Arndt-Corden Department of Economics
Crawford School of Public Policy
ANU College of Asia and the Pacific

Trade Policy in a 'Double-Landlocked' Transition Economy: Kyrgyzstan

Prema-chandra Athukorala
Australian National University
Prema-chanmdra.athukorala@anu.edu.au

and

Hal Hill*
Australian National University
Hal.hill@anu.edu.au

* Corresponding author

January 2023

Working Papers in Trade and Development

No. 2023/02

Trade Policy in a ‘Double-Landlocked’ Transition Economy: Kyrgyzstan

Prema-chandra Athukorala and Hal Hill

Australian National University

Abstract: This paper examines trade and commercial policy in Kyrgyzstan in the context of that country’s distinctive historical and geographical characteristics, drawing on the World Trade Organisation’s latest *Trade Policy Review*. A former Soviet republic, it is a geographically isolated, effectively a ‘double-landlocked’, transition economy. The country was an early liberalizer, both economically and politically, among the former Soviet republics, and it is now a broadly open economy. After a catastrophic economic decline in the immediate transition era it also achieved macroeconomic stabilization relatively quickly. However the growth dividend from these major policy reforms has been modest, and the country has become one of the most remittance-dependent economies in the world. While its geographical handicaps are immutable, we argue that key explanations for the slow economic growth are the limited ‘behind-the-border’ reforms, the dualistic economic structure, and misdirected fiscal allocations. We also draw out some of the broader implications for trade policy reform in other transition economies.

Key words: Kyrgyzstan, landlocked, transition economy, behind-the-border reform

JEL codes: F13, O53, P27, P33

* We thank David Greenaway for his interest in the paper; the authors of the 2021 WTO report on which we have drawn; Richard Pomfret for his pioneering work on the Central Asian and transition economies and several informative discussions; and Takashi Yamano and Edimon Ginting of the Asian Development Bank for inviting the authors to participate in the study of the Kyrgyz economy that resulted in Yamano, Hill, Ginting and Samson (eds, 2019), and in particular the international trade chapter by Athukorala and Pradhananga (2019). However, the opinions expressed in this paper are those of the authors alone. We also thank seminar participants at the Australian National University and the American University of Central Asia in Bishkek for helpful discussions

1. Introduction

Kyrgyzstan, also known as the Kyrgyz Republic, is an isolated, landlocked, transition economy in Central Asia. Historically it was at the crossroads of the 'Silk Road' connecting Europe, the Middle East and East Asia. But for decades it languished as a remote outpost of the Soviet empire, its economy functioning as a distant adjunct to the centralized command economy, and largely cut off of from the rest of the world. With the dissolution of the USSR in 1991, it suddenly became an independent nation state, but one that lacked the institutional capacity and instruments to administer a modern market economy.

Kyrgyzstan is also effectively 'double landlocked' for reasons explained below. Its trade policy and outcomes have therefore been shaped by the confluence of these unusual historical, political, economic and geographical factors. Moreover, it is a relatively small country, with a population a little over six million, attempting to navigate its economic and strategic relationships with two giant neighbours, China and Russia. This analytical assessment of the WTO's latest Trade Policy Review of the country (WTO 2021) is framed by these distinctive factors.

Section 2 surveys the country's economic and institutional landscape, and the implications for the conduct of commercial policy. Section 3 surveys trade patterns, including trade in services, of particular relevance given that Kyrgyzstan is also one of the most remittance-dependent economies in the world. In section 4 we examine trade policies, including the country's membership of the Eurasian Economic Union (EEU). In spite of its significant political, trade and macroeconomic reforms, the country has achieved only modest economic growth. We argue in section 5 of the paper that a key explanation for this outcome is the slow pace of a range of 'behind-the-border' reforms. Section 6 sums up and highlights the trade and commercial policy reform options.

It is important to warn at the outset that precise magnitudes of the relevant variables are uncertain given that the country's data reporting system is still evolving. The coverage of data relating to foreign trade and investment is uneven over time because of the adjustments made to trade and capital flows taking place through informal channels. More importantly, it cannot be assumed for intertemporal analysis that the magnitude of reporting errors remains constant, for two reasons. First, the share of informal trade and the rate of actual implementation of approved investment projects vary over time. Second, the procedures followed by the data recording and compiling agencies to deal with informal trade and remittances seem to have changed from time to time.

2. The Economic Landscape

More than is usually the case, trade policy in Kyrgyzstan is shaped by the country's distinctive geographical, historical, political and structural characteristics. At least eight deserve mention. These characteristics frame our analysis of the latest WTO trade policy analysis of the country (WTO, 2021).

First, Kyrgyzstan is one of the most geographically isolated countries in the world. It is 'double-landlocked' since it borders three other landlocked countries – Kazakhstan, Tajikistan and Uzbekistan. It also shares a border with China, but one that is only remotely connected to the latter's maritime hubs.[1] The efficiency and availability of its international land transportation networks are therefore dependent on the quality of the neighbour's infrastructure, as well as their cooperation in facilitating transit customs arrangements. The resultant higher logistics costs therefore confer considerable natural protection for tradable goods and services. Compounding this international isolation is the challenge of domestic economic integration owing to the country's extremely mountainous terrain. More than 90% of its land area has an elevation in excess of 1,000 metres. The limited connecting infrastructure between the major population settlements in the north and south results in high domestic transport costs. The country is therefore exceptionally dependent on air transport. The country has adopted an 'open skies' civil aviation policies, with visa-free entry for most nationalities. However, Kyrgyz-registered airlines are not permitted to enter European airspace as they fail to meet EU air-safety regulatory standards.

