



Introduction

Countries in transition are faced with the necessity of transforming their economic systems in the context of rapid globalization that has been speeded up by increased economic liberalization and the development of modern transport and communications infrastructure and ICT. The benefits of globalization relate to increased opportunities to participate in the international division of labour by accessing world markets for goods, services and capital. Enhanced productivity, partly owing to improved access to modern technologies, and better product quality contribute to economic growth and rising employment and help to foster human resources development. In its transition to a market economy, Kyrgyzstan has chosen the model of a small, open economy for itself, joining international organizations such as WTO, IMF and the World Bank soon after independence.

Kyrgyzstan is a small, landlocked country in Central Asia but its location, which makes it a natural bridge between Europe and Asia, can be to its advantage. The republic has the potential to become an important transit country for road, rail and air transport and the development of the infrastructure for this will benefit its poorer and more remote regions.

Globalization is not, however, without risks. One of the main risks of the globalization process in the world economy is the rapid spread of financial crises globally, as happened with the Asian financial crisis, for example. Without appropriate policies in place, this can lead to economic instability but there are concerns about globalization other than purely economic considerations. Many of those who are against the integration process care about its influence on a wide range of issues, such as culture, the environment, public health, migration, crime and the loss of control over personal life. To neutralize some of these risks, it is necessary for countries to create new institutions and policies able to deal with them that are strengthened by participation in international markets, organizations and forums.

A. Globalization and regional integration

1. Integration into the multilateral trading system

After independence, Kyrgyzstan in common with other newly independent States that were members of the former Soviet Union experienced sharp decreases in production and trade. It lacked an effective trade and payments policy, a problem that was aggravated by the deep economic interdependence of the new States. Trade and economic cooperation agreements concluded with its partners in CIS in 1992-1994 did not generate sufficient trade for Kyrgyzstan and hindered the development of market forces in this area as the agreements institutionalized centrally regulated trade.

The Government considers that the long term success of economic reforms and economic development in Kyrgyzstan depend on full integration into the world trading system. As a small country with limited natural resources, Kyrgyzstan needs imports of raw materials and other goods and wide access to foreign suppliers. New foreign markets are also necessary for its exports so as to stabilize the balance of payments and to encourage domestic and foreign investment in sectors where its comparative advantage lies. Thus, membership of WTO is of considerable importance to Kyrgyzstan.

After an accession process that lasted three years, Kyrgyzstan became a member of WTO on 20 December 1998. The speed of the process reflected the country's strong desire to participate in a free and fair international trading system, the absence of major domestic obstacles to membership and the liberal trading regime already existing in Kyrgyzstan. The country now has a legal regime and external trade regulations that accord with WTO agreements. It has also accepted the principal obligations governing access to its goods and services markets. These include obligations on tariffs, which are to be contained in the 10-30 per cent range. Kyrgyzstan has agreed to open access to the services sector and to limit domestic subsidies and to eliminate export subsidies for agriculture.

The number of Kyrgyzstan's trading partners now exceeds 100, of whom 80 per cent are WTO members. External trade has been reoriented during the transition period from markets in CIS to WTO members. The share of CIS countries in total external trade was 80.1 per cent in 1992 but by 2002 this share had fallen to 45.7 per cent; the corresponding increase in the share of WTO members was from 19.9 to 52.9 per cent in the same period. Although there is no clear trend in the growth of external trade since joining WTO, merchandise exports from Kyrgyzstan have grown in 2000-2002. Turning to the services

sector, exports such as transport, construction and business services have increased fairly steadily since 1998 but imports of services such as transport and insurance have decreased. As a result, the deficit on the services account narrowed sharply.

A consequence of WTO membership is the declining contribution of tariff revenues to the public budget. Before joining WTO, the average tariff rate was 9.18 per cent; in 2000 it had fallen to 5.2 per cent and has continued falling in line with WTO obligations, reaching 5.07 per cent in 2002. Combined with the effects of declining imports, the share of customs revenues in total public revenues fell from 6.2 per cent in 1998 to 2.4 per cent in 2001 before increasing to 2.9 per cent in 2002 as imports revived.

Several problems continue to stand in the way of Kyrgyzstan fully benefiting from WTO membership. First among these are its geographical remoteness and high transport costs owing to underdeveloped transport infrastructure. A related problem is the need for trade destined to and from Kyrgyzstan to transit through countries that are not WTO members. The poor quality of domestic products is another problem, as well as difficulties in accessing markets in neighbouring countries. Some of these difficulties will be removed when fellow members of CIS accede to WTO. As an illustration, China's recent accession to WTO may prove very beneficial to Kyrgyzstan, although some time may elapse before the effects can be fully evaluated as the agreed transition period before China adheres fully to WTO obligations is rather long. Nevertheless, an indication can be had from 2001, when Kyrgyzstan's exports to and imports from China increased by 52.3 and 17.9 per cent respectively as compared with the previous year.

2. Regional trading arrangements and partnerships

Kyrgyzstan is currently a member of several regional trading arrangements. It joined ECO in November 1992, CIS in September 1993, CAEC (now CACO) in April 1994 and the EurAsEC in March 1996. However, the process of genuine integration in unions that have been formed among countries of the former Soviet Union is still handicapped by trade barriers, which decrease the mobility of goods, services, factors of production and technologies, as well as political limitations.

ECO seeks to develop regional economic cooperation subject to the needs of member countries and external economic and political circumstances. Under ECO, Kyrgyzstan is a signatory to a framework agreement on transit trade since

1995 and a framework agreement on trade cooperation since 2000. Access to the sea is a major problem in the ECO region and plans for improving transport and communications infrastructure and facilitating this access are well under way. Under the trade cooperation agreement, countries agreed to decrease tariffs and remove non-tariff barriers and to establish a WTO-compliant regime to regulate trade in the region. However, Kyrgyzstan's trade with ECO has been declining steadily, in part because many members are CIS countries and also because of unfavourable economic circumstances.

