

THE PROSPECTS OF KYRGYZSTAN'S ACCESSION TO THE CUSTOMS UNION AND COMMON ECONOMIC SPACE¹

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ABSTRACT

This article looks at the goals, conditions, and possible consequences of Kyrgyzstan's accession to the Customs Union (CU) and Common Economic Space (CES), describes the current state of the country's export and import situation, and analyzes the role of re-export in the Kyrgyz

economy in the past decade. It studies the alleged positive effects and risks that could arise if Kyrgyzstan joins the CU and CES and presents the data of an analysis of the comparative advantages of commodity groups. The authors justify the importance of pursuing a coordinated policy with the other CU

¹ This article was prepared based on the results of a study of the prospects for Kyrgyzstan's participation in the integration project being implemented by the Russian Federation, Kazakhstan, and Belarus carried out in 2013 by a group of experts. This article refers to certain provisions of the report published by the National Institute of Strategic Studies of the Kyrgyz Republic (see: "Prospects for Kyrgyzstan's Participation in the Eurasian Economic Union: Pluses and Minuses," National Institute of Strategic Studies, Bishkek, 2013, 99 pp.), which the authors participated in writing.

countries to develop priority industrial and agricultural sectors. This will encourage large companies to come to Kyrgyzstan and open their branches in the country, as well as help to solve tasks aimed at modernizing agriculture and creating an agroindustrial cluster.

Keeping in mind that commodity flows and business will have to undergo major re-

orientation after the country joins the CU and CES, the authors conclude that a certain transition period will be needed to enable gentler adaptation of the economy. The authors propose creating a mechanism based on EU experience within the CU and CES to support countries with slower rates of development.

KEYWORDS: *Kyrgyzstan, Customs Union, Common Economic Space, Common Customs Tariff, economic modernization, competitiveness, sensitive commodities, transition period.*

Introduction

The creation of a Customs Union (CU) and Common Economic Space (CES)² by Belarus, Kazakhstan and Russia is very conducive to CIS integration. Several other republics of the former Soviet Union, including Armenia, Tajikistan, and Kyrgyzstan, are also considering joining this integration group. Their governments have already submitted an application to join the CU.

However, we should not forget the important role that re-export has been playing in the country's foreign trade in the last decade. It is having a significant influence both on the state of the economy and on the employment and income of the population. Since commodity flows and business will need to undergo major reorientation following accession to the CU and CES, the country will require a certain transition period to enable gentler adaptation of the economy to the new foreign trade conditions.

The main mid- and long-term goals of accession to the CU and CES are sustainable economic growth, economic modernization, and closing the gap (or at least not permitting it to widen) between Kyrgyzstan's level of development and that of the other member states. The key tasks to be solved when joining the CU and CES are also being examined.

The Attraction of Integration Projects

The Kyrgyz government has adopted a decision on the country's accession to the CU created by Russia, Kazakhstan, and Belarus.

The CU officially went into operation on 1 January, 2010; a Common Customs Tariff (CCT) came into force in trade relations with third countries. The Customs Code (CC) of the CU came into force on 1 July, 2010 and envisages the main customs regulations. All coordinated types of monitoring were shifted to the outer periphery of the CU on 1 July, 2011. There is no longer any customs, transport, sanitary, veterinary, and phytosanitary control on the internal borders of the CU member states.

When the CU went into operation, preparations were accelerated for creating a legal base for transfer to a higher level of integration; the matter concerns the CES.

² The Customs Union was created in 2010 by the Russian Federation, Kazakhstan, and Belarus. The agreements of the said countries on the establishment of a Common Economic Space came into force on 1 January, 2012.

The CES was established in order to implement the “four freedoms” in the territory of the three countries—movement of goods, services, capital, and labor. On 1 January, 2012, a basic set of 17 agreements forming the contractual and legal framework of the CES came into force.

It is very obvious that it only makes sense for Kyrgyzstan to join this integration project if it can later become a member of the CES. So this article examines accession to the CU and the CES as a single project.

As the economic literature notes,³ when assessing the effect of regional integration, the differences between the static and dynamic factors should be understood.

The static effect of regional trade agreements reflects the influence of price changes caused by lowering the tariff and non-tariff barriers. This results in an increase in trade volume among the member countries by means of trade creation. In so doing, more efficient producers from the CU member countries replace local producers in the market. Trade diversion can also take place, when more efficient producers from third countries are replaced by producers from the CU member states.