A second characteristic is that Kyrgyzstan is a relatively young nation state, becoming an independent country only in December 1991. Prior to this time, it therefore had almost no

[1] The China-Kyrgyz border was opened only in 1990, on the eve of Kyrgyz independence, as relations between China and the USSR were normalized. The border has also been closed occasionally since then owing to cross-border sensitivities in the neighbouring Chinese province of Xinjiang. Of relevance here is that fact that almost 90% of the Kyrgyz population is Moslem.

commercial contact outside the Soviet bloc, including also with China from 1960 to 1990. The newly independent country inherited a command-style, state-dominated economy with major investment decisions determined by Moscow. The authorities lacked any knowledge of the institutional underpinnings of a modern market economy. It therefore experienced one of the sharpest economic declines among the former Soviet republics, with GDP falling by almost 50% in the early 1990s (Pomfret, 2019). Nevertheless the transition to independence was politically relatively uncomplicated. Relations with Russia remained cordial, and some of the ethnic Russian community chose to remain in the country. Moreover, Kyrgyzstan was able to maintain a comparatively open and non-aligned foreign policy until recently.[2]

Third, among the five ‘Stan’ economies that were Soviet republics,[3] Kyrgyzstan was an early liberalizer, both economically and politically (Pomfret, 2019). It was the first to introduce open, competitive elections and to experience democratic regime change. It was also the first Soviet-successor state to accede to the WTO, in December 1998. Its economic openness has attracted intra-regional Central Asian commerce, including its Dordoi bazaar, the largest market of its kind in the region. In addition, this openness attracted international investors in sectors such as education, health and tourism, including foundations and not-for-profits seeking to establish a regional base for their Central Asian operations. In spite of its relatively small population, the capital, Bishkek, is the seat of several international universities serving the region. Some of these, notably the University of Central Asia and the American University of Central Asia, have attracted international philanthropic support.

Nevertheless, a key feature of the economic liberalization has been the much slower pace of reform ‘behind the borders’, reinforcing the country’s dualistic economic structure, and partially explaining its unusually large informal economy, estimated to be as large as 40% of GDP. This highlights one of the overlooked issues in the political economy of economic reform in transition economies. It is relatively straightforward to reduce trade barriers at the border and to introduce an open foreign investment regime. But reform of the business regulatory environment administered by a bureaucracy accustomed to running a centrally planned, predominantly state-owned economy is much more difficult.

[2] This is illustrated by the fact that the US was permitted to maintain its Manas air force base, used mainly for its operations in Afghanistan, until 2014.
[3] That is, the four already mentioned in addition to a fifth, Turkmenistan.

A fourth characteristic is that Kyrgyzstan is one of the most remittance-dependent economies in the world, with remittances equivalent to about 30% of GDP. These labour outflows reflect the combination of sluggish economic growth, near universal literacy, and privileged access to the Russian and Kazakh labour markets, the principal destination of its migrant workers. This privileged access is the result of largely unhindered movement to these labour markets and linguistic proficiency (with Russian the regional lingua franca), in addition to wage levels that are less than half those prevailing in the destination economies. While the usual brain drain concerns persist, these labour flows have at least facilitated trade. For example, Kyrgyz garment manufacturers are familiar with Russian clothing tastes and styles. They have also enhanced Kyrgyz tourist attractions, particularly the renowned Issyk-Kul Lake, in the Russian market.

Fifth, and related, Kyrgyzstan is a member of the Eurasian Economic Union (EEU), a customs union comprising Russia, Armenia, Belarus, Kazakhstan, and Kyrgyzstan. The EEU is a comprehensive EU-style agreement permitting the free flow of goods and labour among member countries, although each member country retains an independent monetary policy. Kyrgyzstan acceded to the agreement in 2015. The effects of this agreement on the Kyrgyz economy are mixed. There are trade creation benefits of access to the much larger Russian economy, but there are also trade diversion effects, including that Kyrgyzstan has been required to increase its tariffs to those of the higher, predominantly Russian, EEU levels. We return to this issue below.

Sixth, notwithstanding the EEU, the major 21st century commercial dynamic for Kyrgyzstan is its relations with China. If and when smoother political relations develop, Kyrgyzstan will be drawn increasingly into China's economic orbit. A key consideration here is the evolution of China's Belt and Road Initiative (BRI). Until very recently Kyrgyzstan was a missing link in China's strategy to develop a southern Eurasian land bridge. However, there now appear to be good prospects that Kyrgyzstan will agree to the construction of a rail network through its territory, and the associated transit protocols. This would be a shorter and faster route connecting China to Turkey and through it to Europe.[4] The economic benefits for Kyrgyzstan could be substantial, not only from transit fees but also for cheaper trade logistics to China and Europe (and possibly also South Asia if ancillary rail networks become available).

[4] This southern route would be about 900 kms shorter than the existing northern route through Kazakhstan and Russia. Following the outbreak of the Ukraine conflict, it would also avoid any trade sanction problems with Russian-connected trade (Economist, September 10, 2022).

A seventh distinctive feature of the Kyrgyz economy is that a single company, the Kumtor Gold Mine, accounts for almost 10% of GDP, and about 40% of merchandise exports since it started commercial operation in 2008. It is also the country's largest taxpayer and the largest private sector employer. As a result Kyrgyz economic and export performance is significantly shaped by global gold prices, in addition to any disruptions to company output. Not surprisingly the mine is the centre of sporadic controversy, particularly related to taxation and environmental issues. Depending on global gold prices, the mine's output is expected to decline from around 2026. However, the country is thought to have considerable unexploited geological prospectively not only in gold but also some rare earth minerals (such as beryllium and dysprosium) and tin, tungsten, coal, and possibly oil (Faye et al. 2004). In addition, with glacial rivers flowing from high mountains, Kyrgyzstan has significant potential to expand hydroelectric production (ADB 2014).

A final significant feature is that Kyrgyzstan is a multi-currency economy. It introduced its own currency, the som, in 1993, but other currencies, mainly the Russian rouble and the US dollar, circulate freely. Foreign currency use is extensive, equivalent to 35-40% of M2. This dollarization is reluctantly accepted by the Kyrgyz monetary authorities, reflecting the very large remittances and the public's limited trust in the regime's macroeconomic management. After a brief episode of hyperinflation in the early transition years, inflation has generally been moderate. But it has usually exceeded that of the country's major trading partners, in turn requiring continuous currency depreciations to restore international competitiveness. Occasional periods of real effective exchange rate appreciation, owing to unusually high gold prices or lagged nominal exchange rate depreciations, do not appear to have triggered significant demands for increased import protection, principally because the non-mining tradables sector is relatively small and a sizeable proportion of agricultural output is only quasi tradable. This substantial dollarization entails the loss of a key policy instrument, the exchange rate, but the system constitutes a workable compromise and it has not been a major factor explaining the country's sluggish economic performance.

