Document
of the EurAsEC
Anti-Crisis Fund
00008

Eurasian Development Bank
Resources Manager of EurAsEC Anti-Crisis Fund

EVALUATION REPORT

on Preliminary Application

of the Ministry of Finance of Kyrgyz Republic

for Investment Loan
to be financed by the EurAsEC Anti-Crisis Fund for the project
“Agricultural machinery supplies
to Kyrgyz Republic”

in the amount of US$ 20 million

May 2013

Kyrgyz Republic
Fiscal year: 1 January –31 December

National Currency Exchange Rate
as of 01/05/2013

Currency	KGS
1 Russian Ruble	1.5502
1 Kazakh Tenge	0.3182
1 US$	48.1235
1 EUR	62.8758

Weights and Measures: Metric System

Acronyms and Abbreviations

ACF, Fund the Anti-Crisis Fund of the Eurasian Economic Community
ADB the Asian Development Bank
Agri Agricultural
EBRD the European Bank for Reconstruction and Development
EDB, Resources Manager the Eurasian Development Bank
EurAsEC – the Eurasian Economic Community
FS - Feasibility StudyFeasibility StudyGDP - Gross Domestic Product
GNI – Gross National Income per capita
IDB - International Development Banks
IFI - International Financial Institutions
KR – Kyrgyz Republic

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1. BASELINE PARAMETERS OF LOAN RECOMMENDED BY RESOURCES MANAGER

Borrower:	Ministry of Finance of Kyrgyz Republic
Amount and financial conditions	• Requested amount of ACF loan: US$ 20 mln (total project amount including cofinancing contribution by lessees in the amount of US$ 25 mln). • Loan currency: US$. • Interest rate: 1% per annum. • Risk premium: amount to be defined upon completion of project preparation. • Front-end fee: 0.5% (toward partial funding of operating costs of Resources Manager). • Commitment fee: none • Loan maturity, including grace period: 20 years. • Grace period for principal repayment: 5 years (borrower requested 7 years). • Grant-element: 38.32%. • Cofinfancing contribution by the borrower: US$ 5 mln. (20% of total cost of project). • Recommendations on financial conditions will be specified in the process of project preparation with due consideration of the long-term sustainability of KR and guidelines of the IMF program, which will be running in KR on the date of the loan approval by the ACF Board.
Term of Project	20 years (loan maturity; details available in the financial model of the project).
Type of operation	Investment Loan
Sector	Agricultural, infrastructure
Main performance indicators	• Upgrading of fixed assets in agricultural sector; • Expansion of infrastructure of maintenance facilities for agricultural machinery; • Modernization of agricultural machinery and tractor fleet in Kyrgyz Republic; • Generation of additional budget revenue in KR to enable continued funding of agricultural machinery supplies by own financial resources and establishment of a leasing budget support fund; • Increase in production and exports of agricultural products and strengthening of food security; • Consolidation of balance of trade through enhancement of agricultural production capability; • Increase in agricultural productivity in ploughing, growing and harvesting activities; • Increasing mutual investments and trading between ACF member-countries.
Main Objectives	• Extended service life and efficiency of the agricultural machinery by means of developing existing and building new maintenance infrastructure facilities; • Reduction of poverty level of rural population; • Improvement of debt sustainability of Kyrgyz Republic by building up project profits in agricultural machinery leasing budget support fund and by reducing the need for external borrowing for purchasing such machinery; • Development of small and medium-sized agricultural businesses; • Integration through increased exports of agricultural products to EurAsEC markets and importing machinery from ACF member-countries.

2. RESOURCES MANAGER'S APPRAISAL REPORT ON PRELIMINARY APPLICATION

This Appraisal Report provides an assessment of the preliminary application of the Ministry of Finance of Kyrgyz Republic (hereinafter the Application). The principal declared objective of the Loan consists in fundraising for the project "Supplies of agricultural machinery produced in EurAsEC to Kyrgyz Republic" (hereinafter the Project).

Section 3 of this document contains rationale for the Appraisal of the preliminary application by the ACF Resources Manager's (hereinafter the Manager).

Having considered the Application, the Manager offers the following recommendations and conclusions for consideration of the ACF Council:

1. *The Application conforms to the mission of the Fund, its funding objectives, lending policy and conditionality, as defined by the Treaty on the Establishment of the Fund, the Fund By-Laws, the Regulation on ACF Investment Loans and relevant decisions of the ACF Council* the Fund Statute, and Regulation on the use of ACF resources for providing investment loans, and decisions of the Fund Council.

