank, was, was liquidated in 1994
due to high levels of non-performing loans. On the other hand, commercial banks were unwilling to lend to farmers, most of whom were associated with high credit risk and low profitability. Additionally, commercial banks were lacking experience in rural lending and had no adequate branch network. The shortage of finance to the agricultural sector prompted the Kyrgyz government to channel financial resources through the Ministry of Agriculture and regional and district authorities. As a result, this program failed due to high levels of non-repayment (Jeenbaeva, 2003). The conventional method of direct government support was an economic fiasco, and the Kyrgyz government had to approach the World Bank for assistance. With the advice and help of the World Bank, a Kyrgyz Agricultural Finance Corporation was established, in essence greatly similar to a typical agricultural development bank. Over time, the project proved to be successful, and eventually, in order to increase its scope of authorized activities, the Kyrgyz Agricultural Finance Corporation (KAFC) was transformed into a full-fledged bank. Presently, the state-owned JSC “Aiyl Bank” (formerly KAFC) is an absolute leader in agricultural finance and one of the top five banks in the country. As of December 1, 2015, Aiyl Bank’s credit portfolio consisted of 66.73% loans extended to agriculture (JSC "Aiyl Bank", 2015).

Another example is the Development Fund of the Kyrgyz Republic. It was a state financial institution established in the form of a closed joint venture in 2007. The main objectives of the institution were to create an effective and sustainable base for the financial support of real sector, accumulate financial resources from different sources, support priority and strategic sectors, provide credits to projects oriented to multiplicative results and high economic impact, provide enterprises with cheap medium and long-term credits, stimulate investment attraction into national enterprises, promote national exports,
introduce modern methods of management, evaluation and control. All in all, the Development Fund was supposed to stimulate economic activities in every way possible. Its activities were regulated mainly through special law and it was only partially under the supervision of the National Bank of the Kyrgyz Republic. Poor control and improper corporate governance of the Development Fund have resulted in considerable financial abuses (Abdygulov, Chuikov, & Kadyraliev, 2014). Consequently, on April 30, 2010, the Temporary Government of the Kyrgyz Republic liquidated the Development Fund.

Although the Kyrgyz Republic has had a negative experience with the Development Fund, it never stopped believing in the value of development banks as an instrument of economic stimulus and growth. In 2012 the Government established the State Development Bank (SDB) with initial capital of 2 billion soms (around 30 million USD). The purpose of the new financial institution was to diversify and stimulate the economy by providing medium and long-term credit resources to increase investments. As has been stated before, SDB’s investment policy includes investments into big national projects (Ministry of Justice of the Kyrgyz Republic, 2012).

The on-going problems with SDB’s financing prevented its actual launch. Politico-economic realities were soon to change, however, as the Kyrgyz Republic was on its way to becoming a member of the Eurasian Economic Community – masterminded by Russia, Kazakhstan and Belarus. Therefore, on May 29, 2014, the governments of Kyrgyzstan and Russia had signed an agreement about the development of economic cooperation in the context of Eurasian economic integration. The agreement envisioned the creation of a Russian-Kyrgyz Development Fund (RKDF), which could help mitigate the shortage of long-term finance in the country.
The goal of Russian-Kyrgyz Development Fund is to facilitate the accession and transition of the Kyrgyz Republic into Eurasian Economic Community. The main objectives were defined as promoting economic cooperation between the Kyrgyz Republic and Russia, modernizing and developing the economy of the Kyrgyz Republic, and allowing for the effective use of economic opportunities in the context of the newly created Economic Community. Agro-industrial complex, clothing and textiles, processing, mining, transport, housing construction, trade, entrepreneurship and infrastructure were set as areas of cooperation. Initial capital in the amount of $500 million USD has been transferred fully by Russia. In addition, Russia agreed to provide another $500 million in concessional loans until 2017. Since September 2015, the Russian-Kyrgyz Development Fund has provided loans to 200 projects in Kyrgyzstan, totaling $70 million USD.¹

Table 3 Credits in local currency (som) provided by financial sector in the Kyrgyz Republic

<table>
<thead>
<tr>
<th>Type of institution</th>
<th>Average Interest Rate (end of period)</th>
<th>Maturity (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>RKDF</td>
<td>12%</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>5% (for SME)</td>
<td>7 (for SME)</td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>22.83%*</td>
<td>5</td>
</tr>
<tr>
<td>Non-bank financial institutions (Micro-finance organizations)</td>
<td>32.16%**</td>
<td>3</td>
</tr>
</tbody>
</table>

* weighted average interest rate in December of 2015
** weighted average interest rate in the IV quarter of 2015
Source: NBKR, bulletin 12 (239), 2015

Within the Kyrgyz financial sector, special financial institutions are not the only ones to provide medium and long-term funds, but also commercial banks. The Kyrgyz Republic’s banking system is composed of twenty-five commercial banks. However, the financial resources provided by banks are extremely expensive. In December 2015

¹ http://www.rkdf.org/
commercial banks provided loans with an average interest rate of 22.83% (National Bank of the Kyrgyz Republic, 2015). It is no surprise that only 8% of businesses take loans from commercial banks for the purpose of investment (International Monetary Fund, 2016).

In the case of a macro-level assessment of government needs in terms of medium and long-term funding, the National Sustainable Development Strategy for the Kyrgyz Republic for the period 2013-2017 (NSDS) could explain a lot. According to the Strategy, five strategic sectors have been identified: agro-industrial sector, energy, mining, transport and communications, tourism and services industry. The Sustainable Development Strategy approved national projects are to be financed in each sector of the economy during the years of the strategy’s implementation, between 2013-2017.