3. Trade Patterns

Kyrgyzstan's balance of payments draw attention to the country's unusual international orientation (Table 1). Several features deserve emphasis. First, the country runs large balance of trade deficits: merchandise exports are typically only about 40% of merchandise imports. Second, there is considerable year to year volatility, especially in exports. This reflects the importance of the Kumtor gold mine, and in turn the mine's output and international gold prices. Improved customs recording procedures also explain some of the variability. Third, over 90% of the trade deficit is partly financed by remittances, but the country still runs significant current account deficits, in some years in excess of 10% of GDP. Fourth, in turn the capital account finances the current account deficit, through substantial foreign direct investments (FDI) and ODA. Of these two flows the ODA is far more stable, owing to the lumpy nature of some FDI projects.

In the 1990s and well in to the first decade of this century, grants and concessionary institutional lending in the form of soft loans helped the Kyrgyz Republic finance the current account deficits. However, over the past one-and-a-half decades, the composition of capital inflows has shifted from concessionary flows to loans at commercial rates. Foreign capital inflows in the form of commercial credit to the private sector have also increased significantly given the virtually open capital account regime, coupled with the high cost of domestic bank credit (with rates generally over 10% per annum). FDI, the most desirable form of capital inflow, which has the potential for strengthening the external position by expanding tradable production in the economy, has not yet emerged as a significant form of capital inflow.

The stock of external debt stood at $7 billion in 2019, up from $5.2 billion in 2012 (WTO 2021, Table 1.1). The stock of debt relative to GDP increased from 81% in 2012 to 119.5 % in 2015 and then declined to 82.7% in 2019. However, this decline is a deceptive indicator of debt sustainability because most of the borrowed money has so far been spent on long-term projects, which have little capacity to generate foreign exchange earnings in the short to medium term. The debt service ratio (debt repayment and interest payment on debt as a percentage of goods and services exports) has already reached 30%, and is bound to increase as the accumulated debt reaches maturity, and given the limited export-generating potential of much of the debt-financed investment.

Table 2 shows the composition of exports for the period 2012-19. Gold[5] dominates merchandise exports, accounting for about 40% of the total in 2018-19. Minerals and metals

[5] Included in the SITC classification as precious or semi precise stones.

contributed 22%, so that the mining and related sectors generate almost two-thirds of total exports.

Table 1: Kyrgyz Republic: Balance of Payments, 2012-19 ($ million)

	2012	2013	2014	2015	2016	2017	2018	2019
Trade balance	-2577	-2781	-2807	-2241	-2136	-2383	-3034	-2626
Exports (f.0.b)	2588	2833	2483	1619	1608	1814	1916	2043
Imports (f.o.b)	5165	5614	5290	3860	3744	4197	4950	4669
Services (net)	-336	-13	-326	-205	-204	-92	-133	62
Current transfers[1]	2061	2238	2176	1628	1903	2365	2421	2270
Other (net)	-504	-436	-636	-465	-555	-464	-384	-717
Current account	-1020	-979	-1267	-1078	-788	-482	-997	-1073
Capital transfer	166	280	66	79	113	131	335	88
Foreign direct investment	293	626	233	1009	579	-78	44	337
Portfolio investment	6	5	0	-129	-7	-25	-9	25
Other investment (net) [2]	379	75	305	-186	17	578	167	104
Other (net)	-1	0	-1	5	6	3	-1	0
Errors and omissions	309	43	398	221	386	-112	297	566
Capital account	843	986	603	778	708	609	536	554
Overall balance	131	51	-266	-79	306	15	-164	47
Financing	-131	-51	266	79	-306	-15	164	-47
NBKR reserves	-142	-66	270	67	-312	-44	188	-16
IMF loans	9	12	-5	12	6	1	-29	-26
Exceptional financing	3	3	1			27	5	5

Note: (1) Predominantly migrant worker remittance. 2) Assets and liabilities of banks, general government and the private sector (net).

Source: Compiled from WTO (2021) Table 1.3.

The major manufactured export in both years is garments. The share of garments in total merchandise exports increased from 2.0% in 1995-1996 to 16.8% in 2018–2019. Almost all garment exports from the Kyrgyz Republic are destined for Kazakhstan and the Russian

Federation, where its exporters have emerged as niche suppliers. The key determinants of the successful penetration of Kyrgyz apparel in these markets are relatively low labour costs, ability to produce better quality items to meet customer preference in middle-level markets in contrast to products from China and Turkey, and easy access to imported fabric (mostly from China, but also from Turkey) through the bazaar-centred trade networks. Kyrgyz garments are aimed at middle-class customers in these markets. Garments from Bangladesh, China, and Vietnam are cheaper and of lower quality, and are marketed to less affluent consumers. Chinese garments sold in these markets come from the less-developed western parts of China. The most sophisticated China factories producing high-quality garments are in the eastern part of China and these products are sold primarily to the developed markets of Europe and the United States. Turkish garments are much more expensive than Kyrgyz garments and do not compete for the same market (Spector 2018, Jenish 2014).

Kyrgyzstan imports a wide array of manufactures, processed food products, and petroleum products (WTO, 2021, Table A1.2). In spite of its low population density it is a net food importer. Apart from food products, the scope for developing a strong manufacturing export sector is constrained by proximity to the Chinese industrial powerhouse.

