Commentary on the article: Assessing the Economic Effect of Kyrgyzstan’s Accession to the Customs Union

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In his article, the author analyses the foreign trade ties of Kyrgyzstan (based on the research conducted by the Russian Academy of Sciences’ (RAS) National Development Institute for the EDB Centre for Integration Studies) which have formed due to the country’s membership of the World Trade Organisation, and the prospects for their advancement if Kyrgyzstan joins the Customs Union of Belarus, Kazakhstan and Russia. The author believes that Kyrgyzstan’s economic problems, such as underdeveloped competition and low economic efficiency, prevent the country from using the full potential of free trade in the framework of the WTO. The author believes that Kyrgyzstan’s accession to the CU, given the existing economic ties between its member states, would have a positive economic effect on Kyrgyzstan and the CU member states. The article provides a detailed analysis of the technical compatibility between the obligations Kyrgyzstan has undertaken in the framework of the WTO and its new obligations if it joins the CU, and identifies the issues that would require special attention in the course of negotiations between Kyrgyzstan and the WTO. In the author’s opinion, the effect of the CU on Kyrgyzstan’s economy will be bivalent, especially in the short term, as it could cause a rise in prices through increased customs duties, tougher customs
control and a reduction in Chinese imports and, possibly, employment in this segment. At the same time, it should have a positive effect on budget revenues. In the long term, membership in the CU could allow Kyrgyzstan to refocus its economy on production with the help of new investments, market expansion and other improved conditions.

In their 2011 study, Economic Effects of Kyrgyzstan’s Accession to the Customs Union of Belarus, Kazakhstan and Russia for the Kyrgyz National Institute of Strategic Studies, Faruk Ulgen and Haluk Levent came to the conclusion that Kyrgyzstan joining the CU would have a positive effect. The study analyses the effects of trade creation and trade diversion in Kyrgyzstan’s trade records with China and other countries from 2008 to 2010. A trade diversion will take place if the CU countries promote trade inside the union, even if their production is less efficient compared to proposals by other countries. In this instance, the volumes of trade can decrease because of protective measures against the rest of the world and this would affect the welfare of the member countries and the global trade as a whole. However, if external trade barriers are not too high and the CU increases trade through the expansion of markets and larger investments, this can lead to increased revenues, which in their turn will improve the demand for imports from non-member countries.

The authors have also studied the interrelation between trade creation as a result of joining the CU and the growth in employment. An estimate of dynamic panel data used in this analysis has shown that, in a 95% confidence interval, a 1% increase in production will cause a 0.295% growth in employment in Kyrgyzstan’s economy. Despite the fact that the change in the CU tariffs for third countries such as China can reduce multilateral trade, Ulgen and Levent believe that the reduction in trade will not be significant and can result in increased domestic production. This can happen if a portion of the reduction in trade is compensated by broader trade with the CU and increased domestic production. The authors believe that production could grow by 8.8% and employment by about 2.5% after Kyrgyzstan joins the CU, as a result of net trade creation.

The authors have also calculated the trade specialisation index (TSI) and the bilateral revealed comparative advantage index (BRCA) to find out how the Kyrgyz economy relates to its main trade partners: China, Kazakhstan and Russia. These calculations have shown that in 2008-2010, Kyrgyzstan traded significantly more product categories with Russia and Kazakhstan than with China, which is why its trade with the former two countries has a comparative advantage².