2. *The Application is executed in full compliance with the requirements of the Fund.* The The level of the Application preparation in terms of the required data for assessment purposes and supporting documentation to enable a preliminary completeness approval is deemed satisfactory.

3. *The Project is consistent with the ACF mission.* The Project promotes improved sustainability of the Kyrgyz economy (growth of production and exports of agricultural products), reduction of poverty and further integration of the economies of the ACF member countries (provision is made for increased mutual investments and trade between ACF member states). To improve the anti-crisis impact of the Project the Manager recommends using the loan resources for investments into developing infrastructure facilities for agricultural machinery maintenance. Furthermore, in the course of preparation of the application for investment funding the Manager recommends providing more details on the mechanisms of establishing and operation of the agricultural machinery leasing budget support fund.

4. *Kyrgyz Republic has complied with all the commitments set out in the Treaty on the Establishment of the Fund, the Fund Statute, and decisions of the Fund Council.* The obligation to make an initial cash contribution has been fulfilled. According to the information available to the Manager, Kyrgyz Republic has no outstanding debts either to other Fund member states, or to any international financial institutions. By the date of the Fund Expert Council meeting scheduled to consider approval of the Loan, the relevant supporting letters will have been received. Up till now Kyrgyz Republic has never been granted ACF loans, and the requested amount is within the access limit to Fund resources for Kyrgyz Republic.

5. *To ensure proper quality of the project documents and efficient use of the loan the Manager recommends to perform thorough scrutiny of the proposed project by engaging an independent evaluation audit firm and by carrying out specific activities on project documentation preparation. In case the Fund Council approves the Loan, the ACF resources spent on the preparation work should be put up by the borrower as partial coverage in the form of front-end fee.*

6. *According to common EDB investment project preparation practice, the Manager will need to hire independent consultancy services for technical, legal and environmental advice, as well as for procurement support and monitoring proper use of the Loan funds.*

The total amount of such expenses is estimated at no more than US$ 200,000, including:

- procurement consultancy: up to US$ 120,000;
- technical and legal advice: up to US$ 80,000.

The total amount of expenses equal to US$ 100,000 is expected to be covered by the front-end fee (0.5% of the ACF loan amount).

7. *As defined by the Agreement on the Management of Fund Resources, the Manager is required to control procurement of goods, services and work funded by ACF in compliance with in-house procurement policies and regulations, and make provision in ACF Lending Agreements for compliance commitments of the borrowers.* With due regard to the procurement transparency guidelines for ACF projects, as well as reduction of corruption risks, the Manager proposes to consider the possibility to use of the World Bank Procurement Policy (the project company has experience of implementing WB projects in compliance with WB procurement policy), with relevant preferences for machinery to be supplied from the Fund member countries.

8. *Monitoring and appraisal of the Project will be done by the Manager in accordance with the methodology for strategic monitoring and project appraisal of the Manager, and as required by the Manager's Project Cycle Regulation.*

3. RATIONALE FOR APPRAISAL

General

1. *Social and Economic Status of Kyrgyz Republic*

Kyrgyz Republic is a low-income country. In 2011 its GDP was equal to about US$ 5.93 bln. The poverty level is estimated at 37%. 2012 saw continued trend toward shrinking positions of KR on the global competitiveness scale (WEF). Since 2006 Kyrgyzstan has slid 17 points down to position 127. Quality of business environment is the only indicator out of the commonly known development reference indexes, which rates KR in the midrange and not at the bottom amongst the CIS countries.

In 2000-2011 the average annual growth rate of the economy was around 4%. The key sectors are agriculture – 18%, manufacturing industry – 17% with 40% of this share contributed by for the gold mining company "Kumtor", as well as trade - 16% and transport – 8%. In 2012 significant reduction of gold mining activities at "Kumor", resulted in January-September in a deep (over 44%) decline in the manufacturing industry. The positive development pattern, observed in other sectors (including agricultural 2%), was not sufficient to offset the above drop, and, as a result, overall decline was registered at the level of 5.6%. The GDP decline had a negative impact on investment funding from domestic sources. The GDP recovery in 2013 and positive estimates of economic growth for 2014-2017[1] should contribute to mitigating budget limitations, but funding capacity will largely be constrained due to accumulated budget deficit and external debt[2].

