

## THE INVESTMENT SECTOR AND TNC ACTIVITIES IN THE KYRGYZ REPUBLIC

Zalkar KAMALOV

*Ph.D. (Econ.),  
Center for Socioeconomic Reforms,  
KR Ministry of Economy and Finance  
(Bishkek, Kyrgyzstan)*

In recent years, the activities of transnational corporations (TNCs) have been a key element in the development of international economic relations. On the one hand, these companies are a “product” of the intensively developing world economy, since their operation provides the basis for economic growth and technological progress in any country. On the

other hand, TNCs are a powerful mechanism for influencing the economy of states and the world as a whole. Kyrgyzstan is no exception in this respect: the slightest change in the economic situation in the country tends to have a strong influence on the activities of the TNCs, which, for their part, take these ups and downs “very hard.”

### How Did It All Begin?

After gaining independence, Kyrgyzstan took the path of transition from the centralized planned economy to a market-oriented economy. For objective reasons the republic met with a number of economic difficulties: rupture of trade ties, sharp drop in production, crisis of the management system, etc. These negative processes made it necessary for the government to develop new approaches in the field of economic reforms.

The severest problem was the financial one: the huge deficit of the state budget and the lack of long-term credit resources and funds at the disposal of enterprises pointed to the objective need for attracting foreign investment. Everyone understood that the attraction of foreign direct investment (FDI) and advanced technologies would enable the country to develop its industrial base, gain international experience, enter the world market with its own products, create additional jobs, and strengthen its national currency.

Nevertheless, Kyrgyzstan’s integration into the world economic system has turned out to be much more complicated than expected. In the beginning, it was not all plain sailing for Kyrgyzstan in its efforts to attract foreign capital, and the republic has had to travel a difficult road before achieving the current indicators.

For many decades, the Kyrgyz economy developed as a component part of the single economic complex of the former Soviet Union, under tight centralized control. After the declaration of independence on 31 August, 1991, the republic entered a new period: it got an opportunity to

formulate its own economic policy, but the real possibilities for the pursuit of such a policy were limited by Kyrgyzstan's close integration ties with the economy of other CIS countries, especially the Russian Federation. The crisis engulfing all aspects of economic and social life in the republic gathered momentum. Industrial production fell by 26.4% in 1992, 24.2% in 1993 and 24.5% in 1994.

As early as 1993 the authorities approved a liberal code of rules for foreign investment and a law on mining concessions, established "preferential" customs rules and took many other steps, but this did not yield any results. For example, Kyrgyzstan never actually managed to fully expand and develop the manufacture of audio and video equipment jointly with the Gold Star corporation, started in the city of Tokmok in 1993. And this is quite understandable: after all, the class of local businessmen was just beginning to take shape, most joint ventures with private foreign capital existed only on paper, and little progress had been made in the development of free economic zones, industrial or technology parks. This made it necessary to devise and implement a special economic policy.

Although the Kyrgyz government did a great deal to create a favorable climate for local and foreign investments, the former kept shrinking and the latter did not really "get going" until 1994.

The investment process was in effect blocked by inflation. Bank interest rates were too high and inaccessible to an overwhelming majority of enterprises. But even these interest rates fell short of the rate of inflation and were thus negative. Banks were not interested in granting long-term credits and virtually did not do so.

The economic situation in industry in the process of transition to market relations led to a decline in production and to financial difficulties at many enterprises, which meant that less attention was paid to quality in the production and sale of goods. Many managers did not realize that in market conditions the survival of commodity producers is directly dependent on the quality of their products, and this led to a reduction in the number or even to a total liquidation of quality control departments, which contributed to the sharp decline in the competitiveness of domestic products compared to those of foreign companies. In that period, the activity of many enterprises and firms was directed (in most cases) toward the importation of goods, and TNCs launched a sales expansion in the country (whereas their investment activities got underway later). This had a negative effect on the accumulation of foreign exchange in the republic. It should be noted that many domestic enterprises were at a standstill because of fraudulent bankruptcies aimed at tax evasion and concealment of their ability to pay.

Even at that time it became clear that direct investments had to be used to retool and renovate enterprises (to change their product mix) with the use of many local raw materials. These investments had to go into production and the development of enterprises capable of quickly producing good and necessary products for the domestic and foreign markets. This brought into sharper focus the purpose of applying advanced technologies: to produce low-cost, high-quality and competitive products for profitable sale in the domestic and foreign markets.