Static factors are important when evaluating nonrecurring change in the standard of living of the member states resulting from establishment of the CU.

In contrast to the static, the dynamic effect is related to the mid- and long-term consequences of regional integration, thus it is more important for the economy.

The dynamic effect that influences practically all spheres related to the branch’s competitiveness is the most widespread. The benefits from dynamic factors include an increase in effectiveness as a result of growing competition, greater specialization, economy of scale, introduction of new technology and know-how, and so on.

Benefits from deeper regional integration, including comprehensive harmonization of policy, legislation, and institutions and capable of generating dynamic effects related to an increase in the market volume, an increase in foreign direct investments, technology transfer, and a general increase in competition can be noted among the alleged positive aspects of the country’s accession to the CU and CES.

The positive economic factors include, in particular, gaining access to a larger market; this will make it possible to satisfy the demand for goods consumed in the region and become a stimulus for attracting investments. When making their decisions, investors will keep in mind the larger regional market and invest their capital in major projects. This will make it possible to take advantage of economy of scale, keep in mind regional division of labor, and organize the production of new types of products that have never been manufactured before in the country.

However, it should be kept in mind that specific regional trade agreements operate in specific situations. Whether joining the CU will promote Kyrgyzstan’s further successful socioeconomic development will depend on the correlation of conditions in the region and in the CU member countries. Decisions concerning the country’s accession to the CU should be made keeping in mind the state of the country’s economy and the possible consequences of this step.

Therefore, keeping in mind the political and economic instability existing in the country, it is very important to ensure sufficiently soft conditions for the “sensitive” sectors of the economy during the transition period to joining the CU.

Current State of Commerce

In the past ten years, Kyrgyz exports have lagged significantly behind its imports. This has resulted in a large trade balance deficit in Kyrgyzstan, as well as in several other CIS countries.

³ See, for example: *Preferential Trade Agreement Policies for Development: A Handbook*, ed. by J.-P. Chauffour, J.-Ch. Maur, World Bank, 2011; *How to Design, Negotiate, and Implement a Free Trade Agreement in Asia*, ADB, 2008.

On the whole, most of the commodities Kyrgyzstan exports to the CIS countries (mainly to Russia, Kazakhstan, and Uzbekistan) consist of raw materials (including cotton, tobacco, and non-ore minerals), electricity, and some foodstuffs (fruit, vegetables, dairy products, and so on). Products of the manufacturing industry are also exported: garments, goods produced by the metallurgic industry, incandescent lamps, vehicles, and spare car parts.

Export to the countries of the Far Abroad is much less diversified, which makes it extremely vulnerable to external conditions (changes in the price and regional demand for water/electricity, for example); it is limited to gold, cotton, wool, furs, leather, metal scrap, and non-organic chemicals.

Kyrgyzstan's main export partners are traditionally Russia and Kazakhstan. In 2012, the share of these countries in the country's export amounted to 11.2% and 19.3%, respectively.

In recent years, Switzerland has become another of Kyrgyzstan's leading partners (32.6% in 2012), where the country's main export commodity, gold, is exported. In 2011, when gold prices reached a historic high, export of this precious metal topped 50% (of the total export volume). However, in 2012, as a result of changes in the geological situation, the volumes of gold production dropped sharply, bringing the share of export in the total volume down to 33.4%.

In recent years, the volume of petroleum products has increased in Kyrgyzstan's imports, the main articles of which are fuel, wheat, medication, cars, etc., which was related to an increase in their re-export, including for filling foreign war craft. The increase in import of consumer goods was due to the increase in income of a percentage of the population (including the significant increase in migrant remittances during this time). Due to the increased housing construction rates, the import of building materials, equipment, and other commodities also rose. What is more, investment projects were intensively implemented (by means of private capital and state investment programs).

Kyrgyzstan continues to import from a relatively small number of countries, its main partners traditionally being Russia and Kazakhstan. In 2012, the percentage of these partners in the total volume of Kyrgyz imports amounted to 33.2% and 9.7%, respectively. China acquired the status of second most important partner after Russia among the Far Abroad countries, the share of which reached 22.5% in 2009.