Table 2: Kyrgyz Republic: Commodity Composition of Merchandise Exports, 2012-19[1] ($ million and %)

		2012-13	2015-16	2018-19
Total exports		1728	1432	1911
Precious or semiprecious stones (gold)[2]		656	688	685
Gold share in total exports (%)		37.9	48.1	42.6
Total exports excluding gold		1072	744	948
SITC code[3]	Composition of exports excluding gold (%)			
(a)	**Food, beverages and tobacco**	**30.5**	**31.6**	**37.1**
0	Food and live animals	22.6	26.1	27.1
01	Meat and meat products	0.7	0.3	0.5
02	Dairy products	0.6	5.0	4.8
04	Cereals and seral preparations	2.1	0.5	0.6
05	Vegetables and fruit	6.8	17.3	15.4
05423	Kidney beans	5.6	11.1	12.3

06	Sugar and sugar preparations	10.3	0.4	1.1
1	Beverages and tobacco	7.8	5.5	5.2
111	Mineral water	0.1	0.3	0.4
12	Tobacco	5.5	5.0	4.8
(b)	**Primary material**	**35.0**	**21.5**	**14.8**
2	Crude material except fuels	18.8	19.6	16.3
263	Cotton	7.8	4.0	5.3
3	Mineral fuel, lubricants and related material[4]	16.0	1.9	2.1
35	Electric current	15.0	0.0	0.0
4	Animal and vegetable oil, fats and wax	0.1	0.0	0.2
(c)	**Manufactured goods[5]**	**34.5**	**46.8**	**48.1**
5	Chemicals and related products	15.7	5.9	4.1
6	Manufactured goods classified by material	9.6	13.4	13.3
68	Non-ferrous metals	6.5	1.5	1.8
65	Textile yarns, fabric and related products	6.3	1.6	1.7
7	Machinery and transport equipment	4.2	9.3	8.2
71	Power generating machines	0.7	4.5	0.2
72	Agricultural machinery	1.3	2.2	2.3
74	General industrial machines	1.8	2.6	2.1
8	Miscellaneous manufactured articles	5.0	18.2	22.4
84	Apparel and clothing accessories	2.1	12.4	16.8
	Total excluding gold	100	100	100

Notes: (1) Two-year averages; (2) Excluding non-monetary gold and other ‘special’ export items (SITC 9); (3) Standard International Trade Classification; (4) Mostly processed minerals (excluding gold) and basic metal products; (5) Excluding non-ferrous metal (SITC 68).

Source: Compiled from UN *Comtrade* database (SITC Revision 3).

Owing to the dominance of gold, Kyrgyzstan’s major merchandise export market is Europe, accounting for almost 50% of the total in 2019 (WTO 2021, Chart 1.2). Initially gold exports were coursed through Switzerland, but from 2018 they now go to the UK.[6] For non-gold

[6] The original the joint venture partner of Kumtor Gold Inc was the Canadian company Centerra whose global gold trading was based in Switzerland. On June 1,

exports the major markets are neighbouring Kazakhstan and Uzbekistan, and Russia; the first and third of these are members of the EEU (Table 3). The data also highlight the country's very limited export ties to East and South Asia, especially China, where niche processed manufactures, especially livestock, has great potential. However, Asia, particularly China, is much more significant as a source of imports. China is in fact now the major source of imports, supplanting Russia in the earlier period (Table 4). The rising importance of China is as would be expected. While the country retains strong cultural, linguistic and labour market connections to Russia (and Kazakhstan), further buttressed by membership of the EEU, the inexorable economic rise of China is likely to further pull Kyrgyzstan towards China's economic (and probably strategic) orbit. Non-EEU member countries typically account for about half of the total imports. This immediately raises the likelihood that the costs of trade diversion through membership of the Union exceed the benefits of trade creation.

Table 3: Merchandise Exports (excluding gold) by Trading Partners, 2012-19

($ million and %)

	2012-13	2015-16[1]	2018-19[1]
Total non-gold exports $ million)[2]	1197	811	1157
	(% of total exports)		
Americas	1.4	1.4	0.3
USA	0.4	0.1	0.2
Europe	11.2	17.3	15.2
EU-28	4.9	5.6	6.1
Germany	1.1	0.8	0.6
Belgium	1.3	2.2	0.9
Turkey	5.7	10.7	8.4
Commonwealth of Independent states	69.5	61.3	74.4
Kazakhstan	32.9	23.3	26.7
Russian Federation	15.5	18.6	27.6
Uzbekistan	14.6	13.6	12.8

2018 the London-based Chaarat Gold Holding bought Kumtor mine under a profit-sharing agreement with the Kyrgyz government.

Tajikistan	3.8	2.8	4.6
Ukraine	0.7	0.7	0.9
Belarus	1.0	0.9	1.2
Azerbaijan	0.4	0.3	0.3
Africa	0.0	0.1	0.3
Middle East	11.1	10.5	2.6
Iran	0.7	0.8	1.3
United Arab Emirates	10.0	8.4	0.7
Iraq	0.4	1.2	0.3
Asia	6.5	9.3	7.3
China	4.2	7.1	6.1
Mongolia	0.2	0.4	0.2

Note: (1) Two-year averages; (2) Non-gold exports are approximated as total exports net of exports to Switzerland and the UK (See note 6 in the text).

Source: Compiled from WTO (2021), Table A1.3.

Table 4: Merchandise Imports by Trading Partners, 2012-19

	2012-13	2015-16	2018-19
Total imports, $ million	5678	4875	5141
	(% of total imports)		
Americas	5.1	4.1	2.6
Unites States	4.2	4.1	2.6
Canada	0.4	0.3	0.2
Europe	14.2	14.0	11.6
EU-28	10.5	9.4	6.1
Germany	3.8	3.2	1.4
France	0.6	0.7	0.7
Switzerland	0.3	0.4	0.2
Turkey	3.4	4.0	5.0
Commonwealth of Independent States	49.6	50.9	46.4
Russian Federation	33.2	31.9	28.3
Kazakhstan	9.5	13.1	12.2
Uzbekistan	1.4	1.7	3.7
Ukraine	2.6	2.1	0.8
Belarus	2.5	1.5	0.9
Tajikistan	0.1	0.2	0.2
Georgia	0.1	0.1	0.1
Turkmenistan	0.0	0.1	0.1
Azerbaijan	0.2	0.3	0.1
Africa	0.2	0.2	0.3
Middle East	0.4	0.4	0.7
Asia	30.5	30.5	38.6
China	23.2	23.2	35.8
Japan	4.2	4.0	0.7
Korea, Republic of	1.8	1.8	0.6

Note: (1) Two-year average

Source: Compiled from WTO (2021), Table A1.4.