Table 4 National projects of the Kyrgyz Republic

<table>
<thead>
<tr>
<th>Estimated investments into sector of the economy</th>
<th>Total estimated cost (million USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agro-industrial sector</td>
<td>141</td>
</tr>
<tr>
<td>Energy</td>
<td>4,982</td>
</tr>
<tr>
<td>Transport and communications</td>
<td>2,132</td>
</tr>
<tr>
<td>Industrial-logistic field</td>
<td>382</td>
</tr>
<tr>
<td>Mining</td>
<td>3,130</td>
</tr>
<tr>
<td>Total</td>
<td>10,767</td>
</tr>
</tbody>
</table>

Source: National Sustainable Development Strategy for the period 2013-17

Yet, it is important to note that currently, projects in the mining sector are financed only by private investments. Therefore, excluding the mining sector, $7,637,000,000 USD were left to be financed by the state through direct allocation and public-private partnerships. Due to the fact that the Kyrgyz state budget is socially oriented, after fulfillment of all social responsibilities of the state (pensions, welfare benefits and wages to government employees) little to nothing was left for capital investments into infrastructure and energy. But foreign aid received in the form of loans and grants has been channeled to
capital investments. Taking it into consideration and with the aim to mobilize financial support, the government organized a joint conference with Development Partners in July 2013. The outcome of the joint conference was a declaration of financial support in the amount of 2 billion USD in the form of Official Development Assistance (ODA) for the implementation of NSDS during 2013-2017. Despite the substantial financial backing of Development Partners, the investment gap remained in the amount of $5,637,000,000 USD. Furthermore, it is only public need in long-term funds that does not take into consideration the unmatched demand for long-moneys in the private sector.

**Statement of the problem**

As has been illustrated above, today the main problem in the Kyrgyz economy is a significant shortage of medium and long-term funding. The situation is exacerbated by the non-operation of the State Development Bank.

**Purpose of the study**

The purpose of the study is to investigate the financial sector of the Kyrgyz Republic, relevant international best practices and answer for the question whether Kyrgyz Republic needs the State Development Bank. If yes, what role should it play in economic development of the Kyrgyz Republic?

**Research Questions**

Main Question:

1. What role should the State Development Bank perform in the economic development of the Kyrgyz Republic?
Sub Questions:

2. What are the market failures in the financial sector of the Kyrgyz Republic?

3. What are the pros and cons of the State Development Bank in the Kyrgyz Republic?

4. What are the alternatives to the State Development Bank in the Kyrgyz Republic?

**Importance**

There is only one academic article regarding the State Development Bank in the Kyrgyz Republic. The current research investigates the issue of development instruments in an in-depth manner and provides policy recommendations regarding the Kyrgyz State Development Bank. Also, it complements and enriches literature on development banks in the Kyrgyz Republic, in Central Asia, and overall in developing countries.

**Scope of study**

The scope of this study is post-modern economic history of the Kyrgyz Republic starting from its independence in 1991. This date is taken as a starting point because it symbolizes the beginning of a market economy in the country.

**Definition of terms**

A development bank is a financial institution concerned with the provision of capital to projects with high socio-economic benefits (Diamond, 1957; Bruck, 1998; Pena, 2001). If it is put straightforward, a development bank is a “bank” in the business of “development” (Pena, 2001).
Chiefly, an acceptance of the responsibility to promote state policies defined them as development banks (Diamond & V.S, 1982). Under the abovementioned definition almost all banks could be classified as development banks. We should take into consideration that the word “development” implicitly means a long-term process, which requires long-term economic policymaking and state intervention.

After the world debt crisis of 1982, development finance institutions started to be called more widely as development banks because “banking” aspects of those institutions started to be emphasized more than “development” aspect.

Also such terms as “development banks”, “development finance institutions”, “policy banks” and “state investment banks” are interchangeable and have the same meaning (Luna-Martinez & Vicente, 2012; Mazzucato, 2015).

**Chapter Summary**

Chapter 1 provides an overall background of the problem with the shortage of medium and long term funding in the Kyrgyz Republic. Chapter 2 provides a literature review on the issue of development banks from the perspective of developmental, countercyclical roles, and ownership structure. Also it provides an overview of the research methods applied in this research. Chapter 3 consists of the analysis of Japanese development banking experience, analysis of the financial system of the Kyrgyz Republic for the presence of market failures and gives analysis of the law “On the State Development Bank of the Kyrgyz Republic”. Chapter 4 provides findings and discussion of the research based on analysis of primary and secondary data.
CHAPTER II: LITERATURE REVIEW & METHODOLOGY

Literature Review

There are three views on the issue of public banks (development banks). The first looks at development banks from a developmental and social view. Prominent development economists like Arthur Lewis, Albert Hirschman, Gunnar Myrdal and others believe that development banks can serve as a tool to generate long-term finance that will accelerate growth of an economy (Bruck, 1998). It could also be a way to solve market failures such as underfinanced, socially valuable projects with low commercial return, but positive externalities (Levy Yeyati, Micco and Ugo 2004). The second view – from a political perspective – criticizes development banking and claims this institution can misallocate funds by supporting politically connected firms and providing a bailout to underperforming companies (Kornai 1979; Ades and Di Tella 1997). The third view states that benefits associated with public banks are outweighed by costs caused by red tape, bribery and agency operating expenditures (Schmit, Gheeraert, Denuit, & Warny, 2011). There are 750 national development banks across the globe; some of the experiences have been hugely successful, and some were not. Before proceeding to the roles played by successful development banks in their respective countries, let us examine in detail the rationale in the creation of development banks.

Different economics schools think of state intervention differently. Mainstream economists believe that market failures emerge when 1st and 2nd conditions of First Fundamental Theorem are violated. First condition states that markets are complete and 2nd
condition states that all consumers and producers behave competetively. When either of these two conditions are not met, then there is a market failure. Mainstream economists believe that public policy or state intervention can resolve market failure. Of course in such a case benefits and costs of state intervention are estimated, and if there are more benefits then costs, state intervention is taken. On the other hand, there are “public choice” scholars who believe that markets are self-correcting and all that is needed is to leave failures for markets in order to resolve it. Neo-Keynesians, such as J.Stiglitz, believe that imperfect information is the source of market failures and the state should concentrate its efforts on correcting these informational problems (Mazzucato & Penna, 2015).

**Developmental Role (Capital Development)**

It is argued by Mazzucato (2015) that in recent decades the real economy has been financially deprived because finance has turned to speculation, investing into short-term investments and getting profits and serving itself. As a result for example, according to the American Association of Civil Engineers’ report in 2013, none of the crucial infrastructure received a grade above D (Mazzucato, 2015). Not only the financial sector is to blame, but also the real economy started to go away from productive investments by hoarding cash and pulling profits into speculative investments.

