USAID KYRGYZ REPUBLIC ECONOMIC GROWTH ASSESSMENT

ASIA AND THE MIDDLE EAST ECONOMIC GROWTH BEST PRACTICES PROJECT (AMEG)

May 2013

This publication was produced for review by the United States Agency for International Development. It was prepared AMEG, managed by Chemonics International Inc., with technical contributions from subcontractors Banyan Global and the William Davidson Institute.

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Task Order No. AID-OAA-12-00008

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ACRONYMS

ADB	Asian Development Bank
ADR	alternative dispute resolution
AMEG	Asia and Middle East Economic Growth Best Practices Program
ASEAN	Association of Southeast Asian Nations
BEE	business enabling environment
CAD/CAM	computer-aided design/computer-aided manufacture
CAREC	Central Asian Republics Economic Cooperation Project (ADB)
CMT	cut-make-trim (garment manufacture starting with fabric cutting)
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	foreign direct investment
GIZ	Gesellschaft für Internationale Zusammenarbeit (German Development Assistance)
HAACP	Hazard Analysis and Critical Control Points
ICSID	International Center for the Settlement of Investment Disputes
ICT	information and communications technology
IDLO	International Development Law Organization
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IPR	intellectual property rights
ITC	International Trade Center of the WTO
JICA	Japan International Cooperation Agency

JTC	judicial training center
KGS	Kyrgyz soms (currency)
LDP	USAID Local Development Program
LEGPROM	Association of Light Industry Enterprises of the Kyrgyz Republic
MCA	microcredit agency
MCC	microcredit companies
MFI/MFC	Microfinance institution/microfinance corporation
NGO	non-governmental organization
PPP	public private partnership
QC	quality control
SME	Small and medium-sized enterprises
TIKA	Türk İşbirliği ve Koordinasyon Ajansı Başkanlığı (Turkish International Cooperation and Development)
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific, and Cultural Organization
VAT	value-added tax
WTO	World Trade Organization

PURPOSE OF ASSESSMENT

Following political unrest in 2010 that saw the dissolution of the standing government and subsequent elections in 2011, the Kyrgyz Republic is poised for rapid economic growth. USAID/Kyrgyz Republic seeks to support the country's renewed economic prospects by addressing key constraints in the private sector. Toward this end, USAID/Kyrgyz Republic engaged the USAID Asia and the Middle East Economic Growth Best Practices Project (AMEG) to conduct an economic growth assessment. The purpose of the assessment was to review and propose recommendations to address select constraints in the business enabling environment and to increase the competitiveness of the tourism and textile sectors.

The field assessment was conducted from March 30 to April 27, 2013, by Team Leader Douglas Muir, representing Chemonics International. He was supported by James Newton (Chemonics International), Margaret Bishop (Banyan Global), Michael Fox (William Davidson Institute), and Heather Tomlins (Chemonics International). The team would like to thank Michael Trueblood of USAID/Central Asian Republics, and Lawrence Held, Daniyar Ilebaev, and Erkin Konurbaev of USAID/Kyrgyz Republic for their expertise, insight, and assistance throughout the assessment. The team also wishes to acknowledge Danielle Dukowicz and Bryan Byrne of USAID/Washington and USAID/Central Asian Republics respectively, and Andrew Batchelor (Chemonics International) for their technical input to the assessment and written contributions to this report. The report was reviewed by Melissa Scudo, AMEG program manager, and Andrew Batchelor, AMEG research associate.

The executive summary provides an overview of the assessment, brief descriptions of the business enabling environment and tourism and textiles sectors, and key findings and recommendations. Sections I, II, and III of the report offer detailed narratives related to textiles, tourism, and the business enabling environment, respectively. Each of these sections contains the assessment team's methodology for the sector, a short background to provide context, findings related to constraints and opportunities, and finally, recommendations. The report's annexes provide supplementary information on the team's interviews (Annex A), reference material (Annex B), resources employed (Annex C), textile recommendations (Annex D), business enabling environment recommendations (Annex E), gold production (Annex F), and timeline for conducting the assessment (Annex G).

ABOUT AMEG

AMEG is designed to support USAID missions in developing effective and efficient economic growth programs that address technical and strategic challenges that are specific to countries in which USAID operates in Asia and the Middle East. Through AMEG, USAID is able to conduct rapid and strategic economic growth assessments, pilot innovative approaches in economic growth programming, and consolidate and disseminate best practices in economic growth projects learned from decades of USAID implementation throughout the world.

EXECUTIVE SUMMARY

USAID/Kyrgyz Republic engaged AMEG to assess and propose recommendations for the business enabling environment and tourism and textile sectors. AMEG assembled and deployed experts with regional experience in each of these fields, and worked in collaboration with technical officers from USAID/Central Asian Republics, USAID/Kyrgyz Republic, and USAID/Washington. After conducting a four-week assessment that included desk research, more than 190 interviews with government officials, private sector stakeholders, industry associations, and non-governmental organizations, and dozens of site visits to four different provinces, the assessment team developed specific, actionable recommendations to enhance the business enabling environment and improve the competitiveness of the tourism and textile sectors. In proposing their recommendations for potential future activities that USAID might support, the assessment team used the following criteria. The proposed activities must:

- respond to market demand
- contribute to sustainable job creation
- engage or collaborate with a capable implementing partner, as appropriate
- impact areas beyond Bishkek
- leverage prior or current assistance by the U.S. government and/or other donors and/or represent a good opportunity for a Public Private Partnership (PPP), when possible
- positively impact women and/or rural communities

A brief overview of each sector is provided below along with select recommendations. The tables outlining recommendations are meant to present an overview and do not include all recommendations by the assessment team.

Textile and Apparel Sector

Kyrgyzstan's textile and apparel sector is an engine of job creation and is one of the country's major export industries. Given the important roles that women and rural communities play in the industry, they stand to benefit from enhanced competitiveness. Kyrgyzstan's existing textile and apparel sector exhibits many strengths, such as established trade links with regional partners, vertical integration, and well-organized industry associations. However, short- and medium-term challenges persist, including lack of access to finance, skilled labor, and modern inputs; difficulty meeting quality, social, and environmental requirements for accession to the Customs Union of Belarus, Kazakhstan, and Russia; and lack of capacity to market to demanding, yet lucrative European buyers.

Table 1. Textile and Apparel Sector Recommendations and Notes

Recommendation	Notes
Invest in upgrading Kyrgyzstan's textile and apparel laboratories *Potential partner:* Laboratory at the Center for Standardization and Metrology (Ministry of Economy) *Beneficiaries:* Textile and apparel exporters	Kyrgyzstan does not have the capacity to certify the quality of its fabrics — a requirement for accession to the Customs Union of Belarus, Kazakhstan, and Russia and for export to "Western" markets — so the work must be sent abroad, which is costly, time-consuming, and ultimately reduces competitiveness.
Provide targeted equipment grants and associated training to industry organizations and factories *Potential partners:* LEGPROM, LEGPROM South, BioFarmer Cooperative, SoyuzTextil, Cashmere Producers Association, and Osh Business and Training Center *Beneficiaries:* Industry associations and their members	Outdated equipment diminishes productivity, efficiency, and competitiveness. When modern equipment is available, qualified machine operators and mechanics are unavailable. Providing vital assets and training (see detailed recommendations in *Section I: Textiles*) to industry organizations will allow association members to receive better services, expand product offerings, and will facilitate achievement of international industry standards. Equipment grants will also bridge gaps in the value chain, enhancing the sustainability and competitiveness of the entire value chain.
Provide technical assistance to develop a second elite cashmere breeding herd *Potential partners:* Cashmere Producers Association and rural goat herders *Beneficiaries:* Rural goat herders	Kyrgyzstan has only one elite breeding herd that commands premium prices from international markets. The current herd is at risk of inbreeding, and also is not large enough to support a significant expansion of cashmere exports.
Provide technical assistance to develop a campaign to differentiate Kyrgyz cotton *Potential partners:* BioCotton and/or BioFarmer Cooperative *Beneficiaries:* Cotton producers and users	Differentiation will help insulate Kyrgyz cotton producers and users from association with other Central Asian cottons (*e.g.*, Uzbek brands associated with forced labor, child labor, and poor environmental practices)
Provide technical assistance to support compliance with industry-wide safety and social standards *Potential partners:* Kyrgyz industry associations and international third-party social auditors *Beneficiaries:* Participating textile and apparel producers and their workers	To appeal to "Western" buyers, safety compliance training to major factories and industry associations is needed, particularly in the wake of recent tragic events in the textile industry in other parts of the world. For social issues, third-party compliance auditing and certification, through accredited third parties, can help differentiate Kyrgyz garment factories from competitor countries, facilitate further sales into Russia and Western markets, and help safeguard the safety, health, and welfare of Kyrgyz workers.
Offer grants for study tours and technical assistance to expose producers to best practices, including study tours and a case study on the USAID-created Haiti Apparel Center to inform the government's planned "Technopolis" *Potential partners:* Vocational training institutes and "Technopolis" planners *Beneficiaries:* Vocational instructors and their students; creators and users of "Technolpolis"	Vocational training centers for the industry have little access and exposure to best practices. Study tours will allow instructors to diffuse knowledge for more modern production techniques. Similarly, the Kyrgyz government's plans to build a "Technopolis" (i.e. an industrial park) for the textile and apparel sector is in its early planning stages. A case study of the highly-regarded Haiti Apparel Center would help inform the developers of the park.

Tourism Sector

With numerous cultural attractions, the second-largest alpine lake in the world, the Tian-Shan mountain range rising directly from the Kazakh steppe, and a critical section of the

historic "Silk Road," Kyrgyzstan's tourism industry represents an important growth prospect for jobs and economic development. Indeed, since the 2010 social unrest, tourism bounced back quickly, attracting near record levels of visitors in 2012. Key challenges — few industry standards, low service capacity, the lack of a unified marketing and information campaign, and weak local planning — can be addressed over the short and medium term. Given the sector's propensity to create employment opportunities across all skill spectrums of the labor market, offer opportunities for small and medium sized businesses, attract investment, contribute to the diversification of the Kyrgyz economy, and enhance foreign exchange earnings, the assessment team recommends that USAID consider several relatively low-cost, focused interventions.