For CIS countries, integration was stimulated by their common history. Kyrgyzstan imported 33 per cent of its consumption needs from and exported 16 per cent of total production to the former Soviet Union. The collapse of that union had more serious consequences for it than for other States. Therefore, Kyrgyzstan joined in the agreement to form an economic union in CIS, with all that it entailed. Hundreds of agreements were signed with the aim of integrating CIS countries but not all of them were implemented and the economic union is far from being realized. In fact, it is true to say that whereas integration in CIS is proceeding slowly in some areas, in many others disagreements between members appear to have widened. Kyrgyzstan's total trade with CIS almost halved between 1996 and 2002 owing to the reorientation of its trade to WTO members and the weakening of economic links between CIS countries.

Without turning its back entirely on the idea of an economic union within CIS, Kyrgyzstan has been seeking greater cooperation with other Central Asian republics, particularly Kazakhstan and Uzbekistan and, more recently, Tajikistan, including in the context of existing regional trade and economic cooperation bodies such as CIS, CAEC and EurAsEC. However, coordination of national interests among those countries is proving to be difficult as the speed and nature of market-based transition differs between them.

At the end of December 2001, CAEC became CACO, which aims to further cooperation not only in the economic sphere but also in other areas such as regional security. At present, several bilateral agreements exist under CACO on free trade, mutual protection of investments, double taxation, taxation of foreign trade and the formation of stock markets. Customs services in CACO countries have agreed to further cooperation and mutual assistance. A programme of cooperation on migration has already begun and an agreement on the movement of people has been signed. Agreements on cooperation in the exploitation and use of hydropower resources and the financing and maintenance of State-owned projects in this field have also been reached. Despite these agreements, total trade between Kyrgyzstan and members of CACO has been

declining and, in 2002, it was only 30 per cent of its value in 1996. Exports to CACO countries, in particular, have fallen sharply, from nearly US\$ 588 million in 1996 to just under US\$ 75 million in 2002. Regional trading relationships are not as yet being accorded high priority.

In contrast to CACO, relations between members of EurAsEC are more complementary because of the participation of Russian Federation, with its well-developed industry and great technical resources. Participation of Russian Federation opens up remarkable opportunities for all members of EurAsEC to develop economic, scientific, industrial and other relations. Unfortunately, integration has proceeded slowly owing to the difficulties faced by post-Soviet economies and Kyrgyzstan's trade with other members of EurAsEC has declined, from approximately US\$ 585 million in 1996 to roughly US\$ 377 million in 2002. Whereas exports from Kyrgyzstan have fallen by 50 per cent in that time, imports have fallen more slowly, by only 25 per cent. If EurAsEC gains the status of an international organization the situation may improve, particularly when all its members are also members of WTO.

Kyrgyzstan is also a member of SCO, a grouping of large countries such as Russian Federation and China and small countries such as the Central Asian republics in which the interests of the smaller countries are not infringed upon. Cooperation in SCO extends from economic development and general prosperity to strengthening the position of the grouping and enhancing its role in the global economy.

B. Transition assessment

1. Stages in the reform process

At the time of the former Soviet Union, Kyrgyzstan had a broadly based manufacturing sector producing a variety of machinery and industrial and consumer goods, of which approximately 70 per cent were exported. The agricultural sector was specialized in cattle breeding and the production of wool, as well as cotton, tobacco, vegetables and fruits and the country was the largest producer of electric power and coal in the union. Kyrgyzstan also received direct and indirect grants, amounting to 13 per cent of GDP, from the Soviet Union's budget. These grants were either in the form of budgetary support or investments in large enterprises. Significant investment in social infrastructure led to the accumulation of considerable human capital, in terms of education and health, with levels of educational development rivalling those in developed countries.

The transition of Kyrgyzstan to a market economy with economic growth and stability can be divided into three periods. In 1991-1995, GDP was halved and living standards fell sharply as poverty increased by 50 per cent. The rate of inflation accelerated to reach 1,366 per cent in 1993 and hyperinflation led to the national currency, the som, introduced in May 1993, being devalued. Industrial decline was accompanied by an increase in the contribution of agriculture and services to GDP. Old economic institutions collapsed to be replaced by new market structures and mechanisms. Liberalization of the domestic market, privatization of State-owned enterprises, trade liberalization, agricultural reorganization, financial and credit reforms and social sector reforms accompanied this process.

The economy started to recover in 1996 principally owing to faster growth in agriculture but also in gold mining and energy. However, 1998-1999 was a period of financial crisis during which growth slowed, the som was devalued and the budget deficit was high. Finally, beginning in 2000, economic growth recovered but it has not been steady. The rate of inflation slowed, the budget deficit declined, the exchange rate stabilized and external debt was restructured. Real incomes, which had increased briefly in 1997, began to grow again in 2001. During this period, the following strategies were formulated and adopted to plan Kyrgyzstan's development and its economic management:

- The Comprehensive Development Framework (CDF), outlining development in 2001-2010 and the strategy to achieve it;
- The National Poverty Reduction Strategy (NPRS) for 2003-2005 formulated within the context of the CDF;
- The medium-term budget forecast, worked out within the context of the CDF and the NPRS, which will determine their financial base; and
- The Public Investment Programme (PIP), outlining plans for capital investment in line with the CDF and the NPRS.

2. Key reforms

In the transition to a market economy, macroeconomic stabilization has been the principal task for Kyrgyzstan, which was the first republic in Central Asia to introduce a national currency. The country embarked on a programme of stabilization and structural adjustment in 1993, under the aegis of IMF as a pre-condition for external financial inflows, both official and private. The programme was centered on tighter monetary and fiscal policies and trade liberalization.