Kyrgyzstan is characterized by a chronic budget deficit averaging at around 4.2% of GDP in 2000-2012. Prior to 2009 the national external debt was controlled at the level of 33-37% of GDP. The borrowing requirement, which emerged in the post-2008 crisis period, the sluggish GDP growth and weakening of the national currency exchange rate, increased the external debt service burden, and in 2012 the situation was aggravated by a drop in the GDP, which, as a consequence, affected the taxable base. In 2012 the budget deficit was equal to 6.6% of GDP, 85% of which was funded from external sources. As a result the external sovereign debt exceeded 46% of GDP. As estimated by the IMF, the external sovereign debt service to revenue ratio will be close to 5%. Thus in the short term the budget deficit is expected to remain at 3.5-4.5% of GDP. Yet, according to the IMF, any measures with a view to consolidating budget expenditures and further steps in reforming the tax administration system may stabilize the budget of Kyrgyzstan.

The quality of public institutions is poor. With all the ambiguity of ratings, their low performance is indicative of the lack of progress in the last decade.

Thus, the current economic condition of Kyrgyzstan reveals extremely limited capacity for funding investments into production fixed assets from domestic sources; and the capabilities for attracting external investments are also very scarce due to poor business environment.

Impact of ACF Loan on Economic Condition of KR

The approval of the ACF loan to fund upgrading of the agricultural machinery fleet will facilitate investments into production fixed assets. Given the significant share of agriculture in the structure of GDP, modernization of the agricultural machinery fleet should promote economic development, growth of the GDP, consolidation of the balance of payments and diminish the exposure of the economy to external repercussions. In addition, the increased numbers of agricultural machinery fleet will generate demand for maintenance services and thereby will contribute to economic diversification. A special mention should be made in respect of the growth of productivity of the sector, which will promote strengthening of food security of the country. A more specific estimate of the project's impact on the economic development potential can be provided at a later stage in the process of project preparation.

[1] As estimated by the IMF the growth rate will average around 5,2% per annum.
[2] To stabilize the external debt in 2013-2014 net surplus of the budget should be maintained at 5% of GDP.

The impact on debt sustainability is estimated as negligible. The proposed loan will increase external debt by 0.7%, which is less than 0.3% of GDP as of 2013. Considering the grace period (7 years), the Loan will not generate any additional debt service burden in a busy period of repayments of foreign debt liabilities. Despite the tough external debt status the IMF's assessment of the situation is far from critical. The external debt service burden to budget revenue ratio is below the threshold (about 5% projected for the medium term, as against 20%, respectively). The external debt to export receipts and money remittance fees levied from migrant labor is equal to 40% with a threshold at 120%. In addition, writing off the debt to Russia will also substantially reduce the external debt service burden. When "Kumtor" resumes its business, and given conservative external borrowing policies are continued, the budget and debt positions will be evaluated as stable. The approval of the ACF loan in the amount of US$ 20 mln (about 0.3% of GDP) to be provided at such highly beneficial conditions will not lead to any significant increase in the debt service burden of the country.

And the proposed use of earnings from the Project for financing the suggested agricultural machinery leasing budget support fund will provide another factor reducing the requirement in external borrowing and consolidating the national debt sustainability.

2. *Agricultural Sector*

Kyrgyzstan is a mountainous agricultural country. Agriculture in Kyrgyzstan is one of the key sectors of the economy. About 65% of the population live in rural areas. 34% of the active work force, or 14% of the total population, are employed in the agricultural sector (in developed countries this indicator is 1-3%). These data demonstrate that agricultural production in Kyrgyzstan has not only economic, but also social and political significance. The key agricultural subsectors in the country are grain crops, vegetable and potato growing, cultivation of industrial crops, such as cotton, tobacco, sugar beets and cattle breeding. The agri land in the country occupy 10,658.2 thousand hectares, of which tillable ploughland accounts for 12% of the total agricultural land, and native grassland - 9,165.6 thousand hectares and 86%, respectively.

Notwithstanding the large proportion of agricultural in the GDP of KR, the Ministry of Agriculture and Land Amelioration registers low labor productivity in the sector and a trend to further deterioration in the short term. For example, gross crop production in the plant growing subsector in 2012 dropped on the average by 15% as compared with 2011 and was equal to: grain crops – 1,440 thousand tons in 2012 as against 1,580.7 thousand tons in 2011, cotton – 85.3 thousand tons in 2012 as against 101.3 thousand tons in 2011, tobacco – 7.5 thousand tons in 2012 as against 9.9 thousand tons in 2011, potatoes – 1,273 thousand tons in 2012 as against 1,379.2 thousand tons in 2011. Domestic requirement for grain crops in KR is not met by its own production capacity, and there is a trend toward further adverse developments: in 2011 269 thousand tons of grains were imported (about 23% of the total requirement), and in 2012 another 384.2 thousand tons (about 35% of the total requirement). Only potatoes are exported in small amounts (47.9 thousand tons in 2012) and melon crops (99.1 thousand tons in 2012). The most important reason for the poor performance and decline in the productivity in the sector is its low-grade technology and equipment used by farmers and agricultural production companies, as well as a high wear rate of the agricultural machinery.