Starting from 1994, the situation changed dramatically. Liberalization of foreign trade made it possible to intensify the republic's economic relations with FSU and other countries. An open economy helped to saturate the market with goods, to avoid shortages and stabilize the inflation level. All of this created a competitive environment for domestic enterprises, inducing them to upgrade production, enhance product quality, reduce production costs and conduct market research, i.e. to learn to live in market conditions as soon as possible. There was also an increase in the number of joint ventures and foreign enterprises in the republic (Table 1).

On 1 January, 1999, the country had 4,004 registered enterprises with foreign investment, including 2,068 operating enterprises, which means that about 51.6% of all registered joint ventures

Table 1<sup>1</sup>

**Registered and Operating Enterprises  
with Foreign Investment**

	Registered	Operating
1993	125	43
1994	627	128
1995	1,288	363
1996	2,191	908
1997	3,272	1,396
1998	4,004	2,068
1999	4,130	1,470
2000	5,277	2,026

and foreign enterprises were in operation. In 1998, the authorized capital of enterprises with foreign investment totaled 2,121.2 million soms (KGS), with Kyrgyzstan's share amounting to 25.4%. Enterprises with foreign investment in 1998 made up 13% of all commercial entities (30.5 thousand registered entities). Out of the total number of operating enterprises with foreign investment (2,045 enterprises), 845, or 41.3%, were set up by firms from FSU countries, and 58.9%, by non-FSU firms.

Most foreign investments went into industry. However, the share of foreign companies and joint ventures in industry did not exceed 25% of all enterprises with foreign capital, about 46% of which were usually very small and were concentrated in trade and in the restaurant and hotel business. Even in 2000 foreign investments were the main source of capital formation, making up 73% of the total. One can say that the economy began to stabilize in 1996. The increase in industrial production (by 10.8% compared to 1995) was due to growth in the energy sector and the food industry, although in some industries (especially engineering) production continued to decline.

The creation of joint ventures and foreign enterprises in trade and public catering (52.2% of their total number) is explained by their short payback periods, and also by the lack of demand for long-term investment and the absence of a policy designed to promote production by granting benefits and preferences to investors.

The largest volume of industrial products and services was produced by gigantic joint ventures in the republic. In 1998, industrial enterprises with foreign investment in the Issyk Kul Region produced KGS 4,175.7 million worth of goods, or 93.3% of the region's total industrial output (KGS 4,474.8 million), and the largest contribution was made by the Kyrgyz-Canadian Kumtor Gold Company, a subsidiary of Canada's Cameco Corporation (78.2% of industrial output produced by the region's enterprises with foreign investment). Overall, the output of enterprises exploiting the Kumtor deposit in 1998 amounted to KGS 8,112.5 million (38.5% of industrial production in the republic).

<sup>1</sup> Here and below we cite data of the National Statistics Committee of the Kyrgyz Republic (from 1993 to 2004).

In the Chu Region in 1998, JV Bakai turned out KGS 738.4 million worth of products, or 58.5% of industrial output produced by enterprises with foreign investment in the region. In the Jalal-Abad Region, JV Kyrgyz Petroleum Company produced KGS 280 million worth of oil products, which amounted to 60.9% of industrial output produced by enterprises with foreign investment in the region.

In the country's capital, production is carried on by such international companies or joint ventures as Coca Cola (nonalcoholic beverages), Bakai (sugar), Kitlap (food industry), Chui-Glass (glass containers), Bakai-Suu (mineral water), Eridan-Sut (dairy products), Simex (furniture) and Ice Queen (ice cream).

In 1998, foreign companies and joint ventures produced goods and services for the amount of KGS 6,935.7 million, or about 20% of the republic's GDP. In the event, virtually 100% of such products as diesel fuel, computers (assembly), glass containers, tea and salt were produced by foreign enterprises. Moreover, 59.8% of sugar, 83.9% of gasoline and 55.8% of knitwear were also produced by such entities.

As regards the foreign economic activities of enterprises with foreign investment in 1998, imports totaled \$316.5 million, and exports, \$96.9 million.

To sum up the results of that period, let us note that the scale of foreign investment in the Kyrgyz Republic was relatively small (cumulative FDI from 1993 to 1998 amounted to \$80.4 per capita), not counting the Kumtor mining project, which accounted for over 30% of total industrial output in the country.

## What is Happening Today?

From 2001, the investment situation in Kyrgyzstan, greatly enfeebled by the consequences of the Asian and Russian financial crises, gradually began to stabilize. In 2001-2004, the inflow of foreign direct investment totaled KGS 528.4 million, with an average annual increase of 26.7% (Table 2).