The elimination of the post-independence hyperinflation in 1994-1995 was the first sign of stabilization. The exchange rate remained relatively stable after March 1995 when Kyrgyzstan accepted IMF Article VIII obligations and the som became freely convertible. External financial inflows increased but so did external indebtedness. However, high budget and current account deficits sometimes in excess of 20 per cent of GDP continued, leading to long-term macroeconomic instability and vulnerability to external shocks. One such shock was the financial crisis in Russian Federation in 1998-1999 as a result of which inflation increased and the exchange rate was sharply devalued.

The 2000-2003 period in Kyrgyzstan is characterized by more fundamental macroeconomic stabilization. Control over public expenditures led to a decrease in the budget deficit, which had peaked at 17.4 per cent of GDP in 1992, to 5.9 per cent in 2002. This facilitated tighter monetary control so that the rate of inflation level fell to the comparatively low level of 2.3 per cent in 2002. Stringent monetary and fiscal discipline was dictated in part by the high level of external debt as a result of borrowing by the Government to cover current and development expenditures. The devaluation of the som also increased the debt ratio, which amounted to 95 per cent of GDP in 2001.

Liberalization of the internal market in Kyrgyzstan had commenced in the Soviet era and by mid-1994 most price controls and production subsidies were removed. However, until the beginning of the third reform period, State-regulated monopolies continued to exist in public utilities and some municipal services. The reform of these enterprises commenced in 2000 and the domestic market in Kyrgyzstan is now completely liberalized with the exception of energy price controls that will be removed as soon as a mechanism to compensate the poor has been found.

Privatization and structural reorganization of the economy followed macroeconomic stabilization and economic liberalization. Beginning in 1997, legislative reforms secured property rights of juridical and natural persons in Kyrgyzstan and a referendum was held in 1998 to enshrine private property in the country's constitution. A vigorous programme of privatization led to over 70 per cent of State-owned establishments passing into private hands by January 2003. The level of privatization varies between sectors, with almost all enterprises in consumer services, 97.1 per cent in trade and catering and 88.6 per cent in industry being privately owned. Private ownership is somewhat lower in construction, transport and agriculture, where 58.8, 57 and 44.3 per cent respectively of enterprises are in private hands.

Privatization in Kyrgyzstan did not immediately lead to better economic and social performance of the enterprises concerned. On the contrary, output and productivity fell and working conditions in those enterprises deteriorated. The share of industry in GDP decreased from 27.5 per cent in 1991 to 20.3 per cent in 2002 and there was a change in the sectoral composition of industrial output, with a sharp decline in machinery and light industry and growth in the production of gold and power. Subsequently, it has been suggested that the initial privatization was carried out hastily and without adequate economic and financial analysis and this error was not repeated later. Privatization of sectors such as tourism and health resorts as well as basic sectors such as power, gas, telecommunications and mining is currently underway, with the assistance of the World Bank.

Agrarian reform is of great significance in Kyrgyzstan, where 60 per cent of the population lives in rural areas and 30 per cent of GDP is contributed by agriculture. Only 60 per cent of the country's land area can be utilized for agricultural activities and only 7 per cent is cultivable, the rest being used for hay and pasture. At the time of independence, nearly 94 per cent of land was under the control of the State and of farming collectives and just over 6 per cent was being used by small farmers.

As the result of fundamental land reform in Kyrgyzstan, State ownership of land gave way to a combination of collective, municipal, private and other forms of ownership. Currently about 42 per cent of the land is used by private farms, over 26 per cent by collective farms and nearly 15 per cent by State enterprises. Private citizens were allotted free use of land on an equal basis but without transfer and sale rights. Some collective farms were broken up and their land allotted to private farms, initially on 49-year leases that were later extended to 99 years. The allocation of land was in proportion to the sizes of the families involved and, in total, approximately 72 per cent of all agricultural land except pasture was distributed among 2.6 million persons. As a result, all rural residents have some land for their use although the sizes of individual plots differ because of the regional characteristics of the land. A law introduced in December 2000 on land use places restrictions on the concentration of land and, although restrictions on the sale and transfer of land were eased considerably the following year, some restrictions remain in rural areas.

The radical changes that have occurred in the agricultural sector have had an impact on the structure of agricultural output, with crops such as grains, potatoes and sugar beet gaining at the expense of others such as barley, corn and tobacco. The livestock sector, along with the production of meat and wool, has declined and productivity has fallen. However, the reforms, which were

rather painful from both the economic and social points of view, are incomplete as much work remains to be done to build capacity, develop human resources and improve production, processing and marketing in agriculture.

3. Fiscal policy reform

Reform of the financial system is an essential component of Kyrgyzstan's overall reform efforts, necessitating an examination of public finances because of the central role played by the annual State budget. At the time of independence, the financial system in the country was seriously distorted owing to large budget deficits caused by growing expenditures on subsidies and defense. From the beginning of the 1990s there was also a significant decline in tax revenues owing to weaknesses in the relevant legislation, poor tax administration and an absence of a tradition of voluntary tax payments. The problem was compounded by hyperinflation, the collapse in output, increased use of barter and tax evasion.

Tax reform began in 1992, when Kyrgyzstan, which had little experience in tax policy, decided to rely on indirect taxes such as VAT and excises as the main revenue sources. However, VAT was introduced at the relatively high rate of 28 per cent, resulting in problems of tax collection. The rate was lowered to 20 per cent in 1993 in common with other CIS countries and the structure of taxes and the level of taxation have been frequently adjusted since that time. Gradually, simplification of the taxation system leading up to the adoption of a tax code in 1996, the expansion of the tax base and abolition of tax privileges by the Government led to increased tax revenues. More recently, the Government's total consolidated budgetary income increased from 15.1 per cent of GDP in 2000 to 19.2 per cent of GDP in 2002; the increase in tax revenues as a percentage of GDP was from 11.7 to 13.9 per cent in the same period. However, budget deficits and public borrowing have continued.