Table 2. Tourism Sector Recommendations and Notes

Recommendation	Notes
Facilitate the development of a national marketing and information campaign. *Potential partners:* Industry associations, provincial government stakeholders, and national government officials involved in tourism *Beneficiaries:* Tourism sector and ancillary business	Kyrgyzstan is not well-known outside of CIS countries. The country is not well marketed as a tourist destination, either regionally or farther abroad. Development of an appropriate brand, a targeted marketing and information campaign, and other tools (e.g. a tourism promotion website, tourism information centers) could help draw more tourists, particularly those that are "higher spend".
Provide technical assistance for establishing basic professional standards and enhancing the quantity and quality of tourism-related training. Certification for higher skilled positions *Potential partners:* Vocational training institutes and industry associations *Beneficiaries:* Tourism service providers and workers	Kyrgyzstan suffers from a reputation of poor service standards in areas such as cleanliness, food preparation, and facility upkeep. Establishing basic standards will help attract and retain more demanding, higher value clientele. Additionally, certification for high skill positions (*e.g.,* technical mountaineering guides, cultural tour guides) do not exist. Certified tourism workers could enhance safety and tourism experiences.
Facilitate the development of tourism "products" or packages that address seasonality (e.g. cultural tourism) *Potential partners:* Industry associations, local government stakeholders, local chambers of commerce, and major tourist operators *Beneficiaries:* Tourism sector and ancillary business	The peak tourist season, particularly in Issyk-Kul, is only about 50 days per year during the summer, with a much smaller peak season in December/ January. Tour operators collect much of their annual revenue during peak times, hotels cannot always accommodate all visitors, and employment in the industry is largely seasonal. Developing complementary activities, diversifying highly focused activities into a larger portfolio of offerings, and expanding cultural and community based tourism offers an avenue to address these issues.
Enhance international linkages, including through trips to conferences and fairs; support for membership and participation in international organizations; and enhancing regional business to business linkages *Potential partners:* Industry associations (e.g. Kyrgyz Community Based Tourism Association, Kyrgyz Association of Tour Operators), major tourism operators, local planning boards, and key national government officials *Beneficiaries:* Industry association members, tourism operations operating across borders	Interaction at the regional and international level can be an important contributor to establishing standards, diffusing best practices, and creating cross-border initiatives. Kyrgyz participation in conferences and industry fairs is intermittent and often weakly supported. With the exception of a few large actors, international business to business connections are weak to the major markets, notably Russia and Kazakhstan, and almost nonexistent in other target and potential target markets. A few tours do cross national boundaries, particularly "Silk Road" tourism from Uzbekistan and Tajikistan, but there is little discussion on how to integrate services between neighbor countries

General Business Enabling Environment

Businesses in Kyrgyzstan are helped and hindered by the country's overall business enabling environment. Following the breakup of the Soviet Union, Kyrgyz lawmakers and government administrators methodically and purposefully adopted market-oriented policies. Much of Kyrgyzstan's legal and regulatory code was revised soon after 1991, which ushered in many of the laws and institutions that typify a modern, market-oriented economy. However, reform is still needed in critical policy areas, including tax administration, trade regulations, commercial law and institutions, and the labor market. Additionally, corruption and business formalization remain ongoing challenges for the private sector. By addressing these issues through targeted technical assistance and collaboration with ongoing donor efforts, Kyrgyzstan stands to create a more welcoming and enabling environment conducive to broad-based economic growth.

Table 3. Business Enabling Environment Recommendations and Notes

Recommendation	Notes
Support development of a national Bar Association, an ethical code of conduct for attorneys, and a comprehensive bar examination *Potential partners:* Law schools, national lawyer associations *Beneficiaries:* Law offices, users of legal services	Kyrgyz legal education institutions do not adequately train lawyers for real-world practice. Since a regulated bar association for lawyers is not mandatory and little continuing legal education is required, legal services can be weak. Some law schools suffer from corruption as degrees are bought. A Bar Association and code of conduct would provide a means for imposing consequences for unethical conduct; a bar examination ensures that lawyers meet minimum qualifications to practice law and deter corrupt practices for obtaining these credentials.
Provide training and technical assistance to commercial courts and select government institutions involved in commercial law *Potential partners:* Ministry of Justice, commercial courts, law schools *Beneficiaries:* Commercial courts, lawyers, judges, and users of commercial courts	Basic skills of law clerks, paralegals, legal assistants, and court and case administrators is generally lacking. Provision of basic skills training would help improve the overall capacity of the courts, reduce needless errors, and help modernize the current system. Other activities focused on systems—such as improved process flow and introducing automation services and associated training that create more reliable records and case management—would also have a positive impact on the efficiency of the commercial court system and reduce opportunities for corruption.
Provide targeted capacity building to the National Statistical Committee and other primary data collectors/providers *Potential partners:* National Statistical Committee, ministries engaged in major ongoing data collection efforts *Beneficiaries:* Statistical agencies and policymakers relying on their data	Policymakers need reliable information and data to make informed decisions. For example, Kyrgyzstan's National Statistical Committee is the government's leading agency to collect and disseminate data. The institution, and other agencies involved in major data collection efforts, would benefit from technical assistance to develop improved methodologies for data collection and analysis, coordination and harmonization of collection techniques, and sharing of information.
Provide capacity building and skills training to vocational and trade schools, facilitate the development of apprentice/internship programs, and encourage entrepreneurship *Potential partners:* Vocational and trade schools, industry associations, secondary schools *Beneficiaries:* Future tradesmen/women	Despite relatively high unemployment, Kyrgyz businesses have difficulty finding personnel with appropriate skill-sets. The labor force would benefit from enhanced capacity in demand-driven skills at vocational and trade schools, including technical crafts (e.g. electricians) and basic skills (e.g. ICT). Similarly, apprenticeship/internship programs at vocational schools, secondary schools, and universities that help students transition to the job market could play a key role in building needed skills and transferring on-the-job knowledge. Finally, formal SMEs

in vocational/trade schools, individual businesses	providing high quality, critical services (e.g. electricians) are also an ongoing need in the private sector, suggesting entrepreneurship programs that highlight formalization would help fill in service gaps.
Encourage national "quality infrastructure" development, Customs Union accession, and improved operation at the "single window" *Potential partners:* Ministry of Justice, commercial courts, law schools *Beneficiaries:* Commercial courts, lawyers, judges, and users of commercial courts.	To remain competitive in international trade, Kyrgyzstan must have national "quality infrastructure, standards, and certification" in place to establish, test, verify, and certify quality standards. Kyrgyzstan does not have these in place, particularly for textile and apparel and food and beverage. These systems would be critical in acceding to the Customs Union of Russia, Belarus, and Kazakhstan.
Provide limited technical assistance to the "Social Fund" *Potential partners:* Social Fund *Beneficiaries:* Social Fund management, and pensioners of the Social Fund	Kyrgyzstan has two pension funds: a small, relatively new private fund and the much larger state pension fund, generally known as the "Social Fund". The Social Fund is not receiving donor assistance and is facing challenges managing its cash reserves, particularly since the it has a difficult time retaining staff. Enhanced systems in IT and staff training are also considered major needs.

Finally, within the rubric of the business enabling environment, the assessment team developed a brief overview of the gold production industry. While AMEG was not specifically tasked with considering this sector, given gold production's relative share of GDP, the possible effects of a substantial change in the price of gold on the Kyrgyz economy, and potential implications for USAID development assistance, the team briefly analyzed several scenarios and present their conclusions in Annex F. These include recommendations that USAID remain vigilant of the price of gold, monitor Kumtor's (i.e. the primary producer's) and government's responses to large fluctuation in the world gold price, and, if necessary, engage nimble mechanisms to respond to downstream effects. Mechanisms to consider could include existing programming, new programming through rapid response mechanisms, collaboration with other donors and government counterparts, and partnerships with civil society organizations.

SECTION I. TEXTILE AND APPAREL SECTOR

Kyrgyzstan's textile and apparel sector is important to the country's economic health and stability. Exports from this sector, and potential growth to under- and untapped markets (e.g. Russia), position textiles and apparel as key contributors to job creation and employment opportunities, particularly for women and vulnerable populations in rural communities. However, the sector's growth is constrained by factors that undermine its competitiveness in the export and domestic markets. Though donor assistance has helped strengthen the textile and apparel industry, there are opportunities to build on these investments and position the sector to avoid stagnation and maintain sustained growth. This section provides a description of the assessment methodology, a summary of the sector to provide context to its contributions to the Kyrgyz economy, and a description of findings and opportunities for future USAID-supported interventions.

Methodology

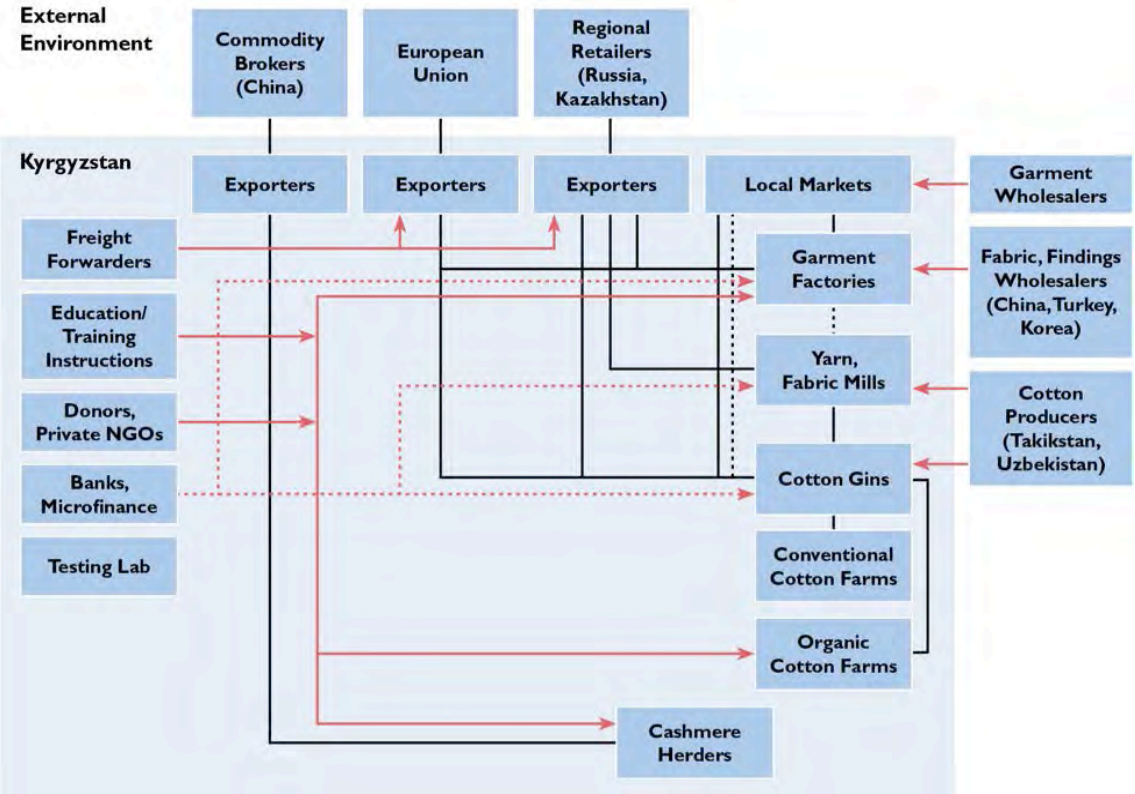
AMEG's approach to assessing the textile and apparel industry included desk research of more than 50 professional, academic, and popular media articles, more than 40 site visits (including one visit to the opening night of Fashion Week Kyrgyzstan), and 102 personal interviews. The meetings addressed international donor assistance and academic and vocational technical training programs supporting the sector, and consultations with stakeholders, including owners of small and medium sized business, third-party traders, and others in fiber production, textile processing, garment design and manufacturing components of the sector. Site visits and interviews included discussion of binding constraints to competitiveness and opportunities to address them through donor assistance. The consultants made site visits to Bishkek, Tokmok, Osh, and Jalalabad.