4. Trade Policies

The Kyrgyz economy is a relatively open one, both de facto and de jure, certainly by the standards of the Soviet-successor states, with merchandise trade equivalent to 80-100% of GDP. In the early 1990s the state monopolies over trade were quickly dismantled, most import licensing restrictions were removed, domestic price controls were largely abolished, a schedule of modest import tariffs was introduced, and currency convertibility was progressively enacted. The result as noted was that the country became a flourishing entrepôt centre for trade with its larger Central Asian neighbours. Nevertheless its trade regime has become somewhat more restrictive over the past decade. In 2015, the Kyrgyz Republic became the fifth member of the Eurasian Economic Union (EEU). The accession to the EEU required that Kyrgyzstan align its tariffs to the higher Russian-dominant Common External Tariff of the Union, including also its generally more restrictive customs protocols, and its other preferential trade agreements.[7] We return to this issue shortly. In recent years specific (non ad valorem) tariffs and tariff quotas have been introduced on agricultural products for domestic food security reasons. Also, some temporary restrictions have been placed on food exports (EBRD 2022).

Table 5 summarizes the key features of the Kyrgyz tariff schedule in 2012 and 2020, before and after accession to the EEU. The WTO report (2021, p.56) concludes that there has been '… a significant deterioration in market access for most-favoured partners …' The number of duty-free tariff lines has declined from 46.4% of the total to 15.5%. The number of non-ad valorem tariff lines rose from 1.4% of the total to 13.3%, while they also increased in their complexity. The simple average tariff rate increased from 5% to 8.4%, mostly in agricultural products, while 'tariff quotas', which earlier had not been present, were introduced on 1.2% of tariff lines.

The Kyrgyz Republic bound most tariffs at the simple average level of 7.5% under its commitments for WTO accession. In 2016 the applied simple average and trade-weighted

[7] The EEU's preferential trade agreements have been minor to date, involving just Iran and Vietnam. In the wake of the Ukraine War further agreements are unlikely for the foreseeable future.

average tariffs stood at 6.9% and 7.7% respectively (WTO 2019). In 2016 the applied simple average and trade-weighted average tariffs stood at 6.9% and 7.7% respectively (WTO 2019). However, as a result of aligning its tariffs with the *common tariffs* of the EEU, the applied rates in some tariff lines evidently exceed WTO bound rates (Table 5). It therefore seems that the country is yet to realign the new EEU tariffs with the WTO commitments.

Table 5. The Structure of the Tariff Schedule, 2012 and 2020 (%)[1]

	2012[2]	2020[3]
Total number of tariff lines	10,990	12,135
Specific (non ad valorem) tariffs (% of all tariff lines)	1.4	13.3
Tariff lines subject to tariff quotas (% of tariff lines)[4]	0.0	1.2
Duty-free tariff lines (% of all tariff lines)	46.4	15.5
Dutiable line tariff average rate (%)	9.4	9.9
Simple average tariff (%)	5.0	8.4
Agriculture	8.4	14.1
Non-agriculture	4.1	6.9
Domestic tariff 'peaks' (% of all tariff lines)[5]	1.3	2.4
International tariff 'peaks' (% of all tariff lines)[6]	1.3	4.5
Overall standard deviation	--	11.2
Nuisance applied rates (% of all tariff lines)[7]	0.0	0.4
Bound tariff lines (% of all tariff lines)	99.9	99.0

Notes

(1) All tariff calculations exclude in-quota lines of products subject to tariff quotas; (2) Calculations are based on national tariff-line level, excluding specific duties and including the *ad valorem* components of the mixed or compound duties; (3) *Ad valorem* equivalents (AVEs) for tariff lines with specific tariffs were estimated based on 2018 and 2017 import data at the 10-digit level obtained from the authorities and 2018 import data at the 6-digit level from UN Comtrade. Two hundred and seventy lines with specific duties were excluded from the calculations, as no AVEs could be calculated; (4) A tariff quota is a two-tiered tariff, with a lower in-quota tariff applied to the first Q units of imports and a higher over-quota tariff applied to all subsequent imports. The terms "tariff quota" and "tariff-rate quota" are used interchangeably in the literature: (5) Domestic tariff peaks are defined as those exceeding three times the overall average applied rate. (6) International tariff peaks are defined as those exceeding 15%; (7) Nuisance rates are greater that 0% but less than or equal to 2%. ... Not available

Source: WTO (2021), Table 3.7.

There are also significant variations in tariff levels both within and between sectors (Table 6). The highest tariffs are for animal products, in spite of the country's comparative advantage in this sector, as well as sugar and confectionery, and garments, the latter also an export sector. Although tariffs on non-food manufacturing are generally lower, there are some notable tariff peaks in these sectors too. Given the country's rather low governance standards, these significant variations in tariffs invite technical if not physical smuggling.

As noted, membership of the EEU has meant that technically Kyrgyzstan's trade regime is no longer consistent with its WTO commitments in at least two respects: for a significant number (almost 4,000) tariff lines the applied tariff rates exceed the bound rates, and it has introduced new quantitative restrictions. The government is now in the process of enacting various modifications to its trade policy settings and WTO commitments.