Public expenditure reforms in Kyrgyzstan have focused on increasing the effectiveness of those expenditures and increasing transparency in planning and performance assessment. The introduction of programme budgeting based on a medium-term budget forecast, which began in 2002, will be completed by 2005 and should improve management of public expenditures. In recent years, public expenditure as a percentage of GDP has fallen from 26.1 per cent in 2000 to 22.1 per cent in 2001 before rising again to 25.6 per cent in 2002. The sharp fall in 2001 reflected reduced debt repayments as well as public expenditure cuts, including in the social sector, which were difficult to sustain the following year in light of Kyrgyzstan's poverty reduction goals. The scarcity of budget resources has brought the question of their effective utilization to the fore.

This is particularly true of the PIP, which was reduced by 2.4 per cent in 2000-2002 and led to an examination of the prioritization of projects, their inclusion in the PIP and their design and management. As the PIP is not fully integrated into the public budget, the desired level of transparency and effectiveness of expenditures are not always achieved.

4. Monetary policy reform

Monetary policy in Kyrgyzstan has been dominated by the need to control inflation and to further the reform process. The country was part of the rouble zone until 1993 when the national currency, the som, was introduced. A policy of strict control of the money supply, as part of a stabilization programme prescribed by IMF, commenced in 1994 and lending to State-owned enterprises was curbed. The rate of inflation slowed sharply, falling to 13 per cent in 1997. An important factor in this process was the relative stability of the som in 1995-1998, owing to IMF-financed intervention by the National Bank of Kyrgyzstan in the interbank currency market. However, continuing large budget and current account deficits undermined macroeconomic stability until they were reined in beginning in 1999. In 2000-2002, the macroeconomic situation improved considerably and the rate of inflation fell to 2.3 per cent in 2002, one of the lowest rates among CIS countries. Currency appreciation was an important factor in the achievement of price stability.

Unfortunately, the adoption of restrictive monetary policies by the National Bank has had some negative consequences as well. Credit growth has been insufficient to foster economic development and consumer demand, including for local goods and services, has remained depressed. High interest rates, which were initially justified by the high rates of inflation, have also impeded development of the banking sector and financial intermediation has been constrained by excessive caution on the part of both borrowers and lenders.

5. Development of the financial sector

In the early stages of transition to a market economy in 1992-1994, the National Bank of Kyrgyzstan and commercial banks were established, alongside State-owned banks. The poor financial condition of many banks subsequently led to the initiation of bank restructuring, with the assistance of the World Bank. Standards of bank supervision were raised and a Debt Resolution Agency established. The payments system was modernized and international accounting standards adopted by the National Bank and commercial banks. The financial

crisis in Russian Federation in 1998-1999 threatened bank stability in Kyrgyzstan but a systemic crisis was avoided through swift action on the part of the National Bank. A strategy of reconstruction and stabilization of the banking system as well as its medium-term development has now been worked out. In recent years, problem banks, with poor management and internal controls as well as those in violation of relevant laws, have been placed under special administration and liquidated.

As the result of the reforms, bank management has improved, which can be seen by a reduction in operational expenses and an increase in interest income from credit activity, despite some reduction in interest rates. In 2001, the combined banking system returned to profitability and total assets increased. The latter reflected increased requirements on capital adequacy and subscribed capital. However, the higher standards have not as yet led to bank consolidation.

In the non-bank sector, which is also regulated by the National Bank, the growth in the availability of microfinance and in the development of credit unions is of note. Access to financial services and small loans for individuals and entrepreneurs in the rural areas of Kyrgyzstan is an important prerequisite for increased employment and poverty reduction and microfinance has received strong donor support, particularly from the World Bank and the EBRD. The Kyrgyz Agrarian Financial Corporation is very active in the microfinance field, increasing the volume of its lending to producers of agricultural commodities by a factor of 18 between 1997 and 2001 to 587 million soms even though interest rates charged increased somewhat. Loan recovery rates have been in excess of 90 per cent.

The development of credit unions in Kyrgyzstan has been remarkable. Currently, there are over 300 credit unions in existence with total subscribed capital in excess of 120 million soms. Donors and the Asian Development Bank have supported their development so far but they are likely to become self-financing in future as the necessary legislation for them to do so is in place. However, the credit unions have not built up their institutional capital as yet, suggesting room for improvement in the quality of their growth.

The insurance sector and pension funds remain relatively underdeveloped in Kyrgyzstan. Although the insurance market has great potential, relevant infrastructure and a normative and legal framework for further growth are lacking. Nevertheless, the sector has seen some increase in premiums collected in recent years. Legislation is in place regulating non-State pension funds but there is only one such fund at present, indicating the lack of development in this area.

C. Markets and trade

Liberalization of external trade is an important indicator of economic reforms in Kyrgyzstan. From 1991 to 1994 control of external trade through tariff and non-tariff measures continued. High rates of customs duties were applied to a large number of export and import commodities and quotas and licenses were also widely used. External trade regulation was radically liberalized in a short space of time commencing in 1994. Export and import licensing was abolished in that year barring a few socially important items and State and private enterprises are now free to engage in foreign trade operations without any restriction, except for those products. Kyrgyzstan no longer has any quantitative restrictions on exports and imports and there are no export duties but import tariffs and quotas on alcohol and spirits remain. The foreign trade regime in Kyrgyzstan today is the most liberal among CIS countries and is also supported by complete convertibility of the national currency.