**Industrialization of Europe: railroad construction**

Money is the blood of the economy. It has to be in constant movement and has to be mobile. The idea of the mobilization of credit comes from the Saint-Simonian movement. According to this movement, a development bank was a product of marriage between banking and industry. One of the first prominent examples of development banks is Credit Mobilier, initiated by the brothers Pereire in France in 1852. The Credit Mobilier was an
innovation, and it was an important instrument in the industrialization of Europe, mainly through railroad construction. Under the leadership of the Credit Mobilier, more than 4000 kilometers of railroads have been constructed in Austria, Spain, Switzerland, Italy, and southern Germany. Along with the mobilization of capital through the issuance of bonds and stocks at the Paris Stock Exchange, technology and organizational skills were transferred to host countries. Having paid-in-capital in the amount of 60 million francs, the Credit Mobilier was among the founders of foreign banks with combined total capital of more than 650 million francs (Cameron, 1953). As such, Credit Mobilier had not only infused money into the economy, but has also built transportation routes, connecting all of Western Europe, positively externalizing trade along those routes and growing the economies of several countries simultaneously.

**Backbone of German industry: electric power generation and coal mining**

Kreditanstalt für Wiederaufbau (KfW) was established after World War II in order to rebuild devastated Federal Republic of Germany. In a coal-rich Germany, KfW mainly financed construction of electric power plants and coal mining industry. At that time those two were bottleneck industries, which were essentially blocking the development of other basic industries. From time to time KfW changed its policy. For instance, when Germany was united in 1991, KfW switched its focus on modernization and development of backward territories of Democratic Republic of Germany, specifically focusing on the modernization of housing. Consequently, around 2.8 million homes have been modernized as a result of the KfW program, improving the living standards of peoples, positively impacting construction companies, and other smaller firms associated with renovation, construction, and raw material providers (Grunbacher, 2001).
China Development Bank’s Infrastructure Investments

In the years of 1994 to 2005 China Development Bank has directed nearly 90% of its credit portfolio towards infrastructure. In particular, the following infrastructure sectors were financed by China Development Bank: power, road construction, railway, petrochemical, coal mining, telecommunications, public facilities, and agriculture (United Nations, 2005). The magnitude of CDB investments is enormous, representing in total over US$2 trillion to infrastructure and urbanization projects since its foundation in 1994 (Mazzucato & Penna, 2015). It is once more proves vital role of state in financing crucial infrastructure through the development bank instrument.

Countercyclical Role

The case of Canada

Development Banks may act countercyclically by extending credit during financial crises when private banking industry experiences a credit crunch. According to the Conference Board of Canada’s Executive Action Briefing, one of the lessons learnt during recessions and financial crises is that “public sector financial institutions prove their worth” (The Conference Board of Canada, 2010). It was stated that due to the existence of development banks, such as Business Development Bank of Canada (BDC) and Export Development of Canada (EDC), the impact of global financial crisis of 2007-2009 on the financial system of Canada was significantly softened. These public development banks were able to fill in the gaps produced by the worldwide credit crunch and serve as a part of the policy solution to systematic risk. It is argued that the response to the financial crisis through expert public banks has been much more efficient than the use of direct intervention via treasuries and central banks. Public banks, particularly development banks,
have been able to better diagnose the problem, provide advice and extend the much-needed credit in a timely manner. It was achieved only due to their prior existence and accrued knowledge and expertise. In the wake of the credit crunch, from both private and foreign sources, the Government of Canada first strengthened the Business Development Bank of Canada and Export Development Bank of Canada by injecting 700 million USD in additional capital. This measure increased the capacity of both institutions to extend credit to the country’s private sector. Additionally, a second measure undertaken by the government of Canada was the establishment of the Business Credit Availability Program in the amount of 5 billion USD. The Business Development Bank of Canada, Export Development Bank of Canada, along with private institutions jointly and successfully operated the program.

The Government of Canada rejected the idea to use its development banks as lenders of last resort because, traditionally, the lender of last resort takes the highest credit risks and undertakes considerable financial risk. Public banks could complement private sources of capital by risk sharing and filling the gaps (Executive Action Briefing). Today, the Business Development Bank of Canada not only provides financial resources, but also provides technical assistance or business counseling to its clients, which potentially decreases credit risks (Culpeper, 2012).

The case of Republic of Kazakhstan

Kazakhstan – an oil exporting country that, over the years since its independence in 1991, has accumulated large amounts of foreign reserves. The lucrative sales money have been diverted into national projects such as Samruk-Kazyna – a sovereign welfare fund established from a merger in 2008. According to Glass (2014) assets of Samruk-Kazyna
amounted to 47 billion USD, equivalent to 45% of Kazakhstan’s GDP. Due to high rates of economic growth of over 8% during the 2000’s until the global financial crisis of 2007, Kazakh banks were significantly leveraged by huge borrowings from international financial markets. Because the borrowings were done in a foreign currency, most notably in the USD and the euro, many top banks of Kazakhstan failed. Then, Samruk-Kazyna played its part in anti-crisis measures. 2.2 billion USD was provided as equity finance to three banks: BTA (75%), Halyk Bank (21%) and Kazkommertsbank (20%). Furthermore, Samruk-Kazyna injected as equity capital another 220 million USD into Halyk Bank and 200 million into Alliance Bank. Along with equity injections Samruk-Kazyna provided funds for commercial banks in order to extend credit for mortgage loans and construction (3 billion USD), SME lending (1 billion USD) and lending for other purposes (2 billion USD) (Ruziev & Majidov, 2013). Thus, Samruk-Kazyna helped mitigate the effects of the global credit crunch and financial crisis on the economy of Kazakhstan. Although these measures proved to be temporary, the fact that capital (in foreign currency) was available at the time when it was in global deficit is a pro for Samruk-Kazyna.

The Case of Brazil

The recent examples of BNDES’s extention of countercyclical lending are last two crises of 2003 and 2008. In 2003 private banks reduced lending due to worries of electoral victory of President Lula. The other case is related to the 2008 Global Financial Crisis. Before the Global Financial Crisis BNDES disbursements were at the level of 51.3 billion real in 2006 but it tripled during the crisis to amount of 168.4 billion real in 2010 and increased aftermath achieving record levels of 190.4 billion real in 2013 (Rezende, 2015).
The BNDES provides the bulk of long-term lending (70%) in Brazil and it is the second most important source of investment after retained earnings. In the height of the 2008 Global Financial Crisis BNDES was the largest source of investment in industry and infrastructure representing 52.5% in 2009 (Colby, 2012).