Table 2

Structure of FDI Inflows  
in 2001-2004 (million U.S. dollars)

	2001	2002	2003	2004
<b>Total FDI</b>	<b>175.6</b>	<b>147.0</b>	<b>115.7</b>	<b>90.1</b>
<i>of which:</i>				
<b>Share capital</b>	<b>33.2</b>	<b>23.4</b>	<b>26.2</b>	<b>23.1</b>
<b>Financial leasing</b>	<b>0.7</b>	<b>3.7</b>	<b>—</b>	<b>—</b>
<b>Retained earnings</b>	<b>48.0</b>	<b>21.8</b>	<b>9.0</b>	<b>12.8</b>
<b>Other capital</b>	<b>93.7</b>	<b>98.1</b>	<b>80.5</b>	<b>54.1</b>

Investments mostly flowed into the manufacturing industry, and also into the trade and financial sectors. That was when the investment activities of the TNCs began to gather momentum.

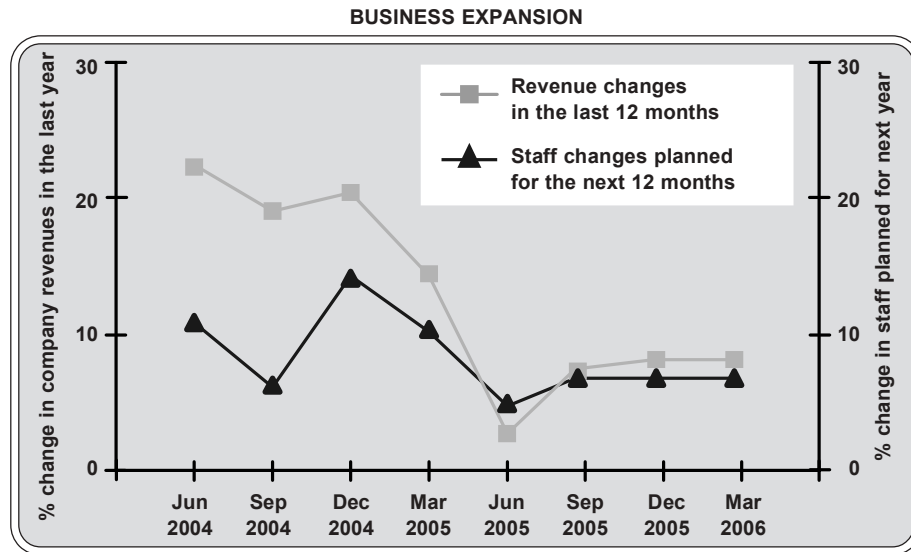
A quarterly survey carried out by the International Business Council (IBC) of Kyrgyzstan (an association of the republic's business entities, including TNCs, which accounts for over \$1 billion of investment in the Kyrgyz economy and over 10,000 employees) shows that the earnings of companies operating in the country have increased by an average of 8% over the past year. This is an improvement compared to June 2005, when this indicator averaged 3%, but a significant decline compared to the 20% annual increase in 2004. The figures for personnel recruitment plans have not changed since December 2005: a 7% increase in staff projected for the following year.<sup>2</sup>

The respondents who took part in the survey had invested about \$140 million in Kyrgyzstan in 2005 and were planning to invest another \$200 million in 2006, which amounts to a projected 43% increase in investment. The mining sector accounts for about 70% of projected investment, given that the mining industry today is at a record level throughout the world due to high gold prices. Investments in other sectors of the Kyrgyz economy are in a state of stagnation.

As things stand today, enterprises with active participation of foreign TNCs are not very numerous, but among them there are such large ones as the Kumtor Operating Company, Coca Cola Bishkek Bottlers, Reemtsma Kyrgyzstan, Interglass, Alliance Oil Company, Bitel, MegaCom and others. I would like to say a few words about these companies.

In gold mining, the largest project and one of the first enterprises in the territory of Kyrgyzstan set up with the participation of a large foreign corporation (Cameco) is JV Kumtor Operating Company. It exploits one of the world's largest gold deposits at Kumtor with reserves of about 615 tons. Overall, the republic has more than 1,000 gold deposits explored in varying degree.