Background

The number of textile and apparel workers in Kyrgyzstan is estimated at 150,000-300,000, or 6.4 to 12.8 percent of total employment.[1] According to Rysgul Babaeva, chairman of the Trade Union of Textile and Light Industry Workers, 70 to 80 percent of industry workers are women. The government of Kyrgyzstan has cited the clothing industry as having "high social importance because of significant potential regarding the creation of workplaces."[2] According to the International Labour Organization (ILO) in Kyrgyzstan, the textile and apparel sector is the country's largest employer after agriculture.

[1] The lack of precision reflects that 1) a large but undocumented number of apparel companies operate in the informal or "shadow" economy, and 2) apparel companies in the formal sector periodically hire additional workers on an informal basis to fill seasonal production needs.
[2] Government of Kyrgyz Republic. "Program. Stability and Dignified Life." 2012

Exhibit 1. Textile and Apparel Value Chain



Value chain. A diagram of the textile and apparel value chain in Kyrgyzstan follows, next page. Black lines indicate flows from producer to market. Solid orange lines indicate flows from suppliers or service providers to producers; broken orange lines indicate where flows are very limited.

The textile and apparel sector in Kyrgyzstan extends from raw fiber to finished garments. Within the value chain, fiber production and harvesting, and garment manufacturing (cut-make-trim, or CMT) are very labor-intensive, making the sector a major employer and a potential engine for job growth;[3] Because Kyrgyzstan's fiber production is limited to three agricultural-based natural fibers, cotton, cashmere, and Merino wool, this portion of the value chain is heavily rural. These three fibers are globally important in the fashion and home furnishings industries, with cashmere enjoying a luxury position in the marketplace. Cotton produces five products; in addition to providing (1) an important textile fiber, ginned cotton also produces (2) lint (waste fibers too short for the production of yarn), used locally for mattress and upholstery stuffing; (3) the seeds, which are pressed for oil, (4) the seed hulls, used as animal feed, and (5) post-harvest dried cotton stalks provide an important source of cooking fuel. As a result, cotton is an important commodity for Kyrgyzstan well beyond export sales.

[3] Manufactured fiber production is equipment-intensive, but production and harvesting of natural fibers remains labor-intensive, particularly in countries with small farm cotton production, such as Kyrgyzstan, and animal hair production (wool, cashmere).

Yarn and fabric production (weaving, knitting), fabric converting (dyeing, printing, finishing), and knit-to-shape[4] garment manufacturing are equipment-intensive, with low labor requirements. Garment manufacturing is concentrated in or near the greater Bishkek area and the southern city of Osh. The more sophisticated garment producers are generally located in Bishkek. Although Kyrgyzstan has a UNESCO-recognized tradition of making wool felt (a non-woven fabric made of wool fiber), this is an artisanal activity that is better integrated with cultural-based tourism and craft initiatives than with the industrial-scale textile and apparel value chain.

Exhibit 2. Textile and Apparel Production Process

Exhibit 2 displays the more limited textile and apparel production chain follows. The two colored boxes (fibers, CMT garments) indicate the more robust segments of the chain; the white boxes (yarn, fabric, conversion) indicate those segments with little or no domestic industrial-scale activity in Kyrgyzstan today.

Exports. According to Farhad Tologonov, director of the Association of Light Industry Enterprises in the Republic of Kyrgyzstan (LEGPROM), an estimated 95 percent of garments produced in Kyrgyzstan are exported, with 80 percent of those exports absorbed by Russia, and most of the balance flowing to Kazakhstan[5]. According to one cotton gin manager, conventionally farmed cotton is exported to Russia. Organic cotton, some greige (unbleached, undyed, unfinished) fabric, and some garments are exported to Europe; cashmere fiber is exported to China. A few garments have been exported to the United States (mostly by the high-end Kyrgyz designer Dilbar Ashimbaeva, whose dresses sell at retail for $1,200 in Bishkek). There is anecdotal reporting of informal movement of goods between Uzbekistan and Kyrgyzstan, including cotton, yarn, fabric, and garments. Because of the labor-intensive nature of natural fiber and garment production and the fact that Kyrgyz producers have established export market links, these aspects of the value chain offers particularly promising growth and job creation potential for Kyrgyzstan.

China. Kyrgyzstan's textile and apparel industry is fundamentally linked to China's textile and apparel production. With negligible domestic yarn and fabric production,

[4] CMT garments are made by cutting fabric (either weaving or knitting) and sewing cut pieces together; knit-to-shape garments are created by knitting garment components (e.g. fronts, sleeves) to their required shape and stitching the components together to form the completed garment.

[5] A recurring issue with this study was the difficulty of finding robust, up-to-date data on the textile industry. The above figures come from multiple sources, notably Farhad Tologonov, director of the Association of Light Industry Enterprises in the Republic of Kyrgyzstan (LEGPROM). Also, while Russia and Kazakhstan dominate export markets, there is anecdotal reporting of informal movement of goods back and forth between Uzbekistan and Kyrgyzstan, including cotton, yarn, fabric, and garments. Uzbek cotton tends to drift into Kyrgyzstan, while at least some Kyrgyz garments get exported to Uzbekistan. Much of this trade is currently illegal or semi-legal.

Kyrgyz garment producers are dependent on imported inputs (fabric for CMT garments, and yarn for knit-to-shape apparel, plus buttons, zippers, and other "findings"). According to factory owners we interviewed, the vast majority of fabric is imported from China; factories either buy through Chinese wholesale agents who travel to Bishkek, order by phone from established vendors, or buy at the local Dordoi, Madina (Bishkek), or Karasul (Osh) markets. Selection and quality of the Chinese fabrics are largely controlled by a few middlemen who present a limited range of fabrics to the buyers. A few factories buy fabrics from Turkey or South Korea, either direct from factories in Turkey or through middlemen. One knitwear factory manager reported buying most of his yarn from Belarus.

At the same time, low-cost Chinese apparel dominates the local market, making it very difficult for Kyrgyz producers to build local brands to maintain and grow domestic market share. This undercuts the sector's ability to build skills and employment opportunities by producing initially for more forgiving local markets.[6] A bright spot, however, is the evolution underway in China's garment sector. With rising wages and declining apparel production capacity, a deliberate reduction in government incentives to its apparel industry, and burgeoning domestic consumption in China,[7] we anticipate that the base price (before Customs duties) of Chinese-made wearing apparel will increase regardless of the Kyrgyz accession to the Customs Union of Belarus, Kazakhstan, and Russia. This may improve the domestic market opportunity for local firms able to design and develop their own fashion brands.

Customs Union and market demand. Accession to the Customs Union of Belarus, Kazakhstan, and Russia would have important implications for Kyrgyzstan's textile and apparel sector. Local producers will have relatively unfettered access to Russia's vast market demand. Additionally, the textile and apparel sector will likely also be impacted in two other important ways: 1) the price of fabrics, sewing thread, findings (buttons, zippers, and other trim) will increase due to the import duties which will go into effect for China and other non-member countries, raising the cost of production (negative affect for producers), and 2) Chinese-made wearing apparel will increase in price in the Kyrgyz marketplace for the same reason (positive affect for producers). Furthermore, Kyrgyz garments will be required to meet the safety and quality standards of the Customs Union. It is difficult to ascertain the net impact that joining the Customs Union may have on Kyrgyzstan's textile and apparel sector. Clearly, garment production would become more competitive through better quality of inputs and of construction, justifying higher prices. Improved efficiency would improve cost management. Contemporary fabrics and design would drive market demand, as would access to export markets.

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[6] A local market often serves as an important entry point for new apparel factories familiar with local clothing tastes and market demands, and able to avoid the costs and delays associated with export processing and unrelenting demands of a foreign brand or retailer. Because quality requirements are often less stringent than for export, the domestic market also provides an opportunities for less experienced workers to build their skills.

[7] These changes are significant enough that nearly every U.S. and European brand and retailer sourcing or producing its garments in China is moving some garment production from China to other countries in Asia, Africa, and the Americas; currently Bangladesh is the primary benefactor of these sourcing shifts.

If Kyrgyzstan chooses to target the European Union (EU), garments must meet EU regulations for banned or restricted substances (metals and chemicals); competitive prices and contemporary design will also be vitally important. Further discussion of the implications of targeting the EU market follows later in this section.

If in addition to — or instead of — targeting export markets, Kyrgyz garment enterprises target the domestic market (particularly if imported Chinese garments become more costly), quality, cost, and design will be critical to growing domestic market share. Although Kyrgyzstan exports an estimated 95 percent of its garment production, a more robust domestic market would enable help nascent companies to succeed, since domestic production and sales is less competitive and less burdensome (shorter production cycles and lack of border delays and Customs processing).

Laboratory. The Customs Union would require that textiles and apparel meet detailed safety and quality standards including setting limits of certain chemicals or heavy metals, static buildup, and colorfastness to washing, perspiration, and crocking.[8] To meet Customs Union regulations, imported products must pass more than 30 tests. Testing must be performed in a Customs Union-certified laboratory. There are no certified labs in Kyrgyzstan, and interviewees report certified labs in Russia charging two to three times the prices for testing that a Kyrgyz lab would charge.

The laboratory at the Center for Standardization and Metrology under the Ministry of Economy of the Kyrgyz Republic in Bishkek lacks adequate equipment for the required tests, a temperature- and humidity-controlled conditioning chamber for preparation of test specimens, and Customs Union certification. Regardless of whether or when Kyrgyzstan joins the Customs Union, a modern, equipped testing facility with properly trained personnel is important for growing and maintaining robust textile and apparel exports. The EU, the United States, and other countries are continually tightening their standards for the presence of hazardous metals, hazardous chemicals, and "conflict" minerals such as tin (used in brass and common in some zippers, buttons, buckles, and other findings), and certified testing plays a critical role in the ability of companies and countries to increase exports to these markets. It must be recognized, however, that creating and equipping such a lab properly will require a substantial capital investment likely to run in the hundreds of thousands of U.S. dollars.

Industry associations. Kyrgyzstan has five industry associations of note: LEGPROM, the Union of Kyrgyz Textile Industry (SoyuzTextil), the Trade Union of Textile and Light Industry Workers, the BioFarmer Cooperative launched with the help of Swiss-funded Helvetas, and the Cashmere Producers Association, a recipient of assistance from the Aga Khan Foundation.

Membership in these organizations includes 700 factories, 28 factories, 30,000 individual workers, and 1,172 farm owners, respectively. In addition, there are an estimated 15,000 cashmere producers in two rayons of Osh Oblast (Alay and Chong Alay, whose goat

[8] Crocking is the undesirable transfer of excess dye from a fabric to another surface through rubbing or friction; crocking is directly linked to the quality of the dyes and dyeing process.

herds have been scientifically studied by cashmere experts Carol Kerven and Sabyr Toigonbaev).[9] Four of the five associations appear to provide meaningful services to members, such as lobbying the government for more favorable legal treatment, organization of local trade shows and other marketing support, and donor-supported training. The effectiveness or value of services of the Trade Union of Textile and Light Industry Workers has not been ascertained during this assessment.[10] A sixth non-governmental organization, the Osh Business and Training Center, run by American Sy Belohlavek, is reported to be doing excellent work with the cashmere producers in conjunction with the Cashmere Producers Association. LEGPROM, SoyuzTextil, the BioFarmer Cooperative, the Cashmere Producers Association, and possibly the Osh Business and Training Center represent an opportunity for USAID to directly impact a vast number of women and rural Kyrgyz while strengthening the value and sustainability of viable membership organizations.