Table 6. The Tariff Structure by Sector, 2020[1]

	MFN			Bound average (%)
	No. of lines	Average (%)	Range (%)	
Total	12135	8.4	0-254.8	7.8
By HS section				
01 Live animals & products	1109	17.7	0– 0-149.8	10.8
02 Vegetable products	616	7.5	0-30	13.5
03 Fats & oil	151	9.1	0-30	12.6
04 Prepared food	1132	12.3	0-254.8	11.3
05 Minerals	281	44	0-10	9.4
06 Chemical & chemical products	1333	4.5	0=10	5.4
07 Plastic & rubber	365	5.7	0-16.8	7.6
08 Hides & skins	218	5.6	0-15	8.5
09 Wood & articles	352	8.5	0-14	1.0
10 Pulp, paper etc	223	7.0	0-14	0.0
11 Textiles & articles	1211	10.9	0-134.4	9.7
12 Footwear & headgear	115	20.2	0-221.7	10.0

12 Articles of stone	299	11.0	0-15	9.7
14 Precious stones	83	16.4	0-123.6	10.0
15 Base metals & products	1176	6.6	0-15	2.4
16 Machinery	1975	3.4	0-31.6	6.5
17 Transport equipment	805	9.5	0-20	9.2
18 Precision equipment	359	4.9	0-15	5.3
19 Arms & ammunition	24	14.6	12-15	15.0
20 Miscellaneous manufacturing	3019	9.7	0-50.6	7.1
21 Works of Art, etc.	7	0.0	0	14.3
By SITC sector[2]				
Agriculture & fisheries	779	6.1	0-30	10.0
Mining	130	4.5	0-15	9.4
Manufacturing	11225	5.7	0-254.8	7.6

Notes

(1) All tariff calculations exclude in-quota lines of products subject to tariff quotas. *Ad valorem* equivalents (AVEs) for tariff lines with specific tariffs were estimated based on 2018 and 2017 import data at the 10-digit level obtained from the authorities and 2018 import data at the 6-digit level from UN Comtrade. Two hundred and seventy lines with specific duties were excluded from the calculations, as no AVEs could be calculated; (2) Standard International Trade Classification (SITC) (Rev. 2) classification, excluding electricity (1 line).

Source: WTO (2021), Table 3.8)

5. Lagging Behind-the-Border Reform

It is a well-established proposition in the trade and development literature that successful trade liberalization episodes require comprehensive behind-the-border reform, especially in the case of transition economies (Bhagwati 2004, Stiglitz 2007). The Kyrgyz experience is an excellent case study of this issue, as an economy where liberalization at the border proceeded quite rapidly, but the accompanying reforms that facilitate global economic integration have lagged. In particular, the performance of the tradable goods sectors, agriculture and manufacturing, has been lacklustre, and the resulting sluggish employment generation has pushed many Kyrgyz citizens to seek employment abroad. As already noted, geographic barriers to integration – isolation and doubled land-locked location – are not directly amenable to policy reform. But complementary policy reform would have enabled Kyrgyz enterprises and households to enjoy greater benefit from the reforms. In the Kyrgyz case there are at least three pertinent examples of the scope for trade-facilitating policies. Notwithstanding significant first generation reforms' of trade liberalization, there has been limited progress with the more complex 'behind the border' (institutional and legal) reforms needed to create "an environment in which market forces could produce socially desirable outcomes" (Pomfret 2018, p. 180).

First, measures that lower the cost of international civil aviation. Kyrgyzstan has a liberal policy towards the entry of airlines on international routes but not domestic routes. Improved domestic safety standards would also enable landing right restrictions (for example in the EU) to be removed. Second, diplomatic resources could be directed to removing impediments to cross-border transit freight movements with its neighbours. This applies particularly to relations with Kazakhstan, and also Tajikistan, where unresolved border and other bilateral issues have occasionally led to border closures and localized conflict. Third, Kyrgyzstan has been slow to capitalize on the benefits of proximity to China, with respect to allowing transit arrangements for China's proposed southern BRI infrastructure project linking it to Europe, and also in joint-venture cross-border commercial opportunities in agriculture, particularly livestock.[8]

To get a perspective on this lopsided nature of reforms it is useful to examine comparatively various additional indicators of progress in the field of structural transformation and institutional reform. A useful guide are the six qualities of a 'sustainable market economy' prepared by the European Bank for Reconstruction and Development (EBRD). Table 7 shows the results for nine former Soviet republics in Central Asia on six indicators for 2016 and 2022. The progress in each area is scored on a scale of 1 to 10, where 1 corresponds to the worst possible performance and 10 to the standards of a sustainable market economy.

The EBRD, in its overall assessment based on these indicators, has noted that the Central Asian countries have lagged behind in the transition process compared to their counterparts

[8] See Pomfret (2019) for further discussion of these issues.

in Central and Southeastern Europe and the Baltic States (EBRD 2022). Interestingly, even among the Central Asian countries, Kyrgyzstan does not stand out as a a better performer in spite of its record as an early reformer. In terms of competitiveness, resilience and integration, it lags behinds Armenia, Georgia, Kazakhstan and Azerbaijan, and. more importantly, its performance has deteriorated between 2016 and 20202. Relating to integration, the EBRD has specifically emphasied, Kyrgyzstan's relatively poor performance in attracting FDI, domestic integration of the wider local community, and trade-impeding effects of increased non-tariff barriers. Relating to economic resilience, the EDRB has speciifically alluded to the marked deterioration in Kyrgyzstan's financial resilience score between 2016 and 2022 on account of rising non-performing loans, contraction in credit to the private sector, and the falling capital adequacy ratios of banks (EBRD 2022, p. 107).

Table 7: EBRD Transition Quality Indicator (TQI)[1] for Central Asian Countries, 2016 an and 2022

		Competitive[2]	Well-governed	Green	Inclusive	Resilient[3]	Integrated[4]
Armenia	2016	4.33	5.18	5.32	4.52	5.05	5.08
	2022	4.81	5.66	5.70	4.78	5.45	5.48
Azerbaijan	2016	4.18	5.18	4.85	4.67	3.31	5.52
	2022	4.20	5.66	5.08	4.77	3.51	5.49
Georgia	2016	4.38	6.47	4.98	6.73	4.42	6.10
	2022	4.71	6.29	5.33	4.97	5.13	6.34
Kazakhstan	2016	4.93	5.61	4.76	5.31	5.12	4.99
	2022	4.98	5.93	5.20	4.76	5.48	5.12
Kyrgyz Republic	**2016**	**3.86**	**4.54**	**4.16**	**4.18**	**4.20**	**4.31**
	2022	**4.13**	**4.36**	**4.54**	**4.23**	**4.16**	**3.97**
Mongolia	2016	4.16	5.31	4.80	4.61	4.31	4.95
	2022	4.23	4.84	4.89	4.89	4.39	5.45
Tajikistan	2016	3.41	4.09	5.00	3.55	2.88	3.29
	2022	3.40	4.56	5.20	3.68	3.28	3.70
Turkmenistan	2016	3.30	2.65	4.31	3.43	2.87	4.17
	2022	3.40	2.71	4.35	3.60	2.92	4.13
Uzbekistan	2016	3.38	4.59	4.38	3.71	3.13	4.00
	2022	3.60	4.71	5.04	3.84	3.54	4.75