Beginning in 2004, the policy of the Kyrgyz government was de facto aimed at creating favorable conditions for importing goods and their subsequent re-export. As a result, in recent years, Kyrgyzstan has become a regional hub for re-exporting Chinese goods to the countries of Central Asia and Russia, which was also promoted by its advantageous geographical location and streamlined logistics.

In so doing, Kyrgyzstan's Dordoi and Karasu bazaars, which act as the main transshipment bases for Chinese export, play an important role. According to the assessment of World Bank (WB) experts, the volume of re-export carried out through the mentioned bazaars reached \$2.7 billion in 2008.⁴ Along with the total amount of import, which, according to official data, equaled \$5.3 billion in 2012, in 2008, the total volume of re-export from Kyrgyzstan amounted to \$10 billion⁵ (according to the estimates of Roman Mogilevskii). This shows a large volume of unregistered import and re-export and of shadow turnover as a whole.

In 2009, there was a drop in re-export volumes, which was associated with the decrease in economic growth rates in Russia and Kazakhstan as a result of the global crisis. In 2010, in conditions of the political instability that ensued, export and re-export decreased even more; at that time, the border between Kyrgyzstan and Kazakhstan was closed to vehicle and passenger traffic. Customs

⁴ See: *Bazaars and Trade Integration in CAREC Countries*, Report prepared by World Bank, May 2009.

⁵ See: R. Mogilevskii, "Trends and Patterns in Foreign Trade of Central Asian Countries," *Working Paper* No. 1, May 2012, University of Central Asia.

control was also tightened when the CU went into operation. It is important to note that Kyrgyzstan's bazaars are the main source of income for the local residents, whereby employment is not determined only by the number of people who work there (that is, vendors and administrative and service personnel). Bazaars promote an increase in indirect employment, such as jobs associated with shipping operations and freight handling. Vendors working at other bazaars and product suppliers (including to warehouses located outside the bazaar's boundaries) should also be included here.

According to the assessment of WB experts, the total fixed costs of the bazaars studied amounted to approximately 33% of Kyrgyzstan's GDP. Labor costs amounted on average to around 30% of Kyrgyzstan's total fixed costs.⁶

On the other hand, the significant orientation of foreign trade toward re-export operations does not in itself solve the problem of ensuring sustainable economic growth in the mid and long term, even though it provides jobs for a large percentage of the population. Sustainable economic growth can more successfully be ensured by a high level of competitiveness of Kyrgyz companies in the regional markets and a stable increase in the export of goods produced in the country.

At the same time, keeping in mind the re-export specialization that has developed in Kyrgyzstan, it can be presumed that if it joins the CU, there will be significant reorientation of commercial flows and business, so a certain transition period will be needed for the country's economy to undergo gentler adaptation.

The Main Goals and Restrictions in Kyrgyzstan's Accession to the CU and CES

Kyrgyzstan is undoubtedly hoping that its accession to the CU will enable it to reach a new level of economic and social development.

At present, not one document adopted by the Kyrgyz government or president has envisaged the specific goals to be achieved as a result of Kyrgyzstan's accession to the CU and CES.

In our opinion, the main mid- and long-term goals of Kyrgyzstan's accession to the CU can be formulated as follows:

- ensuring sustainable economic growth;
- carrying out economic modernization;
- closing (or preventing an increase in) the gap between the country's level of development and that of the other CU states.

In order to ensure these main goals are reached, the following sub-goals must be fulfilled:

- creating jobs and ensuring a high level of employment;
- attracting foreign direct investments;
- increasing the use of new technology;
- becoming incorporated into international production chains;
- improving production structure.

⁶ See: *Bazaars and Trade Integration in CAREC Countries*.

On the whole, accession to the CU and CES corresponds to the main aims designated in the country's sustainable development strategy.

Kyrgyzstan is a small country that lags significantly behind the CU member states in level of economic development. For example, according to the IMF, in 2012, the volume of Kyrgyzstan's GDP amounted to \$6.5 billion, while in Belarus this index was equal to \$63 billion, in Kazakhstan to \$196 billion, and in Russia to \$2,022 billion. In other words, in terms of this parameter, Belarus has an almost 10-fold advantage over Kyrgyzstan, Kazakhstan more than 30-fold, and Russia 311-fold.