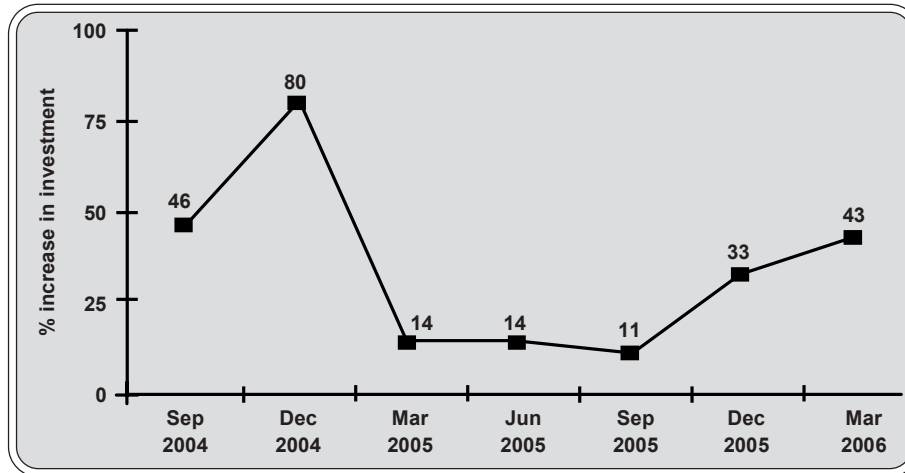
Diagram 1



<sup>2</sup> See IBC Report for the 1st Quarter of 2006.

Diagram 2

## INVESTMENT PLANS



Another company, Coca Cola Bishkek Bottlers, was set up on 12 July, 1995. It is a business association in the form of a closed joint stock company. The first trial run of the line for the production of Coca Cola took place on 8 May, 1996. Its capacity is 6,000 liters or 24,000 bottles per hour. The plant makes soft drinks such as Coca Cola, Fanta and Sprite (in glass and plastic bottles). The main object of its activity is the production, bottling and sale of beverages. The company buys, sells wholesale and retail, imports, exports and transports all kinds of goods, equipment, raw materials, finished and semi-finished products, and other materials required for its activities. The plant is fitted out with the latest equipment and automatic systems installed by American, German and Turkish specialists with the participation of Kyrgyz engineers.

The Reemtsma Kyrgyzstan company (a part of the Reemtsma Group) is the republic's largest enterprise producing tobacco goods. About 60% of the tobacco used in their production is grown in the south of the country, which is proof of one of the main lines of the company's activity: support of domestic business. The plant's design capacity is 12 billion cigarettes per year, but so far the actual figure is 3.5 billion. Although the company is still in the initial phase of its development, it is already exporting its brand to Afghanistan, Kazakhstan, Uzbekistan and Tajikistan. Cigarettes produced by Reemtsma Kyrgyzstan make up about 60% of the republic's total tobacco market. The plant employs 500 Kyrgyz citizens, but if we look at the whole chain—tobacco growing, sweating, processing and sale—estimates will show that the enterprise employs from 50,000 to 200,000 people.

The former Ainek plant is now called Interglass, and its owner is Germany's Steinert Industries GmbH & Co KG. This plant is located in the industrial zone of the city of Tokmok (Kyrgyzstan) and has 15 production buildings. Its technical capabilities today are such that it can provide the market with a wide range of glasses: window, plate, furniture, mirror, bulletproof, automotive, decorative and tinted. At present, it has 1,500 highly professional workers and employees. The main task of the Interglass plant today is to supply sheet glass to Central Asian countries and Siberian cities, and also to launch out into markets in other Asian countries.

The companies Bitel, MegaCom, Fonex and Katel are part of a single chain in the development of cellular communications in Kyrgyzstan. Their total turnover is over \$100 million; each of them represents such brands as MegaFon, MTS, Alliance Group, and others.

Special note should be taken of prominent companies in retail and wholesale trade (Beta, known under the brand name of Ramstore, JV Forester with its Narodny retail trade network) and in the banking sector (Demir International Bank, Halyk Bank and others).

Consequently, Kyrgyzstan is gradually going over to the investment stage of development with active participation of foreign capital, especially TNC capital.

## What Lies Ahead?

An analysis of the current situation in the field of foreign investments shows that since 1997 there has been a steady negative trend toward a decline in their level. Presumably, the abolition of a number of investment initiatives of a tax and legal nature has significantly worsened the investment climate in the republic with a resultant decline in foreign investor interest. By comparison, our neighbors have done a great deal to improve the investment climate in their countries, and their efforts have led to an increase in investment. Of course, a certain role was played by the Kyrgyz revolution of 24 March, and also by the global financial crisis that broke out in the Asian region and entailed significant financial changes in the world (including Russia, Kyrgyzstan's main economic partner). These events have had a considerable effect on economic activity in the country, but nevertheless the main reasons for the smaller inflows of investment lie elsewhere. The "sources" of the unfavorable investment climate in the country are as follows:

- insignificant domestic economic resources;
- limited agricultural area;
- small domestic market;
- unstable legislative framework;
- vast number of rules and regulations often conflicting with basic laws;
- poorly developed communication infrastructure;
- the population's low ability to pay;
- unstable policy of neighboring states in the field of transportation and tariffs;
- high transportation costs in the export of goods;
- the existing licensing system, the need to obtain numerous authorization documents, bureaucracy and corruption;
- insufficiently developed financial sector.