Before 1999 there was a fixed tariff in Kyrgyzstan, equal to 10 per cent of the declared customs value, applied to all kinds of goods. Since that date, customs duties on imported goods have been re-examined annually and import tariffs are currently in the 0-15 per cent range, with an average rate of 5.07 per cent in 2002. Trade liberalization has resulted in 45 per cent increase in total trade between 1992 and 2002, when total exports and imports amounted to US\$ 1,072.2 million. There has also been a change in the direction of trade flows away from CIS countries, as has been mentioned earlier. However, Russian Federation remains the second most important export market, after Switzerland, and the most important source of imports after Kazakhstan. Energy, machinery, equipment and consumer goods dominate imports, while exports are principally products from the mining and agricultural sectors as well as hydropower. The structure of foreign trade has yet to demonstrate fully the benefits of membership in WTO and the various regional trade arrangements.

In order to meet the growth target set out in the CDF, Kyrgyzstan needs to increase exports by at least 10 per cent annually. In the short term, exports will continue to be derived from the country's natural resources, which determine its comparative advantage. In the long term, however, Kyrgyzstan needs to diversify its export base to include high-value products such as power, precious metals, highly processed goods and goods that are capital- and technology-intensive. At present, export promotion efforts are confined to encouraging increased sales of goods that are currently produced. However, financial

assistance is the most effective means for stimulating exports and measures such as export credits, together with export credit insurance and State guarantees could be used in future to encourage development of high value added exports. The export potential of the four free economic zones existing in the country could also be increased.

D. Investment liberalization policies

Investment policy in Kyrgyzstan is conditioned by the view that without effective mobilization of internal resources, stable growth and development will not be possible. The major component of policy should be the mobilization of domestic savings, both public and private, and support for investment in industry. Foreign investment is an important addition to domestic efforts but economic liberalization and measures to attract FDI are not the only factors that attract foreign investors. The investment climate in a country is determined by a number of variables, including economic, social and political stability, the economic outlook, taxation, investment incentives, quality and availability of labour and infrastructure, bureaucracy, corruption and so on. During the period of reforms in Kyrgyzstan, steps were actively taken to eliminate factors adversely affecting investment but the most significant steps have only been taken recently.

In Kyrgyzstan, foreign investment is governed by the Law on Foreign Investments, passed in 1997, and the Law on Investment, passed in March 2003. There are no restrictions on the inflow of foreign investment in the republic and all sectors of the economy are open for the realization of investment projects. Foreign investors can also be the sole owners of property and other assets in Kyrgyzstan without entering into joint ventures. They are automatically entitled to visas that permit them to work and live in Kyrgyzstan and citizens of some countries that are members of WTO and the Schengen Agreement of the European Union are able to enter the country without visas.

National treatment is given to foreign investors in their business activity and the current tax code in Kyrgyzstan takes a common approach to both domestic and foreign investors. However, tax and customs privileges for foreign investors are considered to be ineffective in attracting FDI, discriminatory and expensive. Prompt payment and fair compensation is guaranteed in cases of expropriation and foreign investors are also guaranteed unrestricted repatriation of capital, dividends and profits. The national currency is fully convertible for this purpose and investors can choose to keep their earnings in foreign currency without having to convert it into soms.

Several new institutions have been created recently to stimulate investment, particularly FDI. An Implementation Council on Foreign Investments¹ was created in August 2001 to evaluate the business environment and to make it more investor-friendly. A Special Representative of the President on Foreign Investments coordinates the activity of ministries, departments and organs of local government on issues relating to foreign investment. An Investment Promotion Center has been set up to act as a one stop shop for both domestic and foreign investors with broad powers to act on their behalf and to facilitate partnerships, as well as to provide business services such as market research and consultation free of charge. It also assists in obtaining permits, licenses and visas. Finally, an Expert-Appellate Counsel has been formed to evaluate suggestions and resolve complaints from investors and entrepreneurs with regard to administrative and bureaucratic difficulties.

Taking into account the importance of SMEs for investment and growth in Kyrgyzstan, a great deal of attention has been given to their support. Two programmes of support have been realized in which the main problems facing SMEs were addressed, including improving tax legislation, simplifying registration and licensing, improving access to credit and reducing unnecessary controls. A network of public and private financial organizations has also been set up to support SMEs.

At present, four free economic zones have been established, in areas suitable for mass production, to attract investment in Kyrgyzstan. Businesses in these zones are exempt from all taxes, levies and customs duties on exports, imports and re-exports except for a 1-2 per cent charge on the income earned from the sale of the goods and services produced. Exports are free of quotas and licensing requirements.

In attracting FDI, Kyrgyzstan also attaches considerable importance to the development of human resources, to improve the quality of its already highly educated and qualified low-cost workforce. However, the country's remoteness and its landlocked character, which increase transport costs, can be a problem but its strategic location can counteract this to some extent.

¹ The Council has seven members, the President, Prime Minister, Special Representative of the President on Foreign Investments, the Ambassador of the United States of America, the Resident Representative of the World Bank and two representatives of major foreign investors serving on a rotational basis.

Since 2001, a document referred to as the Investment Matrix has been produced each year in which the main strategic directions for stimulating investment and attracting FDI are set out. Investment Matrix I was published in September 2001, Investment Matrix II in April 2002 and Investment Matrix III in January 2003. The most recent document focuses on deregulation and other measures to stimulate investment, including strengthening the banking system. Tax and tariff incentives will also be provided to encourage technological imports and the system of technical regulations will be reformed and State intervention reduced. Investment in the ICT industry is to be encouraged and Kyrgyzstan is to be developed as a transport and communications transit country.