In 2012, the per capita GDP in Kyrgyzstan (in terms of purchasing power parity) was equal to \$2,376, while in Belarus it amounted to \$15,634, in Kazakhstan to \$13,893, and in Russia to \$17,709. So the index for Belarus was approximately 6.6-fold, for Kazakhstan 5.8-fold, and for Russia 7.5-fold higher than Kyrgyzstan's.

Kyrgyzstan's striving to join the CES, to which countries with a higher standard of living belong (6-8-fold higher than the Kyrgyz standard), is naturally associated with certain positive expectations for the future. It is presumed that the country's accession to this integration union will allow it to modernize its economy, achieve high production volume growth rates, and, in the future, reach a qualitatively new level of development. However, at present, creating prerequisites for accelerated development requires carrying out a whole set of measures aimed at preparing the Kyrgyz economy for the CU conditions.

The Road Map draft drawn up by the country's government along with the Eurasian Economic Commission envisages a set of measures that includes Kyrgyzstan signing the agreements within the CU, adopting corresponding regulatory documents, strengthening the infrastructure of border crossings (including setting up and providing technical refurbishing of 15 primary check points), setting up the external border, modernizing the material and technical base of laboratories, raising the potential of customs, veterinary and other services, training specialists of ministries and departments, etc. Implementing these measures requires issuing large amounts of funding in several areas.

Joining the CU also envisages an entire set of measures for streamlining agriculture and processing its produce. This sector requires serious reforms that will help to resolve problems related to developing animal husbandry and crop cultivation, enlarging farms, ensuring the well-run organization of veterinary services, improving the epizootic situation, ensuring sustainable pastoral farming, monitoring the technical state of irrigation systems, and so on.

Another important measure is modernizing the material and technical base of laboratories that issue certificates corresponding to international specifications.

It will be impossible to carry out the demands set forth in the relevant agreements or raise the competitiveness of Kyrgyz foodstuffs in the markets of the CU member countries without resolving the above-mentioned issues.

Funding measures aimed at preparing the country for joining the CU is a separate problem. It can be solved by obtaining grant support from the CU countries, including Russia.

It is presumed that it will be possible to negotiate waiver of payment of the Common Customs Tariff during the transition period, as well as carry out other common regulation measures in certain sectors and sensitive types of goods. Their list, which will include the fabric and accessories necessary for manufacturing garments, medication, certain types of equipment and devices, mineral fertilizers, chemicals, plastics, and other types of products, must be discussed by the government.

There are also plans to discuss versions of stage-by-stage transition with long terms for certain types of sensitive products (or sub-branches). There is also the possibility of instituting a transition period for national legislation regulations on technical regulation issues and receiving funding to

support economic development (in particular for ensuring the development of infrastructure and several production branches).

Joining the CES also requires fulfilling several other conditions necessary for creating a common market of goods and services, as well as carrying out a coordinated (in some cases common) policy.

For example, if Kyrgyzstan signs the Agreement on a Coordinated Macroeconomic Policy adopted on 9 December, 2010, it will have to meet several quantitative parameters, including:

- ensuring a state budget deficit of no more than 3% of GDP;
- maintaining the size of the state debt at a level no higher than 50% of GDP;
- ensuring a low level of inflation (it should be no higher than 5 percent of the average inflation level of the other CES member states with the lowest inflation rate).

The actual state of affairs shows that when it joins the CES, Kyrgyzstan could have problems associated with meeting at least two of the three above parameters.

As Table 1 shows, the state budget deficit and state debt indicators with respect to Kyrgyzstan's GDP are higher than the regulation envisaged by the agreement.

Table 1

**Macroeconomic Indices Regulated within
the CES by the Agreement on Carrying Out
a Coordinated Macroeconomic Policy
in Kyrgyzstan**

	2011	2012
Inflation (compared to December of the previous year)	105.7	107.5
Budget deficit, % of GDP	4.7	7.1
State debt, % of GDP	50.1	51.5

An analysis of the state of Kyrgyzstan's economy makes it possible to conclude that it may take several years to improve the situation in the two indicated parameters (state budget deficit and size of state debt).

The prospects for the country joining the CES and later the Eurasian Economic Union being created will greatly depend on how successful Kyrgyzstan's accession to the CU is and at what level the positive possibilities for developing priority sectors will be carried out.