As of 1 January 2012 KR had available machinery and tractors mostly made in Russia, Belarus and Ukraine and supplied in 1980-s. Over 90% of the fleet is machinery with service life 3-4 times overrun and requires total replacement.

Because of the worn down condition of the machinery the farmers and agricultural enterprises incur prohibitive operation and maintenance overheads. The expensive repair and maintenance work is due to the absence of appropriate infrastructure. E.g., for the Russian and Belorussian machinery operated in KR there is only one authorized maintenance center "Avtomashradiator", which is located in Bishkek. For current maintenance of the machinery the spare parts are delivered from Bishkek to where the machines are operated, and maintenance services are also often provided by professionals from Bishkek. In case capital repair is needed, the machines are delivered to the central maintenance facility in Bishkek. Establishment of a network of maintenance stations in the region would enable a significant reduction in operation and maintenance costs incurred by the agricultural producers and extension of service life.

According to the Ministry of Agriculture and Land Amelioration of KR, investments into the agricultural fixed assets are very low: in 2011 the agricultural sector accounted for less than 1.5% of the total amount of investments in KR (in Kazakhstan - 2.3%), which is equal to about 0.1% of GDP (in Kazakhstan - 0.3%). In many agricultural units manual labor is used, as well as horse traction power, because their financial condition does not allow them to purchase new machinery without borrowing at reduced interest rates.

In view of the above, due to the limited resources and lending markets for agricultural units, the only possible arrangement to enable upgrading of the agricultural machinery fleet lies in developing agricultural machinery leasing schemes. It should also be kept in mind that commercial leasing in KR is practically unfeasible. The average interest rate in borrowing from banks (including foreign banks) in KR for leasing purposes is equal to 16%-plus per annum (in US$) payable by the lessee. Faced with such lending terms and conditions most agri producers cannot afford machinery leasing and, at the same time, retain reasonable profit margin.

International development banks operating in KR prior to 2011 provided long-term loans to fund purchasing agricultural machinery in the form of grants or with a grant-element of 50%-plus. The current long-term strategies of the World Bank, Asian Development Bank, European Bank for Reconstruction and Development make no provision for investments into modernization of the agricultural machinery fleet up to 2015. It is noteworthy that some of the leasing programs in the agricultural sector are being implemented involving highly preferential sovereign loans and grants provided by other countries (China, Turkey), but these programs do not account even for 5% of the total requirement in machinery. In these circumstances establishment of the proposed fund for budget support of agricultural machinery leasing is especially relevant, because it enable the government to provide financial resources for leasing programs.

According to the Ministry of Agriculture and Land Amelioration of KR agricultural units are mostly interested in machinery made in EurAsEC countries (farmers have experience in operating such machines and practical skills for repairs, and there are maintenance facilities).

Mindful of the above the Ministry of Agriculture and Land Amelioration of KR requested the Manager to consider a possibility of funding agricultural machinery supplies (primarily from Russia, Kazakhstan and Belarus) for subsequent leasing out to farmers and agri production units.

3. *Foreign Trade with ACF Member Countries*

According to the official statistical data EurAsEC countries account for almost 50% share in the Ex-Im structure and the balance for the rest of the world. Re-export of Chinese goods at reduced prices takes up a substantial proportion in the exports to EurAsEC countries.

The imports from ACF member states in 2009 amounted to a total of US$ 1.4 bln (over US$ 0.5 billion accounted for cereals). Exports from KR in the context of its current market saturation satisfy only a small portion of requirements of ACF countries in specific products.[3] E.g., the total amount of Russia's imports from KR in 2011 was equal to US$ 289.3 mln.[4]

Exports of agricultural produce from KR to RK in 2011 exceeded US$ 450 mln, and to RF - about US$ 70 mln[5].