E. Impact of globalization on social and human resources development

1. The labour market, employment and incomes

In the years since independence, some demographic changes can be observed in Kyrgyzstan. Families with many children have given way to single-child families and migration, both within the country as well as to foreign countries, has increased to the extent that the population of the country actually decreased in 1994 owing to large-scale emigration. Out of a total population of approximately 5 million people, nearly 52 per cent is of working age. However, continued emigration of people in this age group in search of better job opportunities overseas is a matter of some concern as it represents a drain on the country's human resources.

During the transition to a market economy, the changing forms of business ownership following privatization resulted in the creation of new enterprises and new work opportunities and a restructuring of employment. The share of the public sector in total employment fell from 60.2 per cent in 1992 to 22 per cent in 2001. Employment in industry declined while employment in the services sector, particularly financial services, and in agriculture increased. However, unemployment continues to be largely concentrated in rural areas. Informal work has grown in importance as the shadow economy has expanded. Individual entrepreneurship and self-employment have become more significant, noticeably among the indigenous Kyrgyz population, many of whom are now engaged in trade.

Growth in the labour force has outpaced the growth in available jobs and the unemployment rate, including those not officially registered as unemployed, is estimated to have increased from 4.1 per cent in 1994 to 8 per cent in 2002. The official unemployment rate increased from 0.7 to 3.3 per cent in the same

period, but declined to 3.1 per cent in 2003. However, these figures do not include large numbers of discouraged workers and disguised unemployment. Underemployment and part-time employment, including in jobs that have been administratively created, are also significant particularly in industry. A State employment service, together with a fund for employment assistance and a labour registry, has been introduced. However, the majority of the unemployed prefer to search independently for jobs, as they view public employment offices to be unsatisfactory. Of the people applying for jobs through those offices, 52 per cent were women.

Among strategic aims of labour market reform in Kyrgyzstan are increasing employment through the effective distribution and utilization of labour; strengthening labour protection and the rights of employees in a manner consistent with the interests of employers; and increasing labour remuneration. Professional training and retraining and SME development are important elements in employment policy.

Another aim of labour market reform in Kyrgyzstan is to increase the share of labour remuneration in total money incomes. That share decreased from 55.2 per cent in 1992 to 24.5 per cent in 2001 although it remains the main source of income of the majority of the population. The share of social transfers in total money incomes declined drastically, from 27.2 to 10.1 per cent in the same period, as a result of reduced public expenditure on social protection and improved targeting. Incomes from ownership and entrepreneurship have increased rapidly, from 12 to 50 per cent in 1992-2001.

Centralized regulation of labour remuneration, including the minimum wage, together with certain State guarantees affecting employment are elements that have been retained from the socialist era. The minimum wage, which has been reviewed seven times since independence, is determined on the basis of prevailing views on standards of living and it is used in establishing wage rates in the public sector, as well as the minimum pension and other social payments. The size of the minimal consumer budget (MCB) is an important consideration in setting the minimum wage.

In 2002, the average monthly wage was around 1,618 soms, an increase of nearly 11 per cent over the previous year. In this regard, a remarkable differentiation in the level of wages between economic sectors is becoming evident. The most highly paid employees are in finance and banking and State management, with wages 3 to 4 times higher than the average. At the same time, wages for employees in health care, education and other social services and in agriculture and forestry are almost half the average. However, it should be noted that in 2000, for the first time since reforms began, average monthly wages exceeded the MCB.

2. Poverty and living standards

The crises that affected the economy of Kyrgyzstan during its transition to a market economy led to a decrease in the standard of living among the population, particularly for vulnerable groups with low incomes, such as pensioners, invalids and households, generally in rural areas, with limited means and many children. During these years, the incidence of poverty increased, from approximately 44 per cent of the population in 1996 to a peak of 55 per cent in 1999 before declining to reach 48 per cent in 2001 as measured by the food poverty line (table V.1). The food poverty line in Kyrgyzstan is based on the physiological needs of persons and is defined in terms of the income needed to meet the minimal food needs of a household.

Table V.1. Indicators of living standards in Kyrgyzstan, 1996-2001

<i>Indicator</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
Average monthly income per capita, som	244	332	411	575	709	831
Average monthly wage per employee, som	491	680	841	1 050	1 227	1 455
Minimum monthly wage, som	75	83	100	100	100	102
Average monthly pension, som	247	307	378	385	462	553
MCB per month, som	534	691	799	1 097	1 205	1 316
Per cent of the population below food poverty line	44	43	55	55	52	48
Gini coefficient	0.391	0.453	0.447	0.443	0.449	0.441

Source: Data obtained from the National Statistic Committee and the Center of Economic Research and Social Reform under the Ministry of Finance.

The MCB is the set of food and non-foods goods and services that provide a socially acceptable standard of living. The Government of Kyrgyzstan determines the MCB once a year, except in times of inflation when it is reviewed quarterly based on the increase in the consumer price index. The MCB is used in determining the national poverty line, as the criterion used to establish whether a household is living in poverty is the share of income the household spends on food. If the household spends more than half of its income on food, it is considered to be among the poor.

Another indicator of the decline in living standards in Kyrgyzstan is the minimum wage, which is supposed to be equal to roughly 20 per cent of the MCB. However, beginning in 1995, when the minimum wage was approximately 21 per cent of the MCB, its meaning has declined each year as prices have increased rapidly. In 1998-2000, the minimum wage was effectively frozen. As a percentage of the MCB, it has declined to approximately 8 per cent in 2001. In practice, the level of the minimum wage has little impact on wage rates in general, except in the public sector.

The average monthly pension more than doubled in 1996-2001 but it remains well below the MCB, being roughly half the amount needed to ensure a minimal consumption standard in 2001. Thus, one of the main social guarantees provided by the Government has lost its principal function of supporting an acceptable standard of living and cannot reduce poverty among the population. The difficult economic situation during the transition period led to deficits in social insurance programmes and declining social insurance payments. In 1990, there were four employees paying contributions for each pensioner but by 2001 the figure had fallen to 1.7 and it is no longer possible for the State to provide guaranteed social payments such as pensions and other allowances. Aggravating these problems is the increase in income inequality as indicated by the Gini coefficient, which rose from 0.391 in 1996 to 0.441 in 2001.