Notes: (1) The TQI of EBRD assesses progress in the field of structural transformation on the basis of six qualities of a sustainable market economy. The progress in each area is scored on a scale of 1 to 10, where 1 corresponds to the worst possible performance and 10 to the standards of a sustainable market economy. (2) Business environment conducive for private ownership of business and industry. (3) Prerequisites for a stable economy including a well-functioning financial system. (4) Integration of the country (including the wider local community) in the world economy.

Source: EBRD (2022).

We further illustrate the dimensions of incomplete reforms with four examples. The first is the challenge to formalize the informal economy. Kyrgyzstan has a large informal sector, variously estimated at 25-40% of the non-agricultural workforce. In part this is a legacy of the earlier Soviet command economy, and the fact that a sizeable, and largely unreformed, SOE sector remains. For example, informal sector enterprises are largely excluded from bidding for procurement projects to service this large public sector.

This dualistic economic structure also persists because of perverse incentives in the tax and regulatory regimes, accentuated by the presence of five 'Free Economic Zones', that exempt participating firms from various fiscal and regulatory requirements. The country has a flourishing small-scale, export-oriented garment industry, much of it household-based, that according to some estimates employs up to 12% of the non-agricultural workforce. Evidently these enterprises intentionally do not seek to graduate to larger units because of the higher costs of formal sector operations, including higher taxation rates (including onerous social security contributions) and more cumbersome regulatory arrangements.[9] However, there are costs associated with remaining small. Kyrgyz firms enjoy a significant labour cost advantage over their competitors (China, Turkey, Belarus) in their main export markets, Russia and Kazakhstan. But further export growth is hampered by the size of these units, in particular their capacity to service large orders and to obtain a more sophisticated understanding of fashion trends. Consequently, most enterprises concentrate on simple sewing work based on designs provided by buying agents. Their growth is also restricted by the fact that they cannot access finance from the formal banking sector. Their short-term working capital needs are provided through informal financial channels, but at interest rates that are not commercially viable for the purchase of equipment and other fixed assets.[10]

Second, and related, various trade facilitation measures are necessary to enhance export competitiveness and build on the country's competitive advantages in labour and land-intensive activities. In the case of garments, firms typically source their cloth from the informal

---

[9] See Athukorala and Pradhananga (2019) on which this case study is drawn. Kyrgyz wages are less than half those in Belarus, one-third of China's and less than one-quarter of those in Turkey.

[10] The slow progress of financial inclusiveness and intermediation is illustrated by the fact that most bank branches are located in the two main cities, Bishkek and Osh, which together account for over 85% of the deposit base. Formal financial institutions account for less than 10% of total private sector borrowing (Athukorala and Pradhananga 2019).

bazaar economy that emerged as the country liberalized its trade regime. However, some trade barriers, both formal and informal, remain, and they have increased following the country's accession to the EEU. What these firms need is an efficient import duty drawback scheme that places export-oriented enterprises on a free-trade footing. In agriculture, Kyrgyzstan's potential is illustrated by its thriving if small-scale kidney bean export industry, a value chain supported by Turkish importers. In addition, and following Kazakhstan's lead, the country could also become a very large livestock exporter to neighbouring China. However, it would need to improve its animal husbandry standards significantly, including the provision of border quarantine arrangements. Improved animal hygiene, food sanitation, and refrigeration facilities would also create export opportunities in livestock and dairy products.[11]

Third, major fiscal reforms are required to increase economy-wide productivity. Reflecting its history, for a low-income economy Kyrgyzstan has a large state sector, with expenditure in the consolidated public sector accounting for about 35% of GDP. However, much of this expenditure is poorly targeted and meets neither equity nor efficiency objectives. Pensions alone account for about 7.5% of GDP, a figure not far short of total public sector expenditure in some low-income countries. The government also prescribes uneconomically low electricity prices, resulting in ageing energy infrastructure, frequent supply interruptions, and public subsidies costing about 3% of GDP. Private firms are therefore forced to maintain costly small-scale generators. Uneconomic power prices have also inhibited the development of profitable hydroelectric export opportunities to neighbouring countries. More generally, these poorly directed allocations have squeezed much-needed expenditures in education (where standards are deteriorating), irrigigation, roads, and much else.[12]

The fourth behind-the-border policy challenge concerns exchange rate management. As noted, Kyrgyzstan achieved macroeconomic stabilization relatively quickly with the introduction of its own currency in 1993. Thereafter it has transitioned to a managed float regime with a relatively open capital account. However, the central bank (the NBKR) has maintained an unusual inflation target range of 5-7%, which is higher than its major non-EEU trading partners. Combined with large remittance flows and occasional peaks in international gold prices, there has been a persistent tendency for the real exchange rate (RER) to

[11] See Yamano et al (2019) for further discussion of Kyrgyzstan's agricultural export potential.

[12] The problems in the energy sector are discussed in McCulloch et al (2019).

appreciate against the currencies of these trading partners. By contrast, the RER with EEU member countries has been fairly stable, owing to their generally higher inflation. Running a ‘strong som’ policy has the attraction that it contributes to lower inflation by reducing the price of imported tradables. It also reduces the government’s debt service obligations since its foreign debt is denominated in foreign currencies (mostly US dollars). However, it reduces the competitiveness of the tradable sectors, particularly agriculture and manufacturing. An additional consideration here, however, is the country’s high level of dollarization, estimated to be about 40% of M2, which therefore limits the scope of exchange rate management to boost competitiveness in these sectors.