[3] http://www.eabr.org/general/upload/docs/resume_kr_ts.pdf
[4] http://www.kyrgyz.mid.ru/torgec.html
[5] http://www.kyrtag.kg/?q=news/11018

It should be indicated that a substantial portion of foreign trade relations of KR with ACF member countries belongs to migrant labor and their cash remittances. In 2011 about 1 million Kyrgyz migrants were present in ACF member countries. In 2011 the total amount of cash remittances reached US$ 1.7 mln.[6]

Exports of Agricultural Produce to ACF Member Countries[7]

Destination	**Exports from Kyrgyzstan in 2006**			**Exports from Kyrgyzstan in 2011**		
	tons	ths US$	ths KGS	tons	ths US$	ths KGS
Russia	63251.3	11023.071	442994.8	62647.4	20513.076	951301.1
Kazakhstan	14836.1	2100.33	82824.2	237054.9	59979.647	2755364.5
Tajikistan	31.9	14.612	575.3	384.3	188.72	8640.2
Belarus	0	0	0	374.7	368.346	17260.7

Project Description

1. Policy of Project Implementation and Financial Conditions

The Project implementation procedure makes provision for disbursement of ACF funds to the Ministry of Agriculture and Land Amelioration of KR as an investment loan.

The funds raised thereby should be transferred to Aiyl Bank, a state-owned bank providing funding to agricultural projects (hereinafter the Project Company) as per schedule (see Project Financial Model). By refunding according to the above schedule the amount of US$ 20 mln may actually be disbursed by the Kyrgyz Ministry of Finance 6 times in the course of 20 years. The Project Company will use the above funds for procurement of about 4,000 units of agricultural machinery (with preferences extended to machines produced in EurAsEC countries) to be subsequently leased out to agri producers of Kyrgyz Republic during the life cycle of the Project. It should be borne in mind that in the course of the project implementation machinery will be purchased strictly based on acute requirements of new or replacement of obsolete units. Such purchases will be made only to provide the most expensive units of agricultural machinery, i.e. tractors with attached gear and harvester-threshers. The estimates were made on the basis of a hypothetical unit price of US$ 30 ths. Procurement of up to 4,000 units of the above machinery will enable meeting 10%-15% of the country's requirement in such technology.

To ensure uninterrupted operation of the machinery and reduce overhead costs incurred by agri producers, the Manager also recommends to allocate up to US$ 2 mln for building agricultural machinery infrastructure facilities, including maintenance stations, procurement of relevant equipment and spare parts storage. In case the Fund Council approves the Preliminary Application, the Manager in cooperation with the Government of KR will examine the possibility of incorporating the necessary investments into the final version of the Application.

Earnings accruing from the project implementation (leasing interest payments), net of operating expenses, should be used for the establishment of a fund for budget support of leasing, which will be managed by the Government with a view to funding purchases of agricultural machinery to be leased out to farmers without borrowing from external sources. According to the Manager such an arrangement can ensure a long-term anti-crisis impact from the project, improve debt sustainability and promote additional synergistic and integrative motivation. Preliminary assessments show that the amount to be transferred to the proposed fund during the implementation cycle of the project may total over US$ 15 mln.

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[6] http://www.eabr.org/general//upload/CII%20-%20izdania/Proekti%20i%20dokladi/Kyrgyzstan%20-%20CU/EDB_Centre_Report_13_Full_Rus_1.pdf

[7] Source: Ministry of Agriculture and Land Amelioration of KR

Project Funding Requirements:

The Ministry of Agriculture and Land Amelioration of KR has provided information that the total requirement of Kyrgyz Republic is currently equal to 154,002 units of agricultural machinery.

Description	Regulatory requirement, pcs	Available as of 1 Jan. 2012	In operation over 20 yrs, %	Needed per requirement, pcs
Tractors	27,953	20,750	87	-7,703
Harvester-threshers	4,830	2,532	87	-2,298
Corn harvesters	510	99	100	-411
Forage harvesters	1,463	473	100	-990
Seed planters	4,123	2,541	95	-1,582
Tooth harrows	78,274	19,973	100	-58,301
Weeders	7,739	2,208	100	-5,531
Tractor ploughs	5,479	7,052	77	-
Disc harrows	2,124	191	100	-1,933
Tractor trailers	16,773	8,902	98	-7,871
Tractor mowers	2,294	1,668	100	-626
Tractor rakes	1,293	562	100	-731
Pick-up balers	1,147	1,031	100	-116
Total:	**154,002**	**67,982**		**-86,020**

The list of specific machines for procurement based on funding provided by ACF will be compiled as requests are filed by the farms, and upon approval by the Manager. The Manager will require that only indispensable machines are included in the list, i.e. which cannot be purchased on the market without a loss to a reasonable profit margin.

The Manager in cooperation with the Kyrgyz Government and the Project Company will examine in detail the maintenance infrastructure investment projects. According to preliminary assessment such requirement is estimated at US$ 2 mln. In the event of preliminary approval by the Fund Council the Manager will conduct consultations with the Ministry of Finance of KR on inclusion of detailed information on such investment projects into the final draft of the application for the Project (investment application and Project business-plan).