Gaps in workforce development. While several public institutions and one private training center offer curricula in apparel design, pattern making and grading, technical design,[11] cutting, and construction, there are significant gaps in occupations covered, and varying levels of quality of instruction. The Asian Development Bank (ADB) has provided important technical assistance to upgrade the quality of instruction for pattern making and construction courses. However, there are no courses to train quality control inspectors or sewing machine mechanics, and there is a dearth of training for middle managers (e.g. line supervisors, quality control managers, and production schedulers and managers). Factories complain of a lack of design training, but the shortfall is more in the lack of merchandising[12] training rather than a lack of design training. In a sector in which many factory owners received their academic training in medicine, economics, or other non-apparel fields, professional training for middle and senior managers is critical to drive productivity, quality, and merchandising/marketing improvements.

Sewing Machines Sit Idle

A lack of trained sewing machine mechanics qualified to work on modern, electronic sewing machines is severely undermining the industry and the training institutions that serve the sector. Several new sewing machines provided by GIZ to the Shvei Profi training center sit unused because the center lacks instructors knowledgeable about the electronic equipment. When interviewed, the Director said she plans to store the equipment in the basement so it will not be broken or damaged by instructors or students who lack the proper training in the use and care for the equipment. This anecdote, concerning in itself, highlights a larger problem: there are no sewing machine mechanics trained to work on modern machines anywhere in the country. As a result, the industry is using older machines without modern electronics. These are significantly less productive than modern machines, putting the industry at a competitive disadvantage.

[9] 62 villages in Chong Alay and Alay Rayons, times 2,500 goats per village (average), divided by 10 goats per herder (average).

[10] AMEG was able to conduct an interview with the director of the Union, but was not able to determine the actual efficacy of the union in action in the time allowed.

[11] Apparel design is typically limited to designing the shape and aesthetic characteristics of a garment; technical design involves specifying all the technical details related to choice of fabrics, sewing thread, and findings; type of seam construction; stitches per inch or centimeter; exact placement of pockets, buttons, trim; style of buttonhole, etc. Technical design is the engineering of the garment.

[12] Merchandising includes developing collections of garments that can be sold together both at wholesale and retail. Good merchandising vastly increases sales by insuring garments are well coordinated.

The lack of meaningful dialogue between factories and training institutions regarding the skills needs and training offered exacerbates the gaps. The general low quality of training causes most factory owners to train new employees internally, which undermines public training programs and can lead to incomplete, informal ad-hoc training rather than a carefully designed and tested training program taught by qualified instructors trained both in technical and teaching skills. However, there does seem to be collaboration between training institutions and garment factories in Bishkek to offer internships for upper level students. Factory owners report the students bring negligible skills to the internship but they believe, nonetheless, that the internship process is important for the students and provides factories with an opportunity to evaluate potential employees before hire.

The lack of qualified training instructors and of qualified sewing machine mechanics that can work on modern electronic sewing equipment presents a circular problem. Factories are hesitant to invest in modern equipment and training institutions are unable or unwilling to train students on modern electronic equipment they may be granted by international donors out of fear for their damage and an inability to maintain or repair the equipment properly. At the same time, sewing machine mechanics cannot be trained on modern electronic equipment if there is none available or in need of repair. This chicken and egg conundrum has led the director of Shvei Profi training center, launched with assistance from GIZ, to decide to place new equipment granted by GIZ in the basement because it would otherwise "be broken by people who don't know how to use it."

Need for social and regulatory compliance. In the apparel industry, social compliance refers to the safety, occupational health, and proper treatment of workers. It includes such issues as adhering to legal working ages (avoidance of child labor); limits on overtime; exclusion of mandatory overtime; paying workers fairly and on time; creating an atmosphere that does not allow harassment of workers, job applicants, or recruits; the right to assembly and collective bargaining; and other related issues. Regulatory compliance includes adherence to local laws and product safety regulations. The factories and training institutions we visited did not have egregious observable shortfalls, but all clearly need to improve compliance in safety and occupational health practices. Fire safety is poor; factories lack adequate, up-to-date fire extinguishers in strategic locations; electrical wiring is faulty with spliced wires commonplace; combustible waste is abundant and often in close proximity to electrical outlets, irons, and spliced wires. Exacerbating fire hazards is a lack of secondary exits from most factories, particularly those at greatest risk in old, multistory buildings. Even when provided by employers, workers generally fail to use safety tools (e.g. chain gloves when operating electric saws, face masks to prevent inhalation of cotton dust, ear protection against permanent noise-induced hearing loss) to prevent disabilities (amputation, permanent hearing loss) or occupational diseases (e.g. Brown Lung[13]).

In addition, reports of mandatory overtime and informal hiring of seasonal or temporary workers without contracts or payment of social benefits were commonplace. Most North

[13] *Brown Lung* (Byssinosis) is a debilitating occupational disease caused by inhalation of cotton dust during the spinning and weaving processes. It has been compared to coal miners' Black Lung.

American and European brands and retailers (and increasingly Asian brands and retailers) require strong social compliance. Deadly garment factory fires in Bangladesh and India in recent months have heightened sensitivity to fire safety. Coupled with the recent factory fires, the tragic May 2013 collapse of a building housing five export garment factories in Bangladesh that resulted in more than 1,200 worker deaths has raised social compliance in the apparel industry to an unprecedented level of awareness, concern, and action among U.S. and European apparel brands and retailers, and increasingly among factory workers as well.[14]

Lack of affordable financing. Worldwide, the apparel industry is dependent on credit financing of working capital (supply chain financing or purchase order financing). Kyrgyzstan's cotton producers, yarn and fabric producers, and garment producers report serious working capital shortfalls and lack of access to affordable credit. One textile manufacturer (yarn, fabric) with Turkish partners lost its partners and ceased operations in 2012 when it was unable to purchase sufficient cotton fiber due to cash flow constraints. The factory reportedly had letters of credit for $1.5 million but was unable to secure financing at an affordable rate. Similarly, one cotton gin and one vertically integrated textile manufacturer still in operation reported running well below capacity because a lack of access to credit prevented them from buying sufficient cotton fiber to fill capacity. Lack of affordable financing also hinders the ability of factories to replace outdated equipment.

The textile and apparel supply chain worldwide is a low-margin industry built on financing of raw materials purchases, work in process, and labor. As U.S. and European brands and retailers downsized and divested their own manufacturing units, purchase of raw materials to produce a garment order was pushed upstream to the garment factories and textile (fabric and yarn) mills. It is common for cotton gins, yarn mills, fabric mills, and garment factories to pay for their inputs months before they can expect payment for their products. Companies, such as those in Kyrgyzstan, with low capital reserves and obsolete or movable assets (such as sewing equipment) find themselves unable to affordably access the commercial credit necessary to sustain operations. Once a gin or a factory ceases operations, it becomes very costly and extremely difficult to restart production, as skilled workers depart, buyers find alternative sources of supply, and idle equipment loses functionality. Hence, lack of affordable supply chain financing is a critical constraint to further growth, and even survival, of Kyrgyzstan's textile and apparel sector from fiber to finished garments.

Role of Women and Rural Kyrgyz

Worldwide, the apparel industry is largely populated by women. Kyrgyzstan is no exception. LEGPROM reports 50-80 percent of its 700 member companies are woman-

[14] Apparel factory fires in late 2012 resulted in over 200 deaths of workers, with the Tazreen factory fire capturing wide media coverage. The May 2013 collapse of a building housing 5 garment factories producing for the export market killed over 1,200 workers and catalyzed calls by the EU, Government of Canada, and U.S. brands and retailers for much greater scrutiny on workplace conditions within the export apparel industry and possible trade sanctions.

owned. SoyuzTextil reports that 100 percent of its 28 member factories are woman-owned. Most of the garment factory owners, CEOs, and executive directors interviewed for this assessment are women, though often these owners are medical doctors, physicists, or other professionals with no formal training in textiles or apparel. Although no figures were readily available, the vast majority of sewing machine operators are women. The production and lab manager in one large weaving factory (96 looms) is a woman, as is the production director and chief engineer of a knitwear factory. All the department heads interviewed at the vocational and technical schools and universities are women, as is the director of one university. While only 24 percent of the BioFarmer Coop's members (all farm owners) are women, women perform a disproportionate share of the cotton harvesting. Women participate actively in raising the cashmere goats and reportedly do most of the fiber collection and handling.

The one area where men appear to dominate is in the marketplace, which also represents the segment of the value chain that holds the greatest profit potential. While women factory owners participate actively in the wholesale market (though often selling to male middlemen), the retail market stalls that double as small-scale wholesale showrooms appear to be controlled by men. While apparel factories are mainly located in or near urban areas, fiber production in Kyrgyzstan is a rural, and in the case of cashmere, remote mountainous activity. Overall, anything that impacts Kyrgyzstan's textile and apparel sector will heavily impact Kyrgyz women. Anything that assists Kyrgyzstan's cotton and cashmere production will largely help rural Kyrgyz, including those living in remote mountainous regions with very few other economic opportunities.

Donor Assistance

Donor assistance has played a key role in shoring up Kyrgyzstan's textile and apparel. Assistance from USAID, the German and Swiss governments, the ADB, and Aga Khan Foundation has been instrumental in upgrading equipment in numerous factories and educational institutions and training schools. The ADB has been instrumental in providing technical assistance to upgrade quality of instruction in some Lycee through a 2010-2012 pilot project. The ITC, Helvetas, and Aga Khan Foundation have provided support for building market knowledge and market linkages. Collectively, these donor initiatives have helped enhance knowledge and skills in fiber and garment production, awareness of international market demands, and helped forge vitally important market linkages at the fiber and finished garment stages of the value chain.

There is no evidence of donor assistance for textile manufacturing (yarn, fabric) or converting (dyeing, printing, finishing) in Kyrgyzstan, and most primary textile manufacturers have ceased operations in recent years.[15] According to the EU representative we interviewed, the EU will likely shift its focus from tourism and light industry to energy and infrastructure, and UNDP reports no plans to assist the textile and

[15] It appears that the most significant factor in the decline of the primary textile industry was lack of access to affordable credit. This is a low-margin industry, so firms generally cannot afford to pay high interest rates. The Kyrgyz banking sector was unfamiliar with the industry and showed little interest in lending to it.

apparel sector. Table 4 shows the general breakdown of assistance by donor and implementing partners.

Table 4. Overview of Donor Assistance to the Textile and Apparel Sector (2012-2013)

Donor (Implementing Partner)	Value Chain Intervention Point	Donor Assistance
Aga Khan Foundation	Fibers	• Technical Assistance • Training • Livestock
Asian Development Bank	Vocational / Technical Schools	• Equipment grants to Lyceum • Technical Assistance (curriculum development - garments)
European Union	Garments	• Equipment
Germany (GIZ)	Garments	• Revolving loan fund for equipment • Equipment grants, including Shvei Profi training center • European market linkages, trade show participation (through LEGPROM)
Switzerland (ITC, Helvetas)	Fibers	• Technical Assistance • Market Linkages
	Garments	• Technical Assistance • Training • Study Tours • Market Linkages
Turkey (TIKA)	BEE, Education	• Financial and technical assistance
UNDP	--	N/A
USAID (LDP Project)	Garments	• Equipment • Technical Assistance (Customs Union Certification Analysis, and Export Manual)

Despite the assistance international donors have provided to date, critical needs remain for Kyrgyzstan to sustain a vibrant, growing textile and apparel sector. With Customs Union accession pending, the window of opportunity for strengthening the sector is likely to close within two or three years.