**Ownership of development banks**

Inter-American Development Bank research has found out that state-owned banks in developing countries earn less than their privately owned counterparts (Levy Yeyati, Micco and Ugo 2004). Specifically, financing of low return social projects with positive externalities was the cause for such low profitability. It is imperative to note that the majority of development banks that the Inter-American Development Bank looked at had a specific mandate, which prioritized projects with high social return, and focused minimally, if at all, on profitmaking from loans. The research also evidenced that the presence of state-owned development banks had a neutral impact on the economy, and no significant influence on the growth or decline of the economy. It was found out that during the election year, lending by government owned banks increased on average by 11% of its total loans (Dinc, 2005). Another study of operations of BNDES, Brazilian National Development Bank, concluded that politically connected firms that made campaign donations were more likely to receive loans from BNDES (Lazarini, Musacchio, Bandeira-de-Mello, & Marcon, 2011).

Although the study conducted by La Porta has not investigated the impact of development banks, it concluded that government ownership of banks lead to slower financial development and economic growth (La Porta, Lopez-De-Silanes, & Andrei,
The research by Yeyati, Micco and Panizza (2007) have proven that previous findings regarding slower economic growth due to government ownership of banks are not robust. On the contrary Andrianova, Demetriades and Shortland (2010) based on their cross-country study for the period of 1995-2007 concluded that government ownership of banks were associated with higher long-run growth rates.

Gerschenkron (1962) stated that population mistrust in private banks happens because of weak institutional infrastructure, which is caused by widespread corruption and underperformance of agencies supervising the national banking sector and dealing with deposit insurance. Under such circumstances, the author justifies state intervention to the extent of state ownership of banks that could rehabilitate the trust of the population in banking. For instance, a widespread and profound mistrust of Russian citizens in banking in the 2000’s was caused by the 1997 financial crisis, and frequent fraudulent actions by banks throughout the 1990’s. As such, the justification of state intervention, as has been mentioned above, was proven by a recent study of the Russian banking sector, whereby by in 2002 70% of all deposits among the public were in savings in one state owned bank (Andrianova, Demetriades, & Shortland, 2010).

On the contrary, according to a high-profile study of operations of the Brazilian National Development Bank (BNDES), it was evident that the bank was choosing firms or projects with good operational performance in order to finance them, thus BNDES was not acting in line with the general mandate of development banks (Lazzarini, Musacchio, Bandeira-de-Mello, & Marcon, 2011). However, cheap loans received from BNDES did
not influence the operational performance of a firms-recipients. In other words, the firms were not increasing their profit, nor was the profit decreasing though.

Thus it can be inferred that there is no single right answer when it comes to the influence of ownership on the efficiency of development bank operations.

**Research Methodology**

The purpose of this research is descriptive and exploratory. This study is qualitative in its nature. Two research methods were used: qualitative interviewing and the collection, qualitative analysis of texts and documents.

The topic of development banks is highly specialized and requires specific knowledge and experience. In addition, the topic is new in the context of the Kyrgyz Republic and not many research papers have been produced. Those were the primary reasons for selecting a snowball-sampling technique. First, interviewees were found owning to personal contacts. Afterwards, new interviewees were contacted based on a reference from previous interviewees. The interviewees are from key ministries and agencies responsible for the issue of state development bank. Given the uniqueness of the issue, the format of semi-structured interviews was selected. It allowed for a general guideline of main open-ended questions with the option of asking additional questions. The interviewer asked additional questions depending on the answers of respondents. The average interview took 30 minutes. Interviews were administered via video-conferencing (skype), telephone, and e-mail.

The collection, qualitative analysis of texts and documents was used to analyze the experience of Japan in developing banking. The rationale of studying Japanese experiences
comes from the reason that this was the first Asian country that successfully applied such policy instruments as a development bank in its economic development. At the same time, an analysis of the secondary data of contemporary the Kyrgyz banking system was used to identify current market gaps or “failures”. This research used methodological triangulation by studying international experience, especially a Japanese one, assessing financial sector and fieldwork.
CHAPTER III: ANALYSIS OF DEVELOPMENT BANKING AND ITS PRECONDITIONS

Analysis of Japanese Experience

The 1950-70’s were characterized by a period of high growth in economic development in Japan due to the fact that economy grew each year at double-digit rates. This kind of growth had never been seen before in the world, so it was coined the “Asian miracle”. The main reason for the high growth was Japanese state intervention in the economy. Specifically, the government of Japan intervened in the financial sector by establishing several long-term credit banks.

What role should state development bank perform in economic development?

Main bank role

A development banks’ position in the economy had always been crucial, and one more role that was played by them was the role of a ‘main bank’ to newly emerging corporations. The main bank system assumes that every firm develops a special relationship with its primary bank. The relationship is not only limited to the largest share of borrowing by firms from one particular bank, but it also includes interlocking shareholding and participation of the main bank in the corporate governance of the firm (Aoki, Patrick, & Sheard, 1999 ). If a firm was missing its own main bank it simply meant limited or no access to cheap and long-term loans.
The structure of the traditional Japanese financial system, which consisted of Big Six city banks,² a few long-term credit banks and greater number of small regional banks, favored lending to firms affiliated with Japanese corporate groups (keiretsu). Thus capital demands of non-keiretsu firms were not satisfied. Development banks filled this gap, as it was evidenced by Industrial Bank of Japan’s unremitting funding of Nippon Steel, Nissan Motors and Hitachi (Calder, 1999). Today, these companies are not only national champions within their industries, but are also well known globally.

**Coordination within industry**

Development banks also played an intra-industry coordination role. For instance, in the early 1960’s the Industrial Bank of Japan played a key role in negotiations on scaling up of the national shipbuilding industry, which eventually brought the merger of 12 companies into 6 larger ones. The latter restructuring was caused by a crisis in the shipbuilding industry and the companies’ high indebtedness to banks (Yasuda, 1993). Ultimately, the merger was successful, it enhanced the Japanese shipbuilding industry’s global competitiveness, and all debts were repaid.

**What are the market failures?**

**“Over-loaning” problem**

After World War II there was a need to supply cheap loans for industries. But how was it possible for an after war economy that was in dire need for finance? The government introduced artificial control of interest rates by setting up ceilings on interest rates of both deposits and loans. Such a policy of financial restriction forced all banks to provide cheap

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² The “Big Six” included Dai-ichi Kangyo Bank, Fuji Bank, Mitsubishi Bank, Sakura Bank, Sanwa Bank, Sumitomo Bank.
loans to industries. Under this policy not only public banks provided affordable loans, but also commercial ones too. Yet, one still may ask whether there was a need to establish development banks if the entire banking industry was providing cheap loans.