6. Discussion and Future Prospects

During the last quarter century, the Kyrgyz Republic has made significant progress in the transition to global economic integration. However, the patterns of global economic integration have been rather lopsided. Rapid import penetration of the economy has not been matched by export expansion, even though there have been some notable changes in export composition in line with the country’s comparative advantage. This has led to the economy’s increased dependence remittances and external financing. Remittances have filled over two-thirds of the trade deficit during the past two decades. The composition of external financing has also begun to shift from grants and concessionary loans toward borrowing at commercial rates, thus potentially exposing the economy to additional external economic shocks.

Given the country’s rich mineral resource endowment and the distance-related trade costs as a landlocked country, the Kyrgyz Republic has a comparative advantage in the production of gold and other high value-per-unit-weight minerals. An important development relating to non-gold exports, which deserves policy focus, is the emergence of food products (dairy, fruits, and vegetables) and garments as dynamic export lines. The expansion of food product exports is in line with the ongoing compositional shift in global food trade from conventional primary food products to high-value processed food. With the improvement in trade relations with China and transport networks, food exports have the potential to play an important role in narrowing the widening trade gap with China. In the last two decades, the Kyrgyz garment industry has also carved out a niche in middle-income markets in Kazakhstan and the Russian Federation.

The evolution of Kyrgyzstan's commercial policy regime over its three decades as an independent state illustrate the interplay of several factors – the challenges of transition from plan to market, extreme geographic isolation, the geostrategic complexities that small nation states face in managing their relations with giant neighbours, and the political economy of policy reform at and behind the border. These challenges are evident to some degree in all lower-income economies that share some or all of these characteristics.

The Kyrgyz experience also illustrates the limits of partial reform measures. The country has become one of the most remittance-dependent economies in the world. Although significantly augmenting household incomes, overseas employment has become the major economic driver, reducing the political imperative for ongoing economic reform. A dual economy has developed in which employment in the informal sector is resilient but it operates in a business environment that in effect discourages formalization and the development of larger scale economic enterprise.

A final point to note is that this WTO report was completed before the outbreak of the Ukraine War. At the time of writing the conflict is ongoing and it is therefore premature to make definitive judgements on its impact. But two general observations are pertinent. First, the war has exposed Kyrgyzstan's economic and political vulnerabilities. Russia is Kyrgyzstan's major economic and political relationship. It is commercially tied to Russia through membership of the EEU. Russia accounts for 25-30% of its merchandise trade, and is the major source of remittances. But there are also negative consequences, including the impact of sanctions imposed on Russia and its indirect effect on transit trade through that country. More generally, rising geostrategic tensions between Russia and NATO and its allies is adversely affecting international business perceptions of the Central Asian economies.

Nevertheless, second, the effects may not be as serious as initially anticipated. Kyrgyzstan is an open economy and it will be in a position to redirect its commercial relationships, most especially to China, a trend already underway, notwithstanding the inherent complexities of this bilateral relationship. Recent progress on the proposed southern BRI landbridge route is an example of new possibilities. Moreover, Russian capital and skilled labour have flowed into Kyrgyzstan and neighbouring countries as a result of the war, while Russia has been offering discounts on its oil exports to countries that have not severed their ties with the country. Kyrgyzstan’s estimated economic growth for 2022 has been lowered from 5% to 3%, but this reduced figure is due in part to other external factors, including a slowing global economy, particularly in the case of China, and rising interest rates. In fact, the economic effects of the Covid pandemic were far more serious, as GDP declined by 8.4% in 2020.

References

Asian Development Bank (ADB) (2014) *The Kyrgyz Republic: Strategic Assessment of the Economy* (Manila, ADB).

Athukorala, P. and M. Pradhananga (2018), 'International Dimensions of Economic Transition: Trade, Foreign Direct Investment, and Labour Migration', in Yamano et al (eds), pp. 51-90.

Bhagwati, J. (2004), In Defence of Globalisation, New York: Oxford University Press.

European Bank for Reconstruction and Development (EBRD) (2022), Transition Report, 2022-23, London: EBRD (https://www.ebrd.com/transition-report-2022-2

Faye, M. L., J.W. McArthur, J.D. Sachs, and T. Snow (2004), 'The challenges facing landlocked developing countries', *Journal of Human Development* 5, no. 1, pp. 31-68.

Jenish, N. (2014) 'Export-driven SME development in Kyrgyzstan: The Garment manufacturing sector', *Institute of Public Policy and Administration Working paper No. 26* (Bishkek, Graduate School of Development, University of Central Asia).

McCulloch, N., K.Y. Nam, and L. Quiao (2019), 'Reforming the Kyrgyz Republic's Energy Sector', in Yamano et al (eds), pp. 198-237.

National Bank of Kyrgyz Republic (NBKR) (various issues) *Monthly Statistical Bulletin* (various issues) (http://www.nbkr.kg/DOC/07122017/000000000048812.xls.

Pomfret, R. (2019), *The Central Asian Economies in the Twenty-First Century: Paving a New Silk Road*, Princeton University Press.

Spector, R. (2018) 'A Regional Production Network in a Predatory State: Export-oriented Manufacturing at the Margins of the Law', *Review of International Political Economy*, 25(2), pp. 169-189.

Stiglitz, J. (2007), *Making Globalization Work*, New York: WW Norton & Company

World Trade Organisation (WTO) (2019) *World Tariff Profile 2018* (Geneva: WTO), www.wto.org/statistics, accessed 08 May 2019.

World Trade Organisation WTO (2021), Kyrgyz Republic Trade Policy Review, WT/TPR/G/411, Geneva.

Yamano, T, H. Hill, E. Ginting and J. Samson (eds), (2019), *Kyrgyz Republic: Improving Growth Potential*, Asian Development Bank, Manila.

Yamano, T., J. Samson, and K. Tilekeyev (2019), ‘Reinventing the Agricultural Sector’, in Yamano et al (eds), pp. 91-120.