3. Social security and human development

The social aspect of national security in Kyrgyzstan has been adversely affected during the transition to a market economy as social transfers and benefits have been drastically cut back, adding to the dangers of social conflict. Nevertheless, human development in Kyrgyzstan has progressed. According to national estimates, average life expectancy at birth was 68.7 years in 2001, up from 66.6 years in 1996, although women continue to outlive men by 8-9 years. Adult literacy, already high in 1996, was 98.7 per cent in 2001, while the combined primary, secondary and tertiary enrolment ratio was 71 per cent. The human development index increased from 0.688 in 1996 to 0.723 in 2001.

Increased life expectancy will put pressure on the health care system in Kyrgyzstan in future but budget cuts have led to a decrease in the number of hospitals. Low wages in the sector have also caused an outflow of qualified staff and the overall quality of medical services has declined as a result. Insufficient access to medical services is a serious problem. Problems have also arisen in connection with decreased funding for education. Educational facilities have deteriorated, wages for teachers remain low and educational

quality has suffered. The importance of education to poverty reduction efforts cannot be overestimated. At present, education is not free of charge and families spend a large share of their incomes on educational expenses, which can affect enrolment ratios. By some estimates, even a decrease of 2-3 points in the combined enrolment ratio will set back educational progress by 30 years.

The Government of Kyrgyzstan provides social guarantees for all the population irrespective of socio-economic status. The system of social support is based on two principles: guaranteed State support for maintenance of a minimal consumption level and targeted support for the socially vulnerable strata of the population. In practice, targeting is done on the basis of verifiable income levels without a broader assessment of need. Pensions account for approximately 80 per cent of all social support, the balance going to finance allowances and social assistance, as well as scholarships.

At present, social protection in Kyrgyzstan is also implemented by a system of payments of common monthly grants to all poor households. Households where average monthly income per member is no more than 40 soms qualify for this assistance. The system has several limitations. First, the threshold amounts to only 22 per cent of the national poverty line in 2001, thus providing an insignificant level of protection from poverty. Second, targeting is weak and could be improved. One of the characteristics of poverty in Kyrgyzstan is its mobility and keeping track of all those entitled to benefits is expensive and difficult. Large numbers of households can and do fall through the social support net.

Currently, the system of direct transfers also includes the payment of grants to invalids, unwed mothers with ten or more children and orphans. There is also a system of subsidies for electricity and other public utilities for 36 different categories of population. It is impossible to determine the influence of these programmes on the well-being of the poor without clearer information relating to the actual size of the grants and the coverage achieved of the targeted groups. Additionally, there is a system of unemployment grants and old-age pensions in Kyrgyzstan but a very limited part of population currently has a right to them and they do not provide full protection from poverty. The level of grants is absurdly low, taking into consideration actual conditions, although they were increased by 20 per cent in April 2001 along with the income threshold to qualify for these grants. The main conclusions that can be reached is that the system of social assistance in Kyrgyzstan has not been able to play a major role in providing social support and that the level of transfers has been insufficient in mitigating the consequences of poverty.

F. Key challenges ahead

1. Constraints on future growth

The CDF envisages a reduction in the incidence of poverty from 52 per cent in 2000 to 26 per cent in 2010 in Kyrgyzstan. For this goal to be achieved, real GDP has to grow at an average annual rate of 5 per cent so that GDP per capita increases by 50 per cent in 2000-2010 and the high rates of savings and investment needed are realized. However, the natural resources that have fuelled the country's growth so far, in agriculture, gold mining and energy, are already exhausted so that diversification is necessary to sustain growth momentum. This requires an industrial policy that is less focused on individual sectors but more on creating an overall climate favourable to investment and private enterprise and on resolving existing economic problems.

One of these problems is the insufficient level of investment in Kyrgyzstan. In the past, the low level of private investment was offset by public investment in fixed assets but the rising level of external debt owed by the Government limits this option in future. Therefore, measures need to be taken to stimulate private domestic investment and to attract FDI, which needs to double to meet growth forecasts. At the same time, public investment will continue to be needed in developing economic and social infrastructure but will have to be financed through taxation rather than through borrowing, so that tax effort and tax administration will have to be improved.

The other important problem in meeting the economic growth target is increasing exports. Kyrgyzstan will be an attractive destination for FDI only if there are unrestricted opportunities for export as the domestic market is so limited. Export growth is also necessary for macroeconomic stability and for servicing external debt. A consistent policy of support, in the context of integration into regional and multinational trading systems, will be necessary if Kyrgyzstan is to take advantage of the opportunities that are becoming available, for example in trade with China, and exports are to increase. In the sphere of external trade policy, an important problem is the presence of regional limitations. As the member of WTO and CIS, Kyrgyzstan is planning to suggest concrete measures that can be taken with neighbouring countries to ease those limitations. For its part, Kyrgyzstan supports free trade and full currency convertibility and opposes measures such as temporary tariffs or non-tariff barriers. Greater regional trade and economic integration, including the creation

of an internal market, will help in attracting FDI to Central Asia. Kyrgyzstan would find it relatively easy to attract FDI in those areas where it has a comparative advantage, but protectionist policies of some neighbouring countries constitute a handicap.

Improving the competitiveness of goods and services produced in Kyrgyzstan will also be necessary if exports are to grow. Currency devaluation to increase price competitiveness is a poor solution as it increases the cost of debt service and provides only short-term benefits. For a solution that is sustainable in the long term, restraining inflation and increasing total factor productivity are required, along with improved product quality. These changes can be encouraged by making domestic markets function better through increased competition and by fostering more effective utilization of scientific and technical progress.