The problem was that after the war, due to the general lack of finance, commercial banks were only able to provide short-term loans, while long-term loans were underprovided in the market. Accordingly, firms trying to modernize through capital investments were taking many short-term loans from commercial banks that, eventually, resulted in a ‘over-loaning’ problem. To address over-loaning, the government set up several special long-term credit institutions such as the Reconstruction Finance Bank (1947), Industrial Bank of Japan (1950), Japan Development Bank (1951), Long-Term Credit Bank (1952) and Nippon Fudosan Bank (1957). As a result of such policies, development banks provided approximately two-thirds, and half of all outstanding equipment loans in the 1950’s and 1960’s respectively (Stiglitz & Uy, 1996).

**Financing basic industries**

Back in the 1950-70’s, as would be expected, the private sector channeled its investments into commercially attractive industries, those oriented to exports (Yasuda, 1993). The credit gap in financing socially valuable, but commercially unattractive industries, such as public utilities (electricity and gas), iron and steel, coal mining and marine transportation were covered by development banks. For instance, in the 1950’s 70% of all plant and equipment loans were directed to the abovementioned socially valuable and strategic industries (Paker, 1993).
What are the pros and cons of state development bank?

Source of finance

What were the sources of the initial capitalization of development banks and their further funding? The Long-Term Credit Law of 1952 prohibited development banks from engage in mass deposit taking operations, because of the high risk associated with directing deposits, especially short-term deposits, into long-term and volatile investments. Instead the government had authorized to issue debentures – a debt instrument that is not backed by collateral, but rather guaranteed by the creditworthiness of the issuer.³ In the 1950’s, the government purchased the majority of issued debentures with maturity of 5 and 10 years, thereby feeding more capital to banks. It is also crucial to note that in order to raise large amount of quick capital, the government funneled people’s savings and pension funds, traditionally kept in postal savings system, into development banks.

Syndicated loans

Likewise, development banks played a crucial role in the implementation of state industrial policy. The mechanism for the implementation of industrial policies was through syndicated loan lending procedure, whereby a loan would be offered by a group of lenders (called a syndicate) who worked together to provide funds to a single large borrower.⁴ Development banks were responsible for screening and selection of promising undertakings, thereby weeding out poor projects and evading potential risks (Vitas & Wang, 1991).

Provision of qualified staff

One of the more famous development banks was the Industrial Bank of Japan, or IBJ. Specifically, excellence in project appraisal was the Industrial Bank of Japan’s trademark in the national banking industry. Later, the Industrial Bank of Japan’s more qualified and experienced personnel moved on to become competent staff in the rest of the banking industry of Japan. For instance, in the 1950’s, the staffs of the Reconstruction Finance Bank and the Japan Development Bank consisted mostly of ex-Industrial Bank of Japan employees. Moreover, the knowledge further span off due to day-to-day cooperation between credit specialists of syndicate banks, which also enhanced their appraisal skills of large-scale industrial projects (Aoki, Patrick, & Sheard, 1999).

**Signaling effect**

Joseph Stiglitz – professor at Columbia University and recipient of the 2001 Nobel Memorial Prize in economics – argues that development banks in Japan had a signaling effect on the banking industry. It means that loans by development banks indicated the current focus of the state regarding priority sectors. This sort of information was crucial for decision making in other banks when they screened applications for loans. That is how commercial banks got involved in syndicated loans. One of the reasons why the private banking sector participated in syndicated loans was because they were deemed safe due to implicit governmental guarantees on repayment of those loans.

**Financial Loan and Investment Program – government’s ‘second budget’**

Financing through development banks provided flexibility of choice to the government as opposed to financing from the Japanese state budget. Therefore, the government had established the Financial Loan and Investment Program (FLIP) to finance development banks, and it was considered as a ‘second state budget’. In 1960, FLIP
accounted for 482 billion yen equaling to 27.65% of the total state budget (Yasuda, 1993).

The biggest advantage of this program was that it did not require approval by the Diet. Therefore, development banks, using the money from the Financial Loan and Investment Program, were able to react in the best interests of state industries and more promptly to global changes in an economic environment.
Analysis of the Market Failures of the Kyrgyz Financial System

Extremely low level of long-term (capital) funding

As the financial sector performs a crucial role in economic development, it is important to consider its role in the context of Kyrgyzstan. Overall, the level of development of the financial system is still weak, having only 15.9% domestic credit to GDP ratio in 2014. For example, the same ratio is much higher in the developed Organization for Economic Cooperation and Development (OECD) countries like Singapore, Denmark, Finland – 126.3%, 224.9%, 164.7% respectively (World Bank).

There are four ways to finance the investment activities of the private sector: own retained earnings, debt market (bonds), equity market (issuing shares) and banking sector (credit).

Table 5 Financial Market Profile, Selected Economies, 2012

<table>
<thead>
<tr>
<th>Economy</th>
<th>Domestic debt securities market</th>
<th>Market capitalization of listed domestic companies</th>
<th>Banking assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US$ billion</td>
<td>As % of GDP</td>
<td>US$ billion</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>0.1</td>
<td>2.2</td>
<td>0.165</td>
</tr>
<tr>
<td>Selected OECD countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>204</td>
<td>30.7</td>
<td>1233.4</td>
</tr>
<tr>
<td>Singapore</td>
<td>294</td>
<td>102</td>
<td>765</td>
</tr>
<tr>
<td>Denmark</td>
<td>920</td>
<td>283</td>
<td>225</td>
</tr>
<tr>
<td>Finland</td>
<td>277</td>
<td>108</td>
<td>159</td>
</tr>
</tbody>
</table>

1 USD = 68.0847 som (22.05.2016)

Sources: World Bank World Development Indicators
Table 5 shows that the Kyrgyz Republic’s indicators for each source of finance are much lower than in selected OECD countries. Also the data shows that the banking sector dominates the Kyrgyz financial system, representing 85.8% of all credits disbursed to the private sector. In 2014, the banking sector has provided credits with maturity above 3 years in the amount of 29 billion soms or 7.3% of GDP. 17.3% of the financial system’s assets belong to non-banking financial credit organizations mainly micro-credits organizations that specialize on short-term loans (National Bank of the Kyrgyz Republic, 2015).