Assessment of the Consequences of Joining the CU and CES

When assessing the alleged consequences of the country's accession to the CU and CES, the following pluses and minuses can be singled out for Kyrgyzstan at each stage of integration.

For example, access to a much larger market can be classified as a positive effect of Kyrgyzstan's accession to the CU, while economy of scale will give a boost to investments and the incorporation of new technology. Increased competition will also mean an increase in efficiency and decrease in spending.

The risks of accession to the CU include a slump in low-competitive sectors, bankruptcy of certain small and medium businesses, an increase in unemployment, and an increase in inflation.

The positive aspects of joining the CES include modernization of the country's economy, the arrival of large companies in the country, the creation of their branches, and the formation of an agroindustrial cluster and new industries.

The negative consequences of joining the CES might take the form of an increase in population migration, widening of the gap in development between the center and the backward regions, and bankruptcy and absorption in the financial sector.

When assessing the influence of the integration processes within the CU on the change in the structure of branches and sub-branches, it should be kept in mind that certain sectors and production branches might undergo rapid development, while others will not be able to withstand the competition. Correspondingly, the level of employment in certain industries will change.

An analysis of the comparative advantages in terms of commodity groups shows that dairy products and other animal foodstuffs, fresh and dried fruit and vegetables (as well as their processed products), jewelry and stone-cutting items, women's clothes, and so on could have high comparative advantages in export (both to the CU countries and to third countries). Despite the significant change in commercial conditions, products exported to the CU countries will only improve their positions. At the same time, products with insignificant comparative advantages could be successful if they receive government support, marketing efforts are made to promote them in the markets of the CU countries, and so on.

When comparing the competitive advantages of the companies of Kyrgyzstan and the CU countries, the significant differences in their economic policy in support of national manufacturers should be kept in mind. An analysis of the development programs of the industrial and agricultural industries in the CU countries shows the significant level of state support. For example, the government programs of Russia, Kazakhstan and Belarus envisage actively subsidizing interest rates for loans, providing subsidies and grants to exporters of industrial products, issuing preferential loans, insuring trade operations, and so on.

In particular, in 2013, the Russian government envisaged issuing up to \$14 billion in financial support of export. A large part of this amount was meant for insuring export loans and state guarantees during export.⁷ The amount of state support of agriculture to GDP in agriculture in Belarus is equal to 18%, in Russia to 6%, and in Kazakhstan to 4%.⁸

Due to the large budget deficit in Kyrgyzstan, the level of state support of national manufacturers is at a very low level, which leads to large untapped small and medium business development reserves.

Carrying out a joint policy coordinated with the CU countries for developing priority industrial and agricultural sectors is one of the most important factors for promoting an increase in investments and new technology. This will help to draw large companies to Kyrgyzstan, create their branches in the country, resolve agricultural modernization tasks, and form an agroindustrial cluster.

When assessing the consequences of the country's accession to the CU and CES, it is vital that the gap in development level between Kyrgyzstan and the other CU member states be closed in the mid and long term. This issue can be put in different terms: "Can Kyrgyzstan's economic growth rates be expected to enjoy positive dynamics in the future and how will they correlate with similar indices in the three current CU member countries?"

⁷ See: *RBC Daily*, 28 August, 2013, available at [<http://www.rbcdaily.ru/economy/562949988684705>], 29 January, 2014.

⁸ See: Website of the Ministry of Agriculture of the Republic of Kazakhstan, available at [<http://mgov.kz/tezisy-doklada-na-temu-razvitiya-pererabaty-vayushhej-promy-shlennosti-v-respublike-kazahstan/>], 29 January, 2014.

Regional integration could not only promote the development of all the branches of the economy of the countries belonging to the CU, but also ensure an upsurge in economic growth rates and improvement in the population's standard of living.

According to the estimates of academics of the Russian Academy of Sciences, the macroeconomic effect from creating the CU and CES within the EurAsEC will amount to no less than 5% of an increase in GDP calculated for five years and around 15% for ten years.