The Manager will take steps to ensure maximum competitive spirit and transparency in reviewing the applications and, in particular, will consider engaging World Bank experts to take part in allocating machinery to end-users.

Project Implementation Mechanism

The project will be implemented on the basis of the following plan: The ACF Loan is granted to the Government of KR, the Government of KR presents a budget plan to the Project Company, and the Project Company:

1) conducts an open-ended competitive bidding in compliance with the relevant WB Policy under the supervision of the Manager. Upon completion of the open-ended bidding procedure and given approval of the Manager, the Project Company transfers funds to the successful bidders among machinery producers and dealers for machinery supplies (25% as front-end, and 75% - upon delivery). As part of the bidding procedure, preferences will be considered for suppliers from ACF member countries. Machinery supply contracts will contain provisions with commitments to provide maintenance services. The Project Company upon receipt of the purchased machines will hand them over to farms under a lease contract. Leasing out the machinery will also be preceded by competitive bidding following evaluation of the applications of potential lessees. The initial contribution of the lessee will be charged in the amount of at least 20% of the total price of the leased machinery.

A detailed leasing scheme will be prepared by the Manager in cooperation with the Project Company and together with a legal advisor, and it will be incorporated into the Loan Agreement between the Manager and the Government of KR.

2) allocates funds for the development of a regional network of maintenance stations (including lending to the existing maintenance companies). Such transactions will be effected based on bidding procedures (WB Policy with preferences extended to domestic companies and companies of ACF member countries.

Earnings from lease interest payments and interest accrued from maintenance infrastructure investment projects will be transferred by the Project Company, net of its own expenses, to the national budget for repayment of the debt to ACF and for the establishment of a fund to be used for further purchases of agricultural machinery and turning it over to agri producers under lease arrangements without borrowing from external sources.

1	Total amount provided as loans to farmers	US$ 120 mln
2	Total interest payments	US$ 27.6 mln
3	Cost of loan service	US$ 15.3 mln
4	Balance controlled by Ministry of Finance of KR for further funding of Project	US$ 13 mln

2. *Current Status of Project*

As of 1 November, 2012:

- Project Company has been designated for implementation work (Aiyl Bank. See Appendix 4 for details) with experience in implementing similar projects in cooperation with other IFIs. References of implemented agricultural machinery leasing projects:

In 2011-2012 the Project Company with support of the World Bank as part of the project "Agribusiness and Marketing - Leasing" implemented a leasing project in the amount of KGS 59,479 mln whereby 39 units of agricultural machinery were leased out to agri producers, including 6 harvester-threshers, 31 tractors, 1 attached gear set, 1 truck. The two principal components of the project were development of the market with a view to optimizing goods distribution channels through implementing project activities in the private and public sectors, and opening up borrowing capacity for agri farms. The project was closed in March 2013, and the World Bank's preliminary evaluation of its implementation was ‘successful’[8].

The Project Company used loans extended by the National Development Bank of China in 2012 to procure agricultural machinery for the amount of US$ 1.5 mln, for subsequent leasing out. The total amount of loans granted to Aiyl Bank by NDBC between 2009 and 2012 in the form of agricultural machinery supplies amounted to US$ 3.5 mln. In the course of business meetings with the Manager representatives of the Kyrgyz Government and Aiyl Bank showed discontent with the quality of the leased Chinese machines.

- The Ministry of Agriculture and Land Amelioration of KR has made assessment and determined a preliminary requirement in agricultural machinery.

3. *Project Compliance with ACF Mission*

The Project promotes improved economic sustainability of Kyrgyz Republic and aims to achieve:

- Improved balance of payments by increasing exports of finished agricultural products (upon completion of the project export of plant growing products may

[8] http://www.worldbank.org/ru/country/kyrgyzrepublic/overview

increase by up to 15%, or US$ 24 mln per annum, which amounts to about 0.4% of GDP of KR);

- Modernization of agricultural production fixed assets (production may grow up to 100% (if horse traction is replaced with mechanized gear));
- Reduction of overheads incurred by the farmers by building maintenance infrastructure (no longer need to deliver machinery to the only available maintenance facility) and upgrading of the agricultural machinery fleet (e.g. power consumption of new units of machinery may be 40% less than is the case with the currently operated machines); [9]
- Enhanced debt sustainability of Kyrgyz Republic through establishment of a fund to be used by the government for procurement of agricultural machinery and leasing it out to agri producers, thereby reducing the requirement in external borrowing (currently a sovereign loan provided by Turkey is used for the purpose).