The equity market: In 2012, market capitalization of listed domestic companies was 2.5% of GDP in the Kyrgyz Republic. It is a poor indicator in comparison to developed countries. For example, the same indicator in average OECD member country was 85.9% (World Bank World Development Indicators).

**Extremely low levels of funding for export operations**

The Kyrgyz Republic’s legal regulation of state financial support to export is in its infancy (Ponamorenko & Shulyatiev, 2016).

There is no state export-import bank in the Kyrgyz Republic. The only financial support provided by the state is through state program “Financing Agriculture - 4”. The government subsidizes interest rates of credits provided to the agricultural sector. The budget of the program is 5.7 million USD. The final interest rate provided to recipients is 10%. Among the eligible recipients of credits are export-oriented agriculture enterprises.

Banking Sector: Commercial banks provide services to the export sector limited to issuing letters of credit and bank guarantees. Also, credits provided on general terms as to any other enterprises.
Table 6 Provision of export services by top banks in the Kyrgyz Republic

<table>
<thead>
<tr>
<th>#</th>
<th>Name of the bank</th>
<th>Provision of Export Related Services</th>
</tr>
</thead>
</table>
| 1. | Kyrgyz Investment Credit Bank | - letter of credit  
- documentary collection  
- Bank guarantees |
| 2. | Optima Bank                  | - letter of credit  
- Bank guarantees |
| 3. | Aiyl Bank                    | - letter of credit |
| 4. | RSK Bank                     | - letter of credit  
- documentary collection  
- Bank guarantees |
| 5. | DemirBank                    | - letters of credit, including backup of the issuing bank plus deferred payments  
- any kind of guarantee - guarantee payment, performance guarantees, payment guarantees and other forms of payment guarantees  
- bills of exchange and trade transactions are associated with promissory notes.  
- pre-export financing |

Another market failure can be found in the **financing of strategic basic industries**. For example, only 2% of the loan portfolio of commercial banks in 2015 was directed to the transport and communication sector (International Monetary Fund, 2016). Permanently underserved, a strategic sector like energy (hydropower) has transformed the Kyrgyz Republic from exporter of electricity into an importer.

The basic financing of the industry is far from optimal levels in the context of the Kyrgyz Republic. For example, loans to industry (8%) twice below the amount extended to consumers and mortgage loans (17%) in the loan portfolio of commercial banks in 2015 (International Monetary Fund, 2016). It shows the short sightedness of the private sector and its natural drive for profit maximization. Long-term projects require considerable
financial backing and pursue long-horizon profit generation, thus it is unlikely for the private sector to take part in those kinds of projects.

**The funding of innovation**, and provision of venture capital, is also considered a market failure. It is riskier than traditional consumer or mortgage loans for commercial banks, therefore they have no presence in the field (Suleeva, 2014). The infrastructure of the Kyrgyz financial system has not achieved the level of development to have venture funds. Venture capital is essential in a modern economy for its promotion of radical innovation in science and technology.

The other market failure is the attraction of deposits by commercial banks in terms of geographical distribution. 87% of all deposits in the Kyrgyz banking system are from the capital city, Bishkek (International Monetary Fund, 2016); only a small portion of deposits attracted from the rest of the 6 regions of the Kyrgyz Republic.

Leasing can be considered as a market failure. Banks more interested in the provision of credit rather than leasing. If we look at it from a firm’s perspective, it is much more profitable for companies to take leasing instead of credit. For banks, it takes more time for the approval of a leasing contract and “long” money. Leasing is not considered a priority product for Kyrgyz banks.

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5 [https://www.akchabar.kg/article/products/islamic-leasing/](https://www.akchabar.kg/article/products/islamic-leasing/)
Analysis of the Law

‘On State Development Bank of the Kyrgyz Republic’

The article 5 of Section 1 permits a state development bank to participate in a form of equity investment in projects. So there are no restrictions in venture funding by a state development bank. Also, objectives of a state development bank are set in a broad manner and such important spheres as venture funding could be incorporated in the subsequent SDB internal bylaws.

Article 15 of Section 4 states that the initial capital is determined in the amount of 2 billion soms (around 30 million USD). Also it states that the initial capital should be paid only through the state budget. The practice and time showed us that the current mechanism is not working due to constant shortage of state funds. Therefore other sources of funds should be considered. For example, state revenue from a privatization program of state property of the Kyrgyz Republic for the period of 2015-17. There is no approximate market value of the state privatization program, but it contains 17 joint stock companies and 21 state properties.6

Regarding the structure of corporate governance it is designed according to best modern practices. The board of directors consists of 7 members, appointed for a 3-year term by the Prime Minister of the Kyrgyz Republic. The member of Board of Directors could be reappointed for another 3-year term. It is important to note that all candidates should comply with the professional requirements set by the law “On banks and banking in the Kyrgyz Republic”. It is important to have a Board of Directors independent of political

influences, though currently in Kyrgyzstan the scheme of appointments of Board of Directors membership is prone to high political dependency. The members of Board of Directors are implicitly incentivized to seek support from the Prime Minister. It is better to lengthen the term of appointment to 7 years as is the case with the appointment of Board of Directors’ members of National Bank of the Kyrgyz Republic.
CHAPTER IV: FINDINGS AND DISCUSSION

The first part of my research about Japanese experience in development banking presented the following results. As it is well known, the efficiency of an economy and its growth is highly dependent on effective financial intermediation. Particularly on how efficiently the market distributes capital; that is capital flow from those who hold it (lenders) to those who seek it (borrowers). In financial theory, there are two ways to raise capital: direct versus indirect one. Direct finance lets households take risk by investing in the securities market, whereas, indirect finance allows households to take minimum risk by depositing their resources in a bank (financial intermediary). In the case of Japan, the government favored indirect finance, and therefore it implemented financial restraint policies. The latter was the most suited approach to raise capital in a society with risk-averse preferences. Using the population’s money, the government of Japan could successfully channel it to the economy through development banks. In this case, not only development banks served as financial intermediaries between the population and firms, but the government also was serving as an intermediary between the population, development banks, and the firms.