Premium Prices for Premium Fibers

Kyrgyzstan's fibers provide an important economic lifeline in rural and remote mountainous areas of Southern Kyrgyzstan. The country produces export-grade cotton

and cashmere, in excess of its domestic consumption[16]. Furthermore, it produces two premium fibers that are in growing demand in the international marketplace:

1) internationally certified FairTrade organic cotton (produced by more than 1,100 members of the BioFarmer Cooperative in Osh and exported to Germany), and
2) cashmere.

Cotton and cashmere are produced in rural and mountainous areas, respectively, of Southern Kyrgyzstan, where poverty is rife, and farmers and herders have few alternative sources of income.

Wool. Although Kyrgyzstan also has a history of producing Merino wool (the highest quality variety of wool), a near monopoly by Australia and New Zealand, coupled with a notable decline in the quality of wool produced by cross-bred Kyrgyz sheep, has resulted in Kyrgyz wool losing ground in world markets. While this is regrettable, reversing this trend would be a difficult undertaking that might not succeed.[17] This argues against donor assistance to wool producers.

Cotton. Cotton production is concentrated around Jalalabad, with Fair Trade Certified[18] organic cotton produced and marketed with assistance from the Swiss-funded Helvetas BioCotton project. Ninety-seven percent of the co-op members are small farmers (5 hectares or less). While only one quarter of the BioCotton farmers are women, the vast majority of individuals engaged in harvesting the mature cotton are women.[19] Support for this organic cotton production not only provides important income generation opportunities for thousands of women, but also helps safeguard their health (by reducing exposure to hazardous chemicals) and reduces environmental impact by avoiding use of chemical fertilizers, pesticides, and defoliants.

BioFarmer Cooperative Faces Challenges

Productivity by the BioFarmer Coop members is inhibited by lack of necessary equipment. Because they lack tractors, the organic cotton farmers are reliant on one local businessman to plow their fields on a contract basis at monopolistic prices. As the only tractor owner in the area, he refuses to negotiate on either plowing fees or petrol charges, leaving the farmers at his mercy and putting them at substantial risk of losing their crops if and when the tractor needs repairs.

[16] As noted, recent and reliable statistics for these industries are hard to find. However, all organic cotton production and cashmere production is exported. Many farmers have fields in conversion from non-organic to organic and this is a rapidly growing market sector. Growing organic cotton is more challenging but also significantly more profitable than growing standard cotton, so it is not surprising that production is expanding.

[17] Kyrgyz wool has fallen far below Australian and New Zealand wool in terms of price and quality. Wool producers in these countries are extremely well capitalized, have access to skilled workers and advanced technologies, and have developed a number of well-established brands going back for decades. Given the current state of Kyrgyzstan's wool production, an attempt to regain market share from them would be a protracted and uphill struggle with an uncertain outcome.

[18] Certification by Fair Trade International provides assurance, through third-party auditing, that the producer group/s have followed specific international standards for labor, environmental impact, and trade.

[19] One hectare of land produces 2.5-2.8 tons of cotton in Kyrgyzstan; one person can harvest approximately 50 kg of cotton per day. Harvesting is repeated up to 4 times sequentially per field (with decreasing yields) as fibers mature over time.

However, productivity by the BioFarmer Coop members is inhibited by lack of necessary equipment (see text box).

There is a potential threat to the success of Kyrgyz cotton in general, including the organic cotton for which a good European market link has been established. Uzbek cotton has been boycotted in recent years by most major U.S. and European clothing brands and retailers because of widespread labor abuses (use of forced and child labor). While the boycotts are formally limited to Uzbek-grown cotton, many international brands and retailers do not readily distinguish between it and cotton from other Central Asian countries. Kyrgyz cotton, in particular, is not produced or harvested using forced labor (nor, reportedly, child labor). In early March 2013, a U.S. apparel brand compliance officer in New York City stated, "it's all cotton from Central Asia." A quick Google search of Uzbek cotton identifies numerous YouTube videos about labor abuses related to Uzbek cotton. Beyond international certification, no efforts have been made to differentiate Kyrgyz cotton from Uzbek cotton, and no such efforts have been made in the popular digital media such as YouTube, where information (accurate or inaccurate) goes viral.

Kyrgyzstan has two functioning cotton gins, both in Osh, one of which has been certified to gin organic cotton. Both report struggling financially due to a lack of affordable financing for the purchase of adequate stocks of cotton to run at full or nearly full capacity most of the year. Ginning cotton (separating the fiber from the seed) not only adds value to the cotton fiber before export, but retains the seeds and lint in country. These provide sources of seed for the next season, seeds for pressing cottonseed oil, and seed hulls for animal feed. Further, the one functioning vertically integrated spinning/weaving company in Kyrgyzstan reported having to buy Uzbek cotton to supplement its fiber stocks due to a lack of working capital necessary for the purchase of greater stocks of Kyrgyz cotton. Importing Uzbek cotton for re-export, regardless of the state of processing, exposes Kyrgyz companies, products, and cotton fiber to a significant risk of being boycotted in the world market by international companies unwilling to risk market activism that would paint their brand/s or company negatively in the public eye.

Cashmere. Few countries (China, Mongolia, India, Kyrgyzstan, and Tajikistan) have cashmere-producing goats. Cashmere production provides an important source of supplemental family income to rural and remote families in Osh and Naryn. According to Cashmere Producers Association President Sabyr Toigonbaev, 80 percent of Kyrgyz families in the mountainous regions have cashmere-producing goats. International cashmere expert Dr. Carol Kerven stated that, in Kyrgyzstan, goats are known as the "animal of the poor," and "poorer households depend disproportionately more on goats than the other livestock types." Scientific testing in the United States of 1,000 cashmere fiber samples from Kyrgyzstan confirm that indigenous goats in Alay and Chong Alay Rayons of the Osh Oblast produce premium quality cashmere fiber, according to international standards.[20] Although the cashmere is exported by Chinese traders who pay average market prices, a few factors prevent herders from achieving a premium price: the

[20] Quality of cashmere fiber is determined by length, diameter, and crimp (a spring-like characteristic absent in straight fibers).

herders' tendency to shear the goats rather than comb,[21] an inability to process the fiber locally, and the lack of organized grading to differentiate fibers of different length and diameter.

Key Findings and Opportunities

*The missing middle***.** Significant fiber and garment production occurs in Kyrgyzstan today, including internationally certified *FairTrade* organic cotton and premium grade cashmere. Kyrgyz fiber and garment production provides important rural and urban jobs, respectively. However, *very little primary textile production occurs today in Kyrgyzstan*. This is due to lack of access to affordable supply chain financing for working capital, low productivity, low product quality, and competition from abroad. Primary textiles (yarn, fabric production and converting) are the "missing middle" in Kyrgyzstan's textile and apparel value chain. One factory (*Kyrgyzjipteks, Ltd*., Jalalabad) ceased operations in early 2012 despite having Turkish partners, modern equipment, and letters of credit in excess of $1.5 million due to working capital constraints and lack of access to affordable short-term loans to finance adequate fiber purchases. Reinvigorating this portion of the value chain would increase competitiveness and provide valuable jobs, particularly for women. Cotton gins are operating below capacity (and possibly below breakeven, depending on fluctuations in the world price of cotton); spinning, weaving, and knitting factories have ceased operations in the past three years. Reportedly only one cotton weaving factory continues to operate. Within the textile/apparel value chain, a) yarn production (spinning) and b) fabric production (weaving, knitting, and converting – dyeing, printing, finishing) are the weakest links and are currently very fragile.

Rebuilding the missing middle will require a business enabling environment to provide investor confidence, multimillion dollar investment, and outside expertise. Turkish textile companies would be good targets for efforts to attract foreign direct investment to rebuild this portion of the textile and apparel value chain in Kyrgyzstan.

Untapped markets. An estimated 95 percent of Kyrgyzstan's garment production goes to export. While the Russian market, in particular, remains an under-tapped but accessible market for Kyrgyz clothing, the domestic market is an opportunity for Kyrgyz manufacturers (especially smaller factories) to build experience, skills, and domestic brands that are important stepping stones to export. Around the world, domestic markets are an important "seed bed" for local producers; they are typically more forgiving, and do not require the costs and paperwork associated with exports. In the case of Kyrgyzstan, the industry has focused on exports, leaving the domestic market to Chinese imports. International experience suggests that this likely represents a missed opportunity. In addition to the local retail and bazaar trade, untapped opportunities abound in the uniform market (such as for schools, hospitality industry, tour guides, and service businesses). Efforts should be made to build Kyrgyz factories' ability to grow their share of the domestic market, supplant cheap Chinese imports, and stage the sector for greater, higher

[21] In shearing the goats (sometimes with simple paper scissors), herders cut as much as one centimeter of length from the fiber, substantially reducing its market value; to preserve the full length of the fiber and potential for premium market prices, cashmere fiber should be collected by combing the goats.

value and volume of export in the future, particularly with the prospect of Kyrgyzstan's accession to the Customs Union.

Low productivity. Low productivity is endemic throughout Kyrgyzstan's textile and apparel value chain. Underlying causes include a combination of:

- outdated equipment or absence of equipment in farms, factories, and vocational / technical schools (fiber and apparel production);[22]
- lack of affordable financing and a weak business enabling environment that make capital investments difficult, prohibitively expensive, or too risky;
- a large number of factories operating in the informal economy thereby lacking access to donor assistance and access to financing;
- the use of machine count as a limiting criterion for inclusion in the patent system of business registration, discouraging investment in new or additional equipment;
- use of poor quality inputs such as sewing thread and sewing machine needles with higher rates of thread and needle breaks per unit sewn reducing efficiency and generating quality defects;
- lack of qualified sewing machine mechanics (particularly for modern electronic equipment) and training for such mechanics;[23]
- lack of knowledge and/or factory work space to design efficient workflow;
- inadequate dialogue between factories and training institutions on skills needs and training gaps;
- failure of donors and implementing partners to include key personnel from the Technical Professional Education Agency's Scientific Methodological Center in important donor-funded study tours to factories, equipment suppliers, and trade shows in Europe, Russia, and Japan (particularly the individuals responsible for curriculum development and approval);
- lack of proper training for sewing machine operators to teach efficient techniques of handling fabrics and garment components, efficient machine operation;
- lack of proper training for quality control inspectors who are an important part of the feedback loop of identifying and retraining sewing machine operators whose sewing quality is inadequate;
- difficulty attracting and retaining qualified instructors at vocational and technical educational institutions because of low teacher salaries
- use of many seasonal or temporary workers to fill seasonal demands, reduce payments for state-mandated social benefits (pensions, annual leave, etc.), or remain below the threshold for outgrowing the patent system; and
- inadequate social compliance (e.g. workplace safety, proper payment of wages, overtime limits); such inadequacy is generally found worldwide to increase labor turnover (movement between factories and/or out of the sector).