In full compliance with the Regulation on ACF Investment Loans, the Project is classified as national, since:

- The borrower for the Project is the Government of Kyrgyz Republic;
- It is implemented by a project company;
- It is implemented within one member state of the Fund;
- It aims at modernizing and upgrading production fixed assets, and building infrastructure.

The Project is designed as integrating, because its implementation will lead to the following integration results:

- Increased inter-state investments and trade turnover between Kyrgyzstan, Russian federation, Republic of Kazakhstan and Republic of Belarus by promoting imports of machinery, equipment and maintenance services in KR;
- Increased trade turnover between EurAsEC countries by developing exports of agricultural production in KR.

The current economic condition of Kyrgyzstan constitutes a serious constraint for the inflow of foreign investments, and it suppresses opportunities for potential market-driven investments.

The Project cannot be funded by market sources on commercial conditions: all leasing programs in the agricultural sector in KR are currently being implemented on the basis of grants and highly preferential borrowed funds.

In 2011-2012 the World Bank extended a loan for the project "Agribusiness and Marketing - Leasing" at an average interest rate of 1.5% per annum.

The National Development Bank of China (NDBC) in 2012 provided grants and highly preferential loans for procurement of agricultural machinery in the amount of US$ 3.5 mln.

It is noteworthy that the interest rate on the sovereign loan in the amount of US$ 100 mln extended by Turkey to Kyrgyzstan in January 2013, including for funding agricultural machinery supplies with a view to subsequent leasing, is equal to 0.1% per annum.

The interest rate on sovereign loans and highly preferential loans payable by the ultimate beneficiary is 6-9% per annum in national currency. International financial institutions transacting on conditions, similar to market-driven (e.g. EBRD), do not support agricultural machinery leasing programs in the country. It should be indicated that the average interest rate in banks lending in foreign currencies (including foreign banks) in KR is at least 13% per annum (in US$). At the rate of 10% in national currency the average return on investment into ploughing and harvesting machinery in Kyrgyzstan is 5 years. At the rate of 10% for US$ (around 22% in national currency) the ROI triples (up to 13 years). This

[9] United Nations: The State of Food and Agriculture 2009

parameter exceeds the admissible service life for agricultural machinery and makes leasing projects economically unfeasible.

A minimum affordable interest rate on EDB loans in US$ with disbursement period up to 3 years and maturity up to 10 years at an average risk, should be 7.71% per annum (net of fees and project preparation cost recovery). EDB did not specify any risk limit for Aiyl Bank because of the low capital adequacy ratio and capital base. Extension of a sovereign loan by EDB to Kyrgyz Republic is also not feasible on the above conditions, because the current IMF program in KR imposes a limit on non-preferential lending (sovereign loans are allowed but with a grant-element at least 35%). Thus EDB's resources to be used for funding leasing programs in Kyrgyzstan may be sourced only with a bank guarantee or risk insurance provided by reputable agencies, and it makes the loan to Aiyl Bank at least 3% more expensive. In that case the final interest rate on EDB's loans in US$ for the lessee will be significantly higher than 10% per annum.

It should also be indicated that due to low profitability of the vegetable growing and cereals subsectors, the Government of Kyrgyz Republic is forced to subsidize the interest rates on agricultural loans. Thus borrowing of funds at an interest rate higher than 10% per annum payable by the ultimate beneficiary in national currency will generate additional burden on the national budget.

4. *Economic Benefits of Project*

The expected economic benefits accruing from the Project implementation are:

- Special-purpose fund for budget support of upgrading the agricultural machinery fleet and development of maintenance infrastructure in the amount of US$ 13 mln (the exact amount will be specified in the process of preparation of the Project business-plan);
- Increase in supplies of agricultural machinery to the agricultural sector;
- Higher quality agricultural activities performed per due agrotechnical schedule, reduction of losses in harvesting and transportation (presently such losses amount to 70% of the crops, and new machinery will cut down losses by 20%);
- Increased mechanization of agricultural work, reduced manual labor, improved productivity of labor (up to 100% if horse traction is replaced with mechanized gear);
- Lower cost of production of agricultural produce sold on foreign and local markets given the overhead costs are minimized;
- Higher crop yield, gross income, profit margin of agri producers in Kyrgyzstan;
- Reduction of overhead costs incurred in maintenance of the agricultural machinery fleet.

Detailed forecasts will be developed in the process of preparation of the detailed FS of the Project.

The expected financial results of the Project are given in Appendix 2 attached hereto.