However, the benefits might be unequally distributed among the members of the integration union, which is explained by the differences in the countries' starting conditions. If political measures aimed at reducing the inequalities and imbalances are not carried out, the more developed countries (and regions in them) could obtain greater benefits from the voluminous CU market than the less developed states.⁹

In exactly the same way, large transnational corporations (for example, Russian) could obtain greater benefits from the CU market, since they have more opportunities for organizing their cooperative ties and production and supply networks than small and medium businesses, which, as we know, predominate in Kyrgyzstan.

In order to facilitate closing the gap between the level of Kyrgyzstan's development and that of the CU countries, a coordinated policy must be carried out aimed at developing the economic branches of all the members of the integration union. Otherwise, Kyrgyzstan's incorporation into the integration process will not yield the desirable results.

The difference between Kyrgyzstan's development and that of the other CU members could also create an imbalance in the countries' financial and institutional opportunities to promote production and export.

World experience should be used to ensure more balanced development of Kyrgyzstan within the CU and CES. Several integration unions use mechanisms adopted under interstate agreements; they envisage measures for supporting the development and diversification of the economy of the backward member states.

In the EU, this problem is resolved by carrying out a coordinating policy of support of certain industries, as well as by creating special structural funds. For example, there are two funds (the Structural Fund and the Cohesion Fund); their resources are used to support development projects in the less developed regions of the EU. Countries with a high level of income per capita issue funds for this purpose.

It is a well-known fact that successful interaction within an integration group can be achieved if all of its members are at more or less the same level of development.

When talking about minimizing the negative consequences of Kyrgyzstan joining the CU and its future successful integration, it should be emphasized that the country needs help, including financial.

In our opinion, the CU should follow the example of the EU and look at the possibility of creating a mechanism for supporting countries with lower levels of development. This applies both to Kyrgyzstan and future CU members.

Summing up the above, it can be said that Kyrgyzstan's accession to the CU and CES will help to expand the possibilities for developing and modernizing its economy, as well as raise the population's prosperity and standard of living. However, in order to achieve success, a corresponding state policy must be carried out.

There is a certain amount of hope that the gap in development between Kyrgyzstan and the CU member countries will be narrowed. Whether or not this hope is justified depends on many factors,

⁹ See: *Trade and Development Report, 2007*, UNCTAD, 2007.

including financial resources, creating a favorable investment climate (foreign investors must be interested in investing in Kyrgyzstan for this to happen), the willingness of large and medium corporations of the CU countries to transfer some of their intermediate business to Kyrgyzstan (for example, the manufacture of spare parts), and the ability of the country's state institutions to carry out a well-considered and balanced policy.

On 31 May, 2013, the Higher Eurasian Economic Council adopted a decision on the main areas for coordinating the national industrial policies of the CU countries. It envisages several measures for intensifying cooperation among manufacturing companies, creating technological platforms, and forming industrial clusters in priority sectors.

The Kyrgyz government should already be initiating joint consultations with corresponding ministries and departments of the CU member countries on adopting coordinated development strategies for industry and other branches, keeping in mind the advantages of regional labor division, the creation of production networks, clusters, and so on. The pertinence of such consultations is dictated by the need to carry out joint projects with companies of the CU countries in the future.

Conclusion

The analysis carried out of Kyrgyzstan's accession to the CU and CES has made it possible to draw the following conclusions.

The positive effects of accession include access to a larger market, while economy of scale will give a boost to investments and the incorporation of new technology. Increasing competition will promote greater efficiency and lower spending, modernization of the country's economy, the arrival of large companies and the creation of their branches, as well as the emergence of new industries.

The risks that might arise during Kyrgyzstan's accession to the CU and CES include a slump in low-competitive sectors, bankruptcy of certain small and medium businesses, an increase in unemployment, a higher inflation rate, more migration, a widening of the gap between the development of the center and the backward regions, aggravation of the situation in the financial sphere, and so on.

The difference between Kyrgyzstan's development and that of the other CU and CES members could also become aggravated due to the imbalance in the countries' financial and institutional opportunities to promote production and export.

From this it follows that achieving positive results will largely depend on the CU countries pursuing a coordinated policy for developing the priority branches of industry and agriculture. This will draw large companies to Kyrgyzstan, encourage them to establish their branches in the country, help to modernize agriculture, and promote the formation an agroindustrial cluster.

It would also be helpful for the CU and CES to create a mechanism for supporting countries with a lower development level, whereby the experience of the EU could be useful in achieving this.