Development banks provided long-term loans to nationally strategic sectors of the economy, where they were most needed. Certainly, these strategic industries do not tend to yield high and quick profits, therefore they would not be able to rely on commercial banks, and they would not have matured without development banks. Development banks were an inseparable part of the government’s coordination of loan distribution across the economy. The so-called ‘signaling effect’ coined by Joseph Stiglitz on the one hand would let other
banks know where the government’s economic priorities laid, on the other it would garner support across the banking sector and put together syndicated loans. High competence of this financial institution and mechanisms it employed let development banks lead the national banking community, as well as aptly direct financial resources to prospective industries. Development banks in the role of main banks established close ties with non-keiretsu firms, enjoyed profound insight into the firms’ health, and promoted their best interests within financial circles. Such distinctive relationships are far beyond a classical capitalist approach to banking business, as development banks in Japan undertook part of the responsibility to enhance their client-firms. Likewise, the client-firms gave part of their powers, such as membership in the board of directors, to development banks. Development banks were eager to employ high-profile ex-government bureaucrats, which widened the banks’ network, and strengthened ties between the state and the bank. The latter also stresses the importance and sustainability of relationships between the two sides, which only contributed to the overall efficiency of their work. Last but not least, it is pertinent to note that the Industrial Bank of Japan – a privately owned development bank – had played an absolutely unique role in the Japanese economy, which is exemplified by its successful merger negotiations and neutral position within traditional Japanese financial system. The Industrial Bank of Japan is credited for breeding one of the finest cadres in the beginning stages of building the development banking industry in Japan.

The fact that the Financial Loan and Investment Program has been inclusive of development banks, demonstrates how much the Japanese government valued this banking tool. Although the amount of public finance never exceeded 15%, it is without a doubt that development banks were an effective continuation of the government’s policies to both
launch and develop industries and to address structural problems in the economy. Overall, the Japanese government’s strategy worked well.

On the other hand, the second part of my research regarding assessment of internal environment in the Kyrgyz Republic by analyzing primary (interviews) data, presented the following findings.

**Strategic role**

All respondents indicated that the State Development Bank should perform a promotional role in state policy. Thus it was argued that the existence of the State Development Bank is justified only in case of the presence of concrete state development programs. The respondents indicated that nowadays there are no concrete state development programs. Although there is a National Sustainable Development Strategy for the period of 2013-2017, it was argued that this one is too broad and lacks focus. As Mr. Kabanbaev, expert on economy and investments in the department of Prime Minister’s Office of the Kyrgyz Republic, pointed out the “development bank should not exist on its own, it should exist in connection with strategy. If I may say so let's say 10 or 15-year plan of economic development and it should finance those projects which are mentioned in the plan of economic development”.

**Anti-Crisis role**

Although development banks perform anti-crisis, anti-cyclical roles in many countries, in case of Kyrgyzstan experts point out that this role is not of urgent need. Due to the fact that Kyrgyz financial system is not so highly integrated to global financial system it was concluded that there is a need for a state development bank performing its main objective of extending state policy by providing long-term finance.
Market failures

The market failure of the Kyrgyz Republic's financial system was summarized by one of the respondents in the following way: «Today, financial market, securities market, and credit market are not working at all. It is just speculative money, usually the interest rate of borrowing is much higher than the average profitability of industries. Only some, the most successful companies within industry borrow for short-term and only a small amount. The loans at 20%, 18% or 30% interest rate per annum most of the companies could not afford». Due to short deposit maturities maximum of 24 months, current financial system is only able to provide enterprises with working capital, not a developmental capital.

Also it was indicated that bottleneck industry that requires urgent intervention is the energy sector, particularly in the production of electricity. Despite possessing huge hydropower potential, nowadays, electricity produced in the Kyrgyz Republic is not enough to satisfy demand within the country. In 2015 the Kyrgyz Republic imported electricity in the amount of 1 billion kWh from neighboring Kazakhstan and Tajikistan.7

Although the Russian-Kyrgyz Development Fund (RKDF) currently mitigates the shortage of medium and long-term funds, it was highlighted that RKDF is investing only in profitable projects. To date, after 9 months of work RKDF had not invested any resources for the projects in less profitable sectors such as energy, nor in construction of hydropower plants. Despite the operations of RKDF, long-term projects with high social benefits and not so attractive profits are underserved in such sectors as utilities, energy and infrastructure. This is a market failure and there is only the state, with limited capacity of its budget, to counteract upon it.

**Pros and cons**

The advantage of such a development instrument is that it enables the government to concentrate its efforts and focus on one particular industry or set of industries. The merit of a development bank is the application of the economic criteria instead of political one in the process of selection of potential projects. Market mechanisms increase the effectiveness of realized projects and ensure the return of invested capital. In turn enterprises that receive a development bank’s financial backing are incentivized to use effectively resources and payback.

Criticism was expressed in relation to current scheme of borrowing from the International Financial Institutions (IFIs). In fact, Kyrgyz Republic forms 30% of its budget from donor’s grants and credits, and most of that goes to finance state infrastructure programs. The existing scheme of borrowing from IFIs is highly bureaucratized, multi-step, and it takes around 1.5-2 years to pass the state procedures to approve a project. It was highlighted by the respondents that the creation of the State Development Bank could streamline the process and considerably reduce the amount of time spent for the project launch. Also, that kind of measure would reduce pressure on the country’s increasing debt.

Public trust in the State Development Bank (SDB) was listed as an advantage due to the implicit state guarantee of SDB’s liabilities. People do still remember their loss of savings due to the bankruptcy of privately owned banks during the banking crises of the 1990s, but this situation has changed dramatically in recent years. In ex-Soviet countries people, especially the older population, tended to trust the state financial institutions more.
Among disadvantages of a development bank the main one is the risk of getting influenced by politicians, substitution of economic criteria with political one. The loss of independence from executive branch could result in devastating outcomes.

**Lack of progress on the SDB**

One of the respondents expressed a view that there is a lack of knowledge about a development bank among policymakers in the Kyrgyz Republic. It is inferred that this is one of the primary reasons of the lack of progress on the matter of the pursuit of the State Development Bank’s further promotion. After approval of the law “On the State Development Bank of the Kyrgyz Republic” in 2012, there has not been any progress.

**Ownership**

The respondents clearly indicated that ownership of the State Development Bank should be in the possession of the government. It would enable it to independently define its policy. Therefore, the abovementioned law on the State Development Bank should not be changed in this regard.