² In the period under consideration Kyrgyzstan had two product categories in which it traded with China, twelve with Kazakhstan and three with Russia, with a TSI of 1. In the same period Kyrgyzstan had nine, 30 and 22 product categories, with a TSI between 0 and 1, with China, Kazakhstan and Russia respectively. In addition, in the same period Kyrgyzstan had 26 product categories above 84 with a BRCA of more than 1 in its trade with China, 49 with Kazakhstan, and 33 with Russia.
Even in Soviet times, Kyrgyzstan was highly dependent on imports and subsidies from the central budget. Over twenty years of sovereignty, it has not succeeded a lot in improving structural imbalances, but the accession to the WTO has given impetus to the development of an economy orientated on trade and reexport. Today the Kyrgyz economy, with its poor diversification and no scale effect, can hardly surpass the threshold of $5 million, even at the generalised, two-digit level of trade classification; hence its strong dependence on partnering countries with a diversified structure of exports. In addition, high interest rates and economic and political risks explain the low level of investments in production and agriculture. Accordingly, the most developed sectors are the services and retailing sectors as they ensure quick profit, do not require large investments, and are flexible with respect to changes in the external environment.

The studies have shown that Kyrgyzstan’s accession to the CU should entail a number of positive changes. These will include the recovery of trade ties, easier access to main markets, possible increases in investment flows to the country, and the advancement of production and agriculture. The authors agree that hydropower, textiles and agriculture will be the priority sectors, in particular because Kyrgyzstan’s supply to global markets in recent years was primarily composed of textile and agricultural products.

The development of industrial production and agriculture is impeded by the economy’s poor ability to compete with Chinese imports. Because of the WTO membership (and beneficial tax treatment and customs duties that depend not on the customs cost of goods but on their weight) Kyrgyzstan has spotted a niche of a reexporting economy in the CIS. In 2010, the reexport of Chinese goods exceeded 13% of the country’s Gross Domestic Product (GDP). Large platforms of international trade have formed in the country, such as Dordoy and Kara-Suu where, according to the World Bank (2009), the aggregate annual sales approximate $3.5 billion and employment exceeds 70,000 people. Since 2010 (according to the administration of the Dordoy Bazaar), wholesale volumes have gone down but retailing has seemed to grow (in small batches of approximately up to 50 kg per person after the creation of the CU in 2010).

The administration of the Dordoy Bazaar and representatives of the association of bazaars are obviously concerned about how Kyrgyzstan’s possible accession to the CU will influence employment in the market. However, on the whole they understand that the creation of the CU and the Single Economic Space will result in a reduction in Kyrgyzstan’s reexporting activities irrespective of whether it joins the CU or not. In the former instance, access to the main directions of reexport will be complicated and in the latter one, the transition of goods through Kyrgyzstan will become meaningless. In addition, the continuous appreciation of the Chinese yuan against the US dollar and the currencies of the region makes Chinese goods increasingly expensive. This makes it clear that
the desire to preserve the existing reexporting scheme, which has become a source of income for many people in recent years, should not be an argument in refusing to join the CU. Therefore, representatives of the markets have agreed to gradually reorientate toward production with the active support from the Kyrgyz Government, which needs to smoothly reform the markets and preserve, at least for some time, beneficial conditions for importing goods such as textiles.

Kyrgyzstan’s accession to the CU will definitely change the existing economic context and this will require the adoption of correct key decisions to avoid weakening the economic situation further. The undertaken studies are the first step in this area, which requires additional research with respect to Kyrgyzstan joining the SES, including issues such as labour migration and the quality and focus of Kyrgyzstan’s educational system (since the development of new sectors requires qualified specialists). Another important issue that needs to be thoroughly studied is Kyrgyzstan’s shadow economy – primarily in the agricultural, trade and textile sectors. While the shadow economy accounts for 20% (according to official data), international organisations and independent experts suppose it to exceed 60%. In this situation we lack information on the real size of Kyrgyzstan’s economy, which complicates economic analysis and decision making. For this reason it is deemed advisable to develop and introduce a methodology for determining the size of the shadow economy before calculating the economic effects of joining the CU.

The growing number of preferential trade agreements in the world suggests that, in spite of the platform offered by the WTO, regional trade agreements seem to take prevalence over multilateral relationships in the framework of the WTO. This is possibly caused by the fact that the CU offers wider opportunities for integration, which is specifically important to countries with close historical, political and economic ties.