All these factors markedly reduce Kyrgyzstan's attractiveness in the eyes of potential investors.

Yet another negative factor is the uneven distribution of investment across the regions, which has a direct effect on living standards in different regions. This leads to further stagnation in some of our regions which seem unpromising in the eyes of investors, spurring migration and creating social tensions. Accordingly, the state's current policy and its main priority should be to create a favorable

and profitable investment environment for investors by means of appropriate initiatives and incentives, so evening out the development of our regions.

Investors who want to operate in our market are not philanthropists: first and foremost they are businessmen and their main concern is to “recover” their investment and earn a profit. That is why in making an investment decision they start with a thorough assessment of all the costs and risks under the existing investment regime, and only then, given positive results, we can expect their appearance in our markets. So, in order to “overcome” the negative factors the authorities should take proactive steps to foster an investor-friendly environment, offer significant incentives to investors, and create an effective administration system for attracting direct investment.

Today the main factor behind an investor’s decision on whether to invest his money in a country or not is the tax regime. Foreign respondents say that inadequate and constantly changing tax legislation is the most serious problem. The course of implementation of investment projects indicates that investors would naturally like to have favorable conditions for investment, but what is more important for them is a reasonable, transparent and predictable tax system with optimal rates, which would maximize the state’s tax collections. Thus, whereas the 1997 KR Law on Foreign Investments provided for a tax holiday (in the form of an exemption from profits tax in the first few years), the latest legislation does not contain such provisions. Three developing countries (Laos, Indonesia and Kyrgyzstan) do not grant a tax holiday, and the latter is the only developing country in the world that does not compensate for the absence of such a holiday by a low rate of profits tax. One should note that our neighbors and at the same time our direct competitors for investment (China, Uzbekistan and Kazakhstan) actively offer such tax initiatives and simplified customs rules to investors.

It is particularly important to set precise priorities for investment in sophisticated products and services: design and manufacture of diverse machinery and equipment, processing lines, complex technology and production facilities, production efficiency management, etc., where even minor mistakes lead to big losses. For such cases the development of a multilevel system of priorities geared toward a single goal is a necessary condition for ensuring the quality and competitiveness of goods and services.

The advocates of the republic’s accession to the WTO assumed that Kyrgyz enterprises would be able to fit into global processing chains, find a place in the international division of labor and give a new impetus to rapid development of the investment sector. But now that Kyrgyzstan has been a WTO member for some time, there are no weighty statistical data to show that Kyrgyz enterprises are beginning to fit into transnational processing chains. It is also too early to talk about the adequate efficiency of free economic zones and joint ventures. Traditional supplies of such raw materials as antimony, tin or rare earth metals remain uncompetitive (in view of high production costs in the republic) in relation, say, to the Chinese market, where these products are offered at lower prices.

It should be noted that modern TNCs are powerful enough to pursue their interests in the regions they need and at the enterprises of any country even without the WTO. Kyrgyz enterprises whose technological level meets TNC requirements were in any case included within their framework even before WTO accession. It is easy to see that in these conditions Kyrgyzstan’s WTO membership or “non-membership” cannot seriously alter the requirements of any given TNC.

Nevertheless, the political and economic importance of transnational corporations is so great that in the foreseeable future they will remain one of the key factors exerting a growing influence both on the domestic and on the foreign sphere of Kyrgyzstan’s economic relations. Globalization dictates its conditions, and the republic’s active participation in this process is more imperative than even before. This suggests the obvious conclusion that conversion of our leading do-



mestic companies into transnational corporations should become a deliberate goal of state foreign policy. The creation of Kyrgyz TNCs within the framework of the CIS and other countries is not only an economically, but also a politically important task of Kyrgyzstan's industrial policy, especially since the first steps in this direction have already been taken. This is well illustrated by the activities of the Dastan Joint Stock Co in the Russian market and of the Shoro Company in the Chinese market.

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