[22] Including tractors for organic cotton farmers; de-hairing equipment for cashmere processing; computerized pattern grading and marker making equipment, cutting, sewing, fusing, and embroidery equipment in sewing factories.
[23] This is particularly detrimental because it also inhibits a factory's ability and willingness to invest in modern equipment if no one in the country is qualified to maintain or repair the machines.

Recommendations

We recommend that USAID consider a comprehensive package of discrete assistance activities that would address specific deficiencies and gaps in Kyrgyzstan's textile and apparel sector, leveraging donor assistance to date.

Illustrative candidates for USAID activities to drive job growth through Kyrgyzstan's textile and apparel sector can be found below. Suggested priorities and relative costs per initiative are detailed in Annex D.

Equipment grants and infrastructure development:

Laboratory development: provide support and assistance for Kyrgyzstan to develop its own testing laboratory to certify quality of textile products, including support for laboratory design, equipment specifications, procurement of equipment, and training for laboratory workers. At this time, the Center for Standardization and Metrology under the Ministry of Economy is the most viable candidate to receive this assistance. However, if the Kyrgyz government moves forward with the "Technopolis", USAID could consider working with the public and private sector to establish a new laboratory within or with close proximity to the industrial zone to speed testing and certification.

Tractor for BioFarmer Cooperative: eliminates dependence on local merchant operating a monopoly on renting out the region's only tractor, provides a source of income for the cooperative under a fee-based usage service, and creates competition in a market that has sufficient latent demand for two or more suppliers. Such assistance would leverage the work Helvetas has already done and continues to do, and would leverage existing international market linkages, to drive a greater overall level of positive impact.

Computerized pattern-grading, marker making software, plotter, and supplies to LEGPROM South: reduces fabric waste[24] and improves product fit and quality for small garment factories unable to justify individual purchase of the equipment.

Key equipment grants to democratically-run industry organizations such as LEGPROM, LEGPROM South (the LEGPROM branch covering Osh and nearby communities), SoyuzTextil, the Cashmere Producers Association, and the Osh Business and Training Center provides vital assets the organizations could use to provide meaningful fee-based services to facilitate expansion of members' product offerings and members' productivity while building organizational sustainability.

Specific equipment for individual factories: helps bring these factories up to international industry standards, supports growth of individual businesses, and encourages further sector growth in Kyrgyzstan. Learning from other donors' efforts in this area (see GIZ's purchase of sewing machines for Shvei Profi) about requisite complementary and

[24] Fabric is generally the largest cost component of a manufactured garment, so anything that reduces fabric waste directly and positively impacts competitiveness and profitability.

concurrent skills development will also be essential.

Targeted technical assistance:

Support the Cashmere Producers Association to create a second elite cashmere breeding herd:[25] will assist rural herders to obtain premium prices for cashmere fiber.

Support for LEGPROM to develop a searchable database of suppliers and potential buyers to facilitate creation of additional market linkages.

Public-private partnership (PPP) for Belfast MiniMill: the Osh Business and Training Center, whose director is American, is undertaking sound and meaningful work on behalf of the cashmere herders, with hopes of bringing a small processing mill (Belfast MiniMill) to Kyrgyzstan in partnership with a U.S.-based company in Ohio. Supporting this PPP would provide additional capacity to the growing premium fiber industry and help cashmere producers command better prices for their fiber.

Social media campaign to differentiate Kyrgyz cotton: A misleading YouTube video or blog discussion alleging or implying that labor abuses are rampant in the harvesting of all Central Asian cotton could greatly harm or even destroy the market for Kyrgyz cotton, and undo all the good efforts of international donors to build the success of the BioCotton project and BioFarmer Cooperative. We recommend that the BioFarmer Cooperative and/or BioCotton project launch a proactive social media campaign (including one or more YouTube videos) to differentiate Kyrgyz cotton.

Social and regulatory compliance:

Provide training to build awareness of proper compliance issues: needed industry-wide, to include compliance and fire safety training to factories, especially in the apparel and textile manufacturers. USAID could consider providing this training to industry associations, individual businesses, training and education institutions, and government officials.

Cost-sharing international 3rd-party social compliance auditing and certification: such as the U.S.-based Worldwide Responsible Accredited Production (WRAP)[26] organization, SGS, or Intertek Test Labs, or others will raise awareness of the issues of compliance, reward lead factories that are largely compliant, prepare Kyrgyz companies for broader export beyond Russia, and position Kyrgyz companies well for the day when Russian

[25] Kyrgyzstan has one elite breeding herd (a small herd of elite animals that provide genetic support for the entire industry). Cashmere expert Dr. Carol Kerven has worked to conduct scientific research and provide training and technical assistance to the Cashmere Producers Association in Kyrgyzstan, and identified the need for a second elite breeding herd as a vitally important mechanism for ensuring the sustainability and growth of Kyrgyzstan's premium quality cashmere fiber production and marketing. The elite herd is at risk of inbreeding, and is not large enough to support a significant expansion of cashmere exports.

[26] Full disclosure: the Textile and Apparel consultant who conducted this assessment is a member of the International Advisory Group of WRAP.

buyers require social compliance within their supply chain[27]. It would also help differentiate Kyrgyz garment factories from its neighbors, and help safeguard the safety, health, and welfare of its workers.

Training:

Quality control inspectors: industry-wide needs for ensuring apparel manufacturing quality. This training could be delivered to industry associations, individual businesses, and training and education institutions.

Operators and mechanics for sewing machine and other highly-specialized machinery: provide entry-level and advanced training in specialized machinery so that Kyrgyz companies can operate and properly maintain sewing and specialty equipment, including modern electronic equipment necessary to increase competitiveness of the Kyrgyz garment and apparel manufacturing sector. This training could be delivered to industry associations, individual businesses, and training and education institutions.

Middle managers, senior production managers, and line managers: provide training for Kyrgyz workers to advance technical and managerial skills, allowing for growth of the Kyrgyz manufacturing sector, ensuring a larger pool of well-trained workers at every job level, not just for low-skill positions. This training could be delivered to industry associations, individual businesses, and training and education institutions.

Access to affordable financing:

Industry-wide: individual textile and apparel producers will require broader access to affordable financing to ensure steady growth of the sector.

Exposure to best practices:

Study tours: specifically target technical professional agencies and vocational technical training instructors to learn from other countries' experiences in building up the garment and apparel manufacturing sectors.

Case studies: the Kyrgyz government announced, in March 2013, plans to create a Technopolis, or industrial park for the textile and apparel sector. This is to include a training center, among other support services. USAID created a state-of-the-industry training center to support job creation and skills training for Haiti's garment sector in 2009-2010. A case study on the design, development, and launch of the Haiti Apparel Center[28] could share valuable experience to inform the design of a training center for the planned Technopolis.

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[27] Experience in other middle-income countries suggests that it could become an issue.

[28] The Haiti Apparel Center (HAC) project was implemented by CHF International in 2009-2010 under the USAID KATA job creation program. The textile and apparel consultant managed the design and creation of the HAC. The HAC was notable for being a comprehensive training facility including training for all points of the supply chain, from machine operators and mechanics to managers.

Conclusions

Kyrgyzstan's textile and apparel sector is vital to the country's economic health, stability, and job creation. Kyrgyzstan produces important natural fibers in demand on the world market, though there is a significant risk of international boycott if associated or confused with Uzbek cotton. Kyrgyzstan produces garments for export primarily to Russia and Kazakhstan, but the Customs Union requirements for product safety and quality testing serve as a non-tariff barrier. Regardless of if/when Kyrgyzstan joins the Customs Union, a certifiable testing and certification lab is important. Moreover, technical assistance to support the sector will have a positive impact on women; assistance to cotton and cashmere producers specifically will positively impact rural Kyrgyz with limited alternative economic opportunities.

Yarn and fabric production is negligible in Kyrgyzstan and will require an improved business enabling environment plus strong foreign direct investment with accompanying technical assistance. Productivity is low across the value chain, due to obsolete equipment, inefficient processes, and a lack of skills, training gaps, and more. However donor assistance to date has been helpful and continued assistance is advised. With Customs Union accession looming, the window of opportunity to strengthen Kyrgyzstan's textile and apparel sector for long-term sustainability and further job creation is closing, making assistance an urgent and important need.

Four local industry organizations representing more than 700 firms and thousands of workers are viable, offering meaningful services to their members. One additional organization (labor union) requires further assessment to determine its effectiveness. A sixth organization, a U.S.-run NGO, provides important services. These organizations provide valuable levers or implementing partners for further donor assistance.

The Customs Union, EU, North American markets, and increasingly those in the rest of the world require compliance with strict product safety and quality standards. In particular, standards and testing requirements for presence of banned or restricted metals and hazardous chemicals have become more onerous in recent years. Kyrgyzstan has no certifiable testing and certification lab; assistance for the design, specification, and equipping of a properly conditioned, properly equipped testing lab is both urgent and important, but costly.

Compliance, especially for safety, occupational health, and treatment of workers has recently become the focus of unprecedented international attention as a result of apparel factory tragedies in Bangladesh; social compliance is low in factories across Kyrgyzstan's textile and apparel value chain. Training and assistance for auditing and international compliance certification is important both for growth of Kyrgyzstan's export market share and for safeguarding the safety, health, and welfare of its citizens.

Critical training gaps undermine development of a productive sector; assistance to fill these gaps is important and urgent.

Last, USAID and the international donor community at large, have provided important assistance to factories, training institutions, and industry organizations in Kyrgyzstan's textile and apparel sector and these have been critical to driving the sector's success to date. However, the next two to three years, in particular, are crucial to the sector's sustainability and growth, and its ability to continue providing much-needed jobs. Continued USAID support through equipment grants, technical assistance, and improvement to the business enabling environment is urged.

SECTION 2. TOURISM SECTOR ASSESSMENT

Directly contributing 3 percent of GDP—and indirectly up to 9 percent — the tourism industry represents a robust and growing component of Kyrgyzstan's economy. With major cultural attractions, picturesque landscapes, and untapped international markets, tourism has the potential for even more rapid expansion and job creation across all skill spectrums of the Kyrgyz labor market. By establishing and coordinating international marketing efforts, encouraging the development of basic industry standards, improving local planning, and making low-cost, key investments in tourism infrastructure at major attractions (e.g. tourism information kiosks), Kyrgyzstan stands to continue benefiting from this important service industry.

Methodology

Research included a desk review of industry association data and analysis, donor reports, and government strategies; more than 40 meetings with local tourism operators, industry associations, government leaders involved with tourism, and donor organizations focusing on the industry; and site visits to three oblasts (Chuy, Issyk-Kul, and Osh).

Background

Kyrgyzstan was a popular regional destination for tourism during the Soviet era; figures from the 1980s show nearly 1 million tourists annually, nearly all from other Soviet states. Hotels and spas sprang up, along with supporting physical infrastructure including paved roads and administrative infrastructure including travel agencies. However, tourism collapsed after the breakup of the USSR; by the late 1990s, fewer than one-hundred thousand tourists were visiting per year. The sector went through a decade of sharp contraction and disinvestment, from which it has still not entirely recovered.