There is a need to increase the effectiveness of the financial system, an area in which Kyrgyzstan has some problems. Commercial banks suffer from poor management quality, weak internal controls and inadequate supervision. They are also hampered by inadequate domestic legislation regarding the protection of creditors and by low public trust. Non-bank financial institutions, such as credit unions and insurance companies, could play a greater role in financial intermediation. After appropriate financial strengthening, credit unions could be transformed into cooperative banks to serve the population in rural areas. The market for insurance services could be further developed and strengthened if relevant legislation and supervision are improved and institutions such as an institute of actuaries established.

Finally, the wide-ranging structural reforms envisaged in the CDF and the NPRS will not be realized without an improvement in public administration. Improvements to the budget process, a more efficient determination and differentiation of functions, greater transparency in the organs of State and a decrease in corruption are all necessary.

2. Income inequality and poverty reduction

In spite of progress achieved so far, particularly after 2000, poverty reduction is still a major problem facing Kyrgyzstan, which is the second poorest country in the former Soviet Union. Rising income inequality compounds the problem and the first task for the country in reducing poverty is to prevent further increases in income disparities. Social policy measures,

particularly income transfers, are the principal tool in this regard but economic policy also has a role to play. The reduction of poverty in 2000-2001 was achieved by falling rates of inflation during that period, which reduced the inflation tax and its deleterious effects on the living standards of the poor. To reduce income inequality and the incidence of poverty in Kyrgyzstan, it is necessary to take measures to increase employment, as well as productivity and incomes, particularly in rural areas, and to complete pension reform.

An important mechanism for transmitting the benefits of growth to the poor is through increasing employment, as labour is often the only resource of the poor. However, economic growth in Kyrgyzstan in 1996-2001 was not “pro-poor” in the sense that the employment elasticity of growth was quite low. In those six years, GDP increased by 38.4 per cent but the corresponding increase in employment was only 8.9 per cent. Most of the employment growth was in agriculture where, according to the National Statistics Committee, any person with land, irrespective of whether that person is working on it or not, is classified as employed. Growth without employment will have less impact on poverty reduction.

Nevertheless, GDP growth in 1998-2001 was led by agriculture and this appears to have reduced poverty as the majority of the poor in Kyrgyzstan live in rural areas. The incidence of poverty in those areas declined from 62.4 per cent in 1998 to 51.0 per cent in 2001. Agriculture merits greater attention as it supports a disproportionately high percentage of the population. To increase the incomes of the rural population, the strategy of village development should be directed to increasing the productivity of the land, which can be done through improved farming methods. The small plot sizes that are prevalent today do not permit crop rotation, adversely affecting yields. A cooperative and voluntary approach to pooling land resources would help in overcoming this problem.

Further poverty reduction in rural areas could be achieved by measures to assist more vulnerable households in their farming activity. Land redistribution was not accompanied by improved access to additional resources that are necessary to increase capacities among farmers and there is a danger that more efficient farmers will buy out weaker ones and landholdings will be concentrated again. Assistance with agricultural credit and marketing, as well as irrigation, may be needed to encourage individual farmers and cooperatives to take advantage of available services and the services themselves need to be provided more equitably.

During the off-season, many agricultural workers are disoccupied and without incomes, so that they are obliged to sell their assets, including cattle. Providing these workers with productive employment is a major task facing Kyrgyzstan. Encouraging the development of non-agricultural SMEs in rural areas, particularly in food processing, improving transport and marketing infrastructure and access to credit in those regions and removing barriers to trade are all steps that would assist in poverty reduction.

One of the priorities of social protection in Kyrgyzstan at all stages of economic reforms is strengthening the targeting of social support to the most vulnerable population groups. Grants to these groups should be close to the living wage and, budget permitting, protected from inflation. Pensions are an important part of the system of social transfers and are currently paid on the basis of age without regard to actual need. There is a need to distinguish between working pensioners, for whom pension payments are simply a source of additional income, and those who are too sick or old to work but are unable to meet their basic needs with the standard pension payment. A reconsideration of the pension system and the determination of unemployment benefits to help those truly in need is in order.

G. Conclusions

For a small country such as Kyrgyzstan, export-led growth is the only realistic option, obliging it to make every effort to access potential export markets. Liberalization of external trade has been of the principal components of the country's economic reforms. Attaining the CDF targets for growth and investment hinges on achieving sustained high rates of export growth. In the medium and long terms, important national priorities for Kyrgyzstan are greater integration into the regional and multilateral trading system to take full advantage of all available opportunities for expanding and diversifying trade and to increase reliance on private investment, both domestic and foreign. An important task for the country is to take advantage of its location to become a transit transport and communications bridge between Europe and Asia. The revival of the Great Silk Road in the current context takes on additional significance for trade promotion in Kyrgyzstan.

Macroeconomic stabilization has benefited economic growth in Kyrgyzstan but continuing budget and current account deficits undermine what has been achieved and increase vulnerability to external and internal shocks. Economic growth in recent years has been dependent on sectors such as agriculture, gold

mining and energy that are all affected by factors which cannot be easily controlled, such as the weather and global economic conditions, and that do not provide a sustainable basis for future growth. In addition, the financial system has not fully benefited from increased stability and real interest rates continue to be high and reforms are incomplete.

Poverty continues to be a problem, particularly in rural areas where families tend to be large. More attention needs to be given to raising incomes in those areas in order to reduce poverty further. Finally, cuts in social services for budgetary reasons necessitate a closer examination of existing social transfers to improve their effectiveness in helping vulnerable population groups and in reducing income inequality.