5. *Funding Scheme and Financial Conditions*

Funding Scheme.

The ACF loan is provided to the Government of Kyrgyz Republic for subsequent relending to the Project Company. Debt liability to ACF will be sovereign liability of Kyrgyz Republic.

The Government of KR will post the funds borrowed from ACF in its national budget as a source of funding the budget deficit and as expenditure item for financing the Project, as well as it will enter into the national budget of KR outlays allocated for repayment and service of the borrowed funds of ACF.

The funding scheme of the Project conforms to the Regulation on the Use of ACF Resources for Providing Investment Loans.

Financial Conditions of ACF Loan:

Total Cost of Project US$ 25 mln;
Requested amount of ACF Loan: US$ 20 mln;
Loan maturity, including grace period: 20 years;
Fixed interest rate: 1% per annum;
Front-end fee: 0.5% of loan amount;
Loan currency: US$;
Loan format: single tranche of US$ 20 mln;
Grace period: 5 years (borrower requested 7 years, but it may lead to substantial departure from the indicative terms and conditions for investment funding from ACF resources);
Cofinancing by Project Company: US$ 5 mln.

In the context of rapid growth of external borrowing and debt exposure to external impacts, a zero limit for non-preferential lending was agreed upon under the current IMF program for the total portfolio of external sovereign and government-guaranteed loans. KR commits to refrain from borrowing and issuance of guarantees for loans that may reduce the average grant-element for the above portfolio to a level below 35%. The conditions prescribed by the Manager, are consistent with the IMF Guidelines (the grant-element is equal to 38.32%).

Conditions for Relending to Project Company:

The loan is provided to the Project Company in six (6) non-revolving equal tranches (Financial Model attached hereto);
Maturity for each tranche: 6-8 years;
Grace period: 12 months;
Debt ceiling for the Project Company to the Ministry of Finance of KR during the life cycle of the Project must not exceed US$ 20 mln;
Cofinancing by Project Company: US$ 5 mln for each of the five tranches (20% of each tranche). The amount of US$ 5 mln is composed of initial contributions of the end lessees, as well as of contributions of maintenance infrastructure investors.
The Financial Model is given in Appendix 2.

6. Government Support of Project

The borrower is Kyrgyz Republic represented by the Ministry of Finance of KR.

In the Program of the Kyrgyz Government approved by the resolution of Zhogorku Kenesh of Kyrgyz Republic of 5 October, 2012 # 2264-V, development of leasing arrangements for agricultural machinery is presented as one of the top priorities.

7. Preliminary Risk Assessment

Category	Evaluation	Description	Reduction measures	Assessment following reduction measures
Legal risks	High	In the process of implementation and funding of the Project, risks may arise related to the need for permits, licenses and other documents to be obtained by the Project participants because they may be required by the national laws of	The key risk reduction factor will be signing of the loan agreement between the Manager and the Government of KR and its ratification in due process. Also to reduce the above risks it is proposed to invite a	Medium

		Kyrgyz Republic or international agreements, as well as in connection with the proposed execution of the lending agreement and associated documents.	legal advisor for the Manager. In addition the Manager will conduct consultations with the Multilateral Investment Guarantee Agency to discuss insurance of risks of withdrawal of licenses by government authorities before final approval of the project funding.	
Operating risks	Medium	There is a risk that profits from leasing may not reach the target level and will not cover the overhead costs of the Project.	To reduce such risks the Manager will conduct an independent study with a view to enabling the lessees to make payments.	Low
Corruption and fiduciary risks	High	Corruption perception index of Kyrgyzstan according to Transparency International tends to further exacerbation: in 2011 Kyrgyzstan was placed in the 164th position of 183 countries, as compared with 150th in 2007. In the process of funding the Project potentially various corruption and fiduciary risks may arise in connection with alleged inappropriate use of funds.	Reduction of the above risks is expected to be carried out by implementing proper procurement policies on the basis of competitive and transparent procedures. It is recommended to invite an independent technical consultant for monitoring the preparation and implementation of the Project. The Project Cycle Regulation of the Manager makes provision for compliance verification procedures including identification of corruption risks, structure of ownership and ultimate owners of the participating companies. To ensure reduction of corruption risks the Manager will conduct	Medium

			a follow-up due diligence of the participating companies.	

Appendix 1: Preliminary Application of the Ministry of Finance of Kyrgyz Republic with Project Concept Note.
Appendix 2: Financial Model of Project "Leasing of Agricultural Machinery in Kyrgyz Republic".
Appendix 3: Map of Kyrgyz Republic