The last decade has seen gradual recovery, although from a very low base. By 2009, some data sources reported that the number of visitors had come close to 1980s levels.[29] In 2012, the gross added value of tourism was estimated to be approximately 3 percent of formal GDP, and statistics suggest that about 800,000 tourists visited the country. Most of these tourists travel from CIS countries. About 50 percent may visit from Kazakhstan and one-third from Russia, with 1 to 2 percent from European countries.

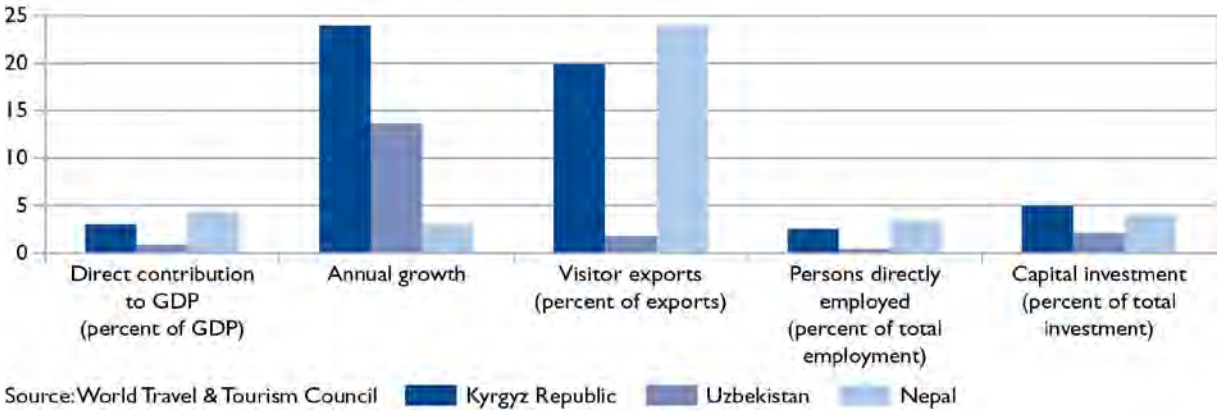
Tourism employs about 40,000 people, or around 1.7 percent of Kyrgyzstan's total formal employment. According to estimates, indirect and direct employment related to tourism was 118,000 in 2011, about 5.2 percent of the workforce.[30] Informal participation

[29] Tourism numbers vary depending on the source. For example, the State Committee for National Security has the visitor figure for 2012 at more than 3 million people. This is unlikely. Kyrgyz Immigration gives a figure of 426,000 – barely one eighth as many. The Tour Operators Association gives a figure of 800,000, consistent with airport arrivals, and so seems most plausible.

[30] These figures should be viewed with even more caution, since they combine the official figures for tourism employment (probably not reliable) with the official figures for employment (definitely not reliable). The tourism sector certainly employs significant numbers of informal sector workers who are not captured in these figures.

in the sector is thought to be quite significant, though official estimates are not available. Tourism statistics for Kyrgyzstan compare favorably with neighboring Uzbekistan, a country known for its cultural tourism. On the other hand, Kyrgyzstan compares less favorably with Nepal, which has similar natural endowments and comparable cultural attractions. According to the World Travel and Tourism Council, while tourism contributed 2.9 percent of GDP in Kyrgyzstan in 2012, it accounted for approximately 0.9 percent and 4.2 percent of GDP in Uzbekistan and Nepal, respectively. However, the sector is still underdeveloped and underperforming.

Exhibit 3. Select Tourism Indicators (2012)



Some of Kyrgyzstan's major attractions include:

- Lake Issyk-Kul, the second-largest alpine lake in the world;
- the Tian-Shan mountain range, which rises from the Kazakh steppe;
- its status as a critical section of the historic Silk Road;
- historic cultural sites, including centuries-old mosques, churches, mausoleums, and bazaars; and
- community-based tourism.

In our assessment, the country could be a major regional tourism destination. Tourism for the last five years has accounted for a relatively low 1.5-2.9 percent of formal GDP. Direct capital investment in Kyrgyzstan's tourism industry, 5.0 percent of overall investment, is relatively strong compared to other countries (2.2 percent in Uzbekistan and 4.1 percent in Nepal). However, more investment, foreign and domestic, is needed as capital provision is not keeping pace with demand to build hotels and other capital-intensive projects in the most popular destinations, notably the Issyk-Kul region. Foreign direct investment (FDI), which not only brings capital but industry know-how and best practices, appears to be fairly low. While the raw numbers are now approaching late-Soviet era level, the structure of the sector has undergone significant changes since the 1980s: there are fewer large hotels, spas, and ski resorts which might attract FDI and many more small hotels and pensions. Yet, even domestic investment is constrained: banks are hesitant to loan to the industry due to perceived risk and low return on investment (ROI). We discuss access to capital in detail later in this section.

Findings and Opportunities

The assessment team identified the following issues and constraints as significant in affecting sustained growth in the tourism sector.

Limited marketing and brand awareness. There is general agreement among industry associations and those interviewed in the private sector that Kyrgyzstan is not well-marketed as a tourist destination, regionally or abroad. Historically, other countries and tourist destinations have benefited substantially from a well-organized, appropriately branded, and targeted effort to attract new markets or build on existing ones. Tourism campaigns are often arranged by a relevant, focused government agency or promotion board, a tourism industry association, or a collaborative effort between the public and private sector. The assessment team did not identify an advertising campaign in any target market promoted by the Kyrgyz government or any organized body of the tourism industry. There are no known advertising campaigns or marketing videos.[31] Branding is weak.[32] The government and tourism industry have not conducted marketing studies in foreign markets, so development of new services is based on a combination of past experience and speculation.

More than 80 percent of tourist arrivals come from two countries: Russia and Kazakhstan. Uzbekistan and Belarus add another 10 or more percent. Beyond that, based on official arrivals statistics and interviews with tourism associations, Kyrgyzstan is little-known as a tourism destination.

A 2013 survey conducted by a reputable Kyrgyz consulting firm found that more CIS travelers relied more on word-of-mouth or personal experience (42.5 and 36 percent) for information on traveling to Kyrgyzstan, than did non-CIS tourists (14 percent and 32 percent, respectively).[33] Non-CIS tourists tend to rely more on information sources that the government and industry are not adequately addressing, such as internet (25 percent versus 13.9 percent for CIS tourists) and travel agencies (10 percent versus 3.9 percent for CIS tourists).

Potentially lucrative target markets that are choosing competitor destinations. Japan, Singapore, Malaysia, Thailand, and Indonesia receive an estimated 1 million Chinese tourists per year each. The number of Chinese tourists in Kyrgyzstan is negligible, even though the two countries share a common border and many Chinese in Xinjiang province live near Kyrgyzstan's most popular tourist destinations. While there has been much discussion and speculation among tourism industry stakeholders on opportunities to attract Chinese travelers to the country, so far limited efforts have been made.

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[31] A short (~5 minutes) promotional video can be viewed on Turkish Airline flights with in-flight video on demand. The quality of this video is not very high.

[32] A branding campaign resulted in the creation of brand images for "Kyrgyzstan", "Jalalabad" and "Karakul". Other than placing the images on some tourist goods for sale, the campaign does not appear to have been a success; the brand images are not widely used by the government or the private sector.

[33] SIAR Research & Consulting (2013). Survey of tourism market in Kyrgyzstan. Provided by USAID/Kyrgyz Republic.

Similarly, neither the government nor the tourism industry has established an internet portal or web site for tourism in Kyrgyzstan, and there does not appear to be any official effort to spread information about lodging, infrastructure, or attractions. The government has established only two Tourism Information Centers (TICs) in the entire country; both are located in the Issyk-Kul region and only staffed seasonally. There is no centralized online reservation system, nor is there an organized system for feedback between consumers and service providers or the government of Kyrgyzstan (nor between the government and the private sector).

Elimination of visa requirements. The Kyrgyz government has moved to improve the enabling environment for tourism by eliminating visa requirements for 44 countries in 2011. This was a significant achievement, as it was a vast improvement on the previous, highly onerous process for tourists, particularly those from "Western" countries. However, the visa requirement change appears to have gone unnoticed outside of the CIS. All tour operators interviewed reported that they are still regularly getting requests for visa forms and visa information.

Collection of statistical data for the sector appears to be very poor. Official statistics are often contradictory, both with statistics provided by industry and with each other.

Weak intra-industry international linkages. Networking in the sector is poor, especially at the international level. Interaction at the regional and international levels can contribute to establishing standards, diffusing best practices, and creating cross-border initiatives. Kyrgyz participation in conferences and industry fairs is intermittent and often weakly supported. With the exception of a few large actors, international business to business connections are weak to the major markets, notably Russia and Kazakhstan, and almost nonexistent in other target and potential target markets. Kyrgyz consulates and diplomatic representatives do not appear to provide any support to the sector, whether in terms of marketing Kyrgyzstan as a destination, providing information to prospective travelers and investors, supporting business to business links, or simply collecting relevant information on the target markets.

Cooperation at the regional level is weak. A few tours do cross national boundaries, particularly "Silk Road" tourism from Uzbekistan and Tajikistan, but there is little discussion on how to integrate services between neighbor countries. A new regional umbrella organization, the Central Asian Tourism Association (CATA), was launched by business associations from Kazakhstan, Kyrgyzstan, and Tajikistan at the March 2012 Berlin International Tourism Fair. It is yet unclear whether this will lead to significantly better linkages and integration across the region.

Seasonal issues in Issyk-Kul. The peak tourist season in the Issyk-Kul region, one of the country's most popular destinations, is short —about 50 days per year, late July to early September. (There is a second, much smaller peak in December and January.) The region collects about half its gross total annual revenue during these 50 days. Hotels in the Issyk-Kul region cannot accommodate all of the peak season visitors, especially middle-

and high-end hotels. This situation is exacerbated by the lack of a centralized online reservation system, which limits referrals and coordination. Construction of new hotels is ongoing, but does not keep pace with rising demand. Other facilities, such as the amusement park at Lake Issyk-Kul, report long lines and maintenance issues during these peak weeks, followed by months of profitless inactivity.

The seasonality is partly driven by the region's climate. Summer is short in Issyk-Kul. Outside of this 50-day window, water sports are unpopular because the lake's water temperature is too cold then. For about half of the year, the hiking trails in the mountains are impassable due to snow. That said, it is not inevitable that the season should be as short as it is. During the Soviet era, tourism extended over a much longer period, with boating, camping, climbing, and hiking taking place in late spring and early autumn as well as summer.

Issyk-Kul is Kyrgyzstan's largest tourist destination, so the intense seasonality raises a number of issues. The summer boom creates thousands of jobs, but all are temporary, and almost all are in the shadow economy, with payment in cash "under the table." Seasonality also makes banks more reluctant to lend to the sector, since a single bad season, such as 2011's, can wipe out a year's profits and render a loan nonperforming.