**Main obstacles to long-term finance**

The Head of the National Bank of the Kyrgyz Republic Mr. Abdygulov indicated exchange risk, small market (6 million people) and lack of competitive enterprises as the main obstacles to the development of long-term finance in the Kyrgyz Republic. Other respondents suggested current tight monetary policy (high discount rate (6%), low money supply), and lack of public trust to banking system as main obstacles to long-term finance in the Kyrgyz Republic.
Although most of the respondents agreed on the advantages of the State Development Bank, none of them expressed an urgent need for it. On the contrary, some of them have not found feasibility in the State Development Bank because of the Russian-Kyrgyz Development Fund’s work. It was argued that the Russian-Kyrgyz Development Fund is already financing priority sectors of the Kyrgyz economy.

Moreover, analysis of secondary data regarding the financial sector presented the following results. In inflationary times, long-term lending is usually shortened to a range of 2 to 5 years (Bruck, 2001). In the case of the Kyrgyz Republic this is also true. The statistics methodology of the National Bank of the Kyrgyz Republic only classifies credits into 3 categories in terms of maturity: until 1 year, 1-3 years, and over 3 years. It can be inferred that there is almost a total absence of long-term funds in the market. In less inflationary economies, usually medium term is classified as 1 - 5 years, long-term 5 - 10 years. Therefore, one of the obstacles to the development of medium and long-term financing is a highly volatile inflation rate.

The identification of market failure in attraction of deposits by commercial banks in the regions of the Kyrgyz Republic presents opportunity for the government. The same as in Japan, the Kyrgyz Republic has a strategic institution such as state enterprise (SE) “Kyrgyz Post”, but currently it is in a deplorable position. The main reasons are the development of information and communication technologies (ICT) and the backwardness of the organization as a whole. However, there is a government plan to transform the SE “Kyrgyz Post” into a bank.\footnote{http://kyrgyzpost.kg/ru/filialy/gp-kyrgyz-pochtasy.html} Similar to the Japanese experience, after the transformation of
SE “Kyrgyz Post”, it can be used to mobilize the population’s savings and further channel it into the State Development Bank. In this case, such a scheme will be highly sustainable because it will reduce SDB’s dependency on external resources.
CONCLUSION

Japan entered the XXI century as one of the most advanced economies in the world. Thus, today its economic priorities, as well as the challenges the country is facing are different from those in the second half of the previous century. Therefore, eventually, development banks were privatized and are currently moving towards an Anglo-American banking model. However, the enormous role they played in reviving the nation after the Second World War’s devastating effects, and turning it into the ‘Asian miracle’ economy may serve as a valuable experience for other countries, including the Kyrgyz Republic.

As it was evidenced by the Japanese economic “miracle” and three waves of “Asian Tigers”, who chose similar paths of active state intervention into an economy, the Kyrgyz Republic could also transform itself into a highly modern and advanced state. The further promotion of the issue of the State Development Bank of the Kyrgyz Republic only should take place when there is appropriate state development program. The State Development Bank serves as instrument in implementation of state development program. The Japanese experience in development banking gives us a lesson that a development bank(s) could serve multiple roles such as main bank, industry coordinator, signaling and crucial source of highly qualified cadres. But, in our context, there is no clear understanding of the instrument as a development bank among policymakers in Kyrgyzstan.

Although Russian-Kyrgyz Development Fund mitigates general lack of long-term finance, it is not solving the problem of credit gap in financing key infrastructure projects. The financial system of the Kyrgyz Republic is in its initial stages and state intervention in the form of the State Development Bank would correct numerous market failures and
provide impulse to the development of new areas within the financial system. To the advantage of a development bank it will increase the efficiency of resource allocation within the economy because of the application of market mechanisms.

There are risks related to political dependence of the State Development Bank, but this research suggests in order to guarantee the independence extend the term of Members of Board of Directors from current 3 to 7 years.

There is a clear shortage of long-term financing in the Kyrgyz Republic despite of Russian-Kyrgyz Development Fund thus the State Development Bank shall take the capital development role as its primary objective.
# ACTION PLAN

<table>
<thead>
<tr>
<th>#</th>
<th>Problem</th>
<th>Solution</th>
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<tbody>
<tr>
<td>1.</td>
<td>Current National Sustainable Development Strategy of the Kyrgyz Republic for the period of 2013-2017 is broad and lacks focus</td>
<td>Development of concrete state program focused on strategic sectors and promotion of new industries</td>
</tr>
<tr>
<td>2.</td>
<td>There is no appropriate development finance infrastructure in the Kyrgyz Republic</td>
<td>Accelerate reform of state enterprise “Kyrgyz Post” into “Kyrgyz Post Bank”</td>
</tr>
<tr>
<td>3.</td>
<td>Lack of state funds to finance State Development Bank’s initial capital in the amount of 2 billion soms</td>
<td>- Issuance of bonds; - Channel revenues from privatization</td>
</tr>
<tr>
<td>4.</td>
<td>Potential political dependence of State Development Bank’s BoD members due to short-term appointment (3 year)</td>
<td>Amend current law “On the State Development Bank of the Kyrgyz Republic” in order to increase BoD member’s term of service to 7 years</td>
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BIBLIOGRAPHY


## APPENDICES

**List of Interviewees**

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<tr>
<th>#</th>
<th>Name</th>
<th>Institution</th>
<th>Position</th>
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<tbody>
<tr>
<td>1.</td>
<td>Tolkunbek Abdygulov</td>
<td>National Bank of the Kyrgyz Republic</td>
<td>Head</td>
</tr>
<tr>
<td>2.</td>
<td>Aibek Kadyraliev</td>
<td>President’s Office of the Kyrgyz Republic</td>
<td>Head of Finance and Economic Analysis and Development Monitoring Department</td>
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<td>3.</td>
<td>Nurgul Akimova</td>
<td>President’s Office of the Kyrgyz Republic</td>
<td>Expert of Finance and Economic Analysis and Development Monitoring Department</td>
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<td>4.</td>
<td>Nikolay Chuikov</td>
<td>Prime-minister Office of the Kyrgyz Republic</td>
<td>Head of Economy and Investment Department</td>
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<td>5.</td>
<td>Timur Kabanbaev</td>
<td>Prime-minister Office of the Kyrgyz Republic</td>
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<td>6.</td>
<td>Daniar Imanaliev</td>
<td>Ministry of the Economy of the Kyrgyz Republic</td>
<td>Deputy Minister</td>
</tr>
<tr>
<td>7.</td>
<td>Kairat Mamatov</td>
<td>JSC “Aiyl Bank”</td>
<td>Head of Board of Directors</td>
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