Weak planning in Issyk-Kul. Growth around Lake Issyk-Kul has been rapid and haphazard in recent years, with little deliberation by government institutions on long-term development or environment considerations. Unsurprisingly, the result has been a chaotic tangle of poorly planned hotels, villas, and pensions, often built rapidly with little regard for the overall layout of the region, the capacity of local infrastructure, or the impact on the environment. The Japan International Cooperation Agency (JICA) conducted a study on integrated development of the Issyk-Kul Zone in 2003 and 2004, which proposed a master plan for integrated Issyk-Kul development. It does not appear that this plan was adopted. More recently, the ADB launched a Issyk-Kul Sustainable Development Project, a longer-term initiative to support environmental management and improve urban service delivery in the Issyk-Kul oblast. The project is intended to improve urban infrastructure, including sewerage and sanitation, solid waste management, and water supply in the towns around Lake Issyk-Kul (Balykchy, Cholpon-Ata, and Karakol). Meanwhile, however, growth in the Issyk-Kul region has continued to be haphazard and unplanned.

It is worth noting that, according to reports by the UNDP, JICA, and USAID's Local Development Program (LDP) the Issyk-Kul region has considerable potential for cultural tourism. However, this has largely gone untapped in favor of adventure and leisure activities on and around the lake, while cultural tourism has been restricted to the Silk Road route, the Ferghana Valley, and Osh.

Poor reputation for sanitation and cleanliness. When asked about positive and negative images of Kyrgyzstan abroad, international visitors agreed on most points. Positive comments almost always included "gorgeous scenery" and "friendly people." Almost

without exception, negative words included "dirty" and poor "sanitation"."[34]

A recent study for USAID's LDP project found that non-CIS tourists' top recommendations to the Kyrgyz tourism sector (after repairing access roads) were "improve sanitary and hygiene conditions (e.g. toilets, shower)" (19.6 percent) and "remove garbage from recreation areas" (13.2 percent).

Similarly, in its major markets of Russia and Kazakhstan, Kyrgyzstan appears to have a reputation as a poor country where norms of sanitation and cleanliness are not consistent. Travel agents and others report that Kyrgyzstan has a negative image for food safety; a lack of drinkable water; a lack of modern plumbing and toilet systems; dirty hotel rooms that are poorly and irregularly cleaned; and dirt and trash at beaches and other tourism attractions. In the same USAID/LDP survey, CIS respondents top recommendations were to (1) "clean recreation places from garbage" (19.5 percent), (2) "repair access roads to accommodations" (19.1 percent), and (3) "improve sanitary and hygiene conditions (toilette, shower, etc.)" (13.8 percent).

No legal framework for the tourism sector. Kyrgyzstan's law "On Tourism" is outdated and does not reflect the needs of a modern tourist industry. While attempts have been made to address this in a piecemeal fashion (e.g. visa requirements), the government has not developed a modern legal framework for the sector generally. The laws that do affect tourism, such as the law on hotels, generally date to the 1990s, deal only with narrow and specific issues, and have not been reviewed for compliance with current international best practices. Some industries, such as travel agents and tour guides, are largely unregulated. This raises real concerns across a wide range of issues. For instance, the absence of a licensing system for guides means that untrained guides may be leading dangerous and highly technical mountaineering expeditions. The absence of a legal framework also means that, among other things, there is no formal framework for dialogue between government and the industry.

However, not all stakeholders are eager to see a law on tourism. Many private sector stakeholders do not trust the ministry's ability to draft a solid law, do not believe that Parliament can pass such a bill without dangerous, corrupt, or unreasonable amendments, and do not trust the government to implement or enforce it.

No functioning national tourism strategy. Kyrgyzstan has had a number of tourism strategies over the last 10 years, including the recent Events Plan for Tourism (2012) and the Stability and Worthy Life Program (2011). These strategies do not appear to have produced significant results. This is likely due to a lack of capacity among relevant ministries, and poor communication between the GOK and most private sector stakeholders.

[34] "Bad roads" and "poor service" also appeared consistently. The most recent study (the 2013 "Survey of Tourism Market in Kyrgyzstan", conducted for the USAID LDP project by SIAR Research & Consulting), confirms this anecdotal data; see, e.g., pgs. 43-49.

The most recent government tourism strategy has nearly been completed. It appears to have been drafted with almost no input from private sector stakeholders, and the capacity at ministries relevant to tourism remains weak. Furthermore, the strategy appears to be largely a "wish list" of activities for donor assistance, rather than a coordinated strategy for the government to achieve particular goals in cooperation with donors and the private sector.

Kyrgyzstan also has a National Sustainable Development Strategy, which includes a section on tourism. This, too, is largely a wish list for donors, though does appear to have involved some stakeholder input.

Lack of leadership. The assessment team observed several recurring themes throughout its interviews with the industry. "There is no vision." "The sector is fragmented." "Communication is not strong." "Nobody is taking the initiative." "Nobody is in charge." "There is no leadership." While these statements are broad and general, they were repeated so often, and by such disparate stakeholders, as to suggest that lack of leadership is an underlying constraint. There is a widespread perception that no one is providing either leadership or a clear vision to move the sector forward. In this context, it should be noted that Kyrgyzstan lacks a Tourism Promotion Board or equivalent.

Relatively strong system of stakeholders. One noteworthy aspect of the sector is its relatively strong system of organized stakeholders, including the Kyrgyz Association of Tour Operators (KATO); the Kyrgyz Tourism Association; the Hotel and Restaurant Association; the Association of Resort and Health Facilities in Issyk-Kul; the Kyrgyz Community Based Tourism Association; and CACSARC (Central Asia Crafts Support Association's Resource Center) in Kyrgyzstan. These stakeholders have all existed for years, are well informed and well grounded in their relevant industries, and have some capacity to work with donors or the GOK in advancing reforms. There are also several competent local stakeholder organizations, such as the Karakol and Cholpon-Ata Initiative Groups.

A common theme in interviews with these organizations was the limited capacity and unreliability of the government of the Kyrgyz Republic, along with a perceived lack of interest from the government in their opinions or input. Several also complained that donor engagement with industry associations seemed sporadic and driven by donor and government goals and policies rather than the actual needs of the sector.

Small-scale successes in community-based tourism. With most tourism activity localized around major destinations like Lake Issyk-Kul, Bishkek, Karakol, and Osh, other regions in Kyrgyzstan have not benefited as substantially or directly from the industry. Additionally, some communities close to these sites have not been integrated as part of the sector. Since 1999, HELVETAS, a Swiss development organization, has taken a leading role in promoting community based tourism (CBT) as an approach to address this imbalance. CBT is generally defined as tourism which is owned and/or managed by communities and generates wider community benefit. For example, a portion of profit generated by a CBT operation might support a local development initiative such as a new

primary school. Other benefits are more intangible, such as preserving natural resources or a way of life. In Kyrgyzstan, CBT ventures tend to be culture and ecotourism services that generate incomes for rural families and are designed to preserve local culture and the local environment. Kyrgyz CBTs offer tourists booking services for unique home-stays, stays in yurts, outdoor excursions (e.g. hiking/trekking), and guided tours of cultural and historic sites, among other services.

Communities throughout Kyrgyzstan are in a strong position to benefit from CBT. The traditional, nomadic way of life coupled with unique access and knowledge of the country's natural resources offer a compelling attraction for culture-based tourists and ecotourists. At least eighteen rural and mountain communities in the oblasts of Osh, Jalabad, Naryn, Talas, and Issyk-Kul have formed self-managed community based tourism operations. HELVETAS and the Kyrgyz Community Based Tourism Association (KCBTA or Hospitality Kyrgyzstan), which HELVETAS helped establish in 2003, provides capacity building, institutional development support, and marketing assistance to these communities. Currently, KCBTA represents approximately 350 family CBT ventures and 1,400 individuals. By demonstrating successful ventures, collaborating with the government, and promoting and booking CBT through its website, KCBTA appears to be succeeding in carving out an attractive CBT niche and even becoming part of the mainstream tourism industry in Kyrgyzstan.

High level of donor engagement. A number of donors are already engaged with the tourism sector. These include JICA (Forest Management project, One Village One Product, study on urban transportation in Bishkek), the Asian Development Bank (Issyk-Kul Sustainable Development Project), CAREC (Transport Corridor 1), the World Bank (Second Village Investment Project), the Lichtenstein Development Service (T-STAR, Tourism Skills Training in Rural Areas), SADEC (some programs indirectly associated with tourism, such as improving infrastructure, water supply, and sewage treatment in major cities), and of course the USAID LDP project.

While the level of donor engagement is high, and likely to continue to be so, it does not appear that the sector is oversaturated with donor investment. For example, guide certification is one need for support that is not currently addressed by the donor community. As noted above, some private sector actors complain that donors have not engaged with them and/or are not advancing private sector interests. There would appear to be areas where additional donor attention might be useful, as discussed in the team's recommendations below.

Poverty reduction and job creation. There is a general consensus that the tourism sector has been a powerful engine of job creation in Kyrgyzstan, especially in the last two years. It is difficult to put numbers on this consensus, because many if not most of the jobs created are in the informal sector. As previous discussed, the tourism sector officially employs about 42,000 people, an estimated 121 percent increase since 2007. The actual numbers are certainly much higher and, if seasonal and intermittent jobs are included, undoubtedly exceed 100,000. The multiplier effect for tourism is high: relatively modest investments can create large numbers of jobs, which in turn can create still more

secondary jobs. Furthermore, anecdotal and indirect evidence from the Issyk-Kul region suggests that tourism is playing an important role in alleviating poverty: this oblast should be one of the poorest in the region, but a variety of statistics suggest that tourism has dramatically reduced poverty there.[35]

Business Environment Issues Affecting the Tourism Sector

Lack of access to finance. Access to finance is an issue throughout all levels of the tourism sector, from hotels and pensions, to drivers and amusement park operators, to input suppliers. One small hotel manager interviewed by the assessment team complained of difficulties with its laundry service; upon investigation, the laundry service was using Soviet-era machines that regularly broke down. The laundry service had a steady income stream, but still could not obtain a loan from a local bank to buy new machines. More generally, lack of access to finance is inhibiting the sector's growth, from the construction of new hotel rooms to the purchase of new cars and buses for tour operators.

A problem across much of the sector is that tourism is perceived as risky. Banks repeatedly mentioned the social unrest events of 2010, which caused tourism to crash dramatically in the summer of that year and to remain somewhat depressed well into 2011. Banks also have stated that they perceive tourism as a sector with low ROI, meaning that most actors in the sector cannot pay high interest rates, and/or have difficulty meeting the typical, regular, and frequent repayment schedule of a bank loan due to the seasonality of the industry. Given that a large portion of recent growth in the industry has focused on small hotels, pensions, and other small enterprises, lack of access to bank credit for working capital and capital projects has been particularly constraining to the tourism industry.

It is unclear whether the banks' perception of a low ROI is actually borne out by the data. Given the generally underdeveloped nature of the sector, it appears likely that at least some opportunities for high return on investment should exist. In this context, it is worth noting—as discussed in this report's discussion of the business enabling environment—that the tourism sector is relatively well served by MFIs, who do make loans to a wide range of individuals and businesses. Many small "bed and breakfast" pensions have been started or expanded with MFI loans, and many tourism support businesses – from drivers to craftsmen to small shops – have accessed financial services through MFIs. MFI loans typically have interest rates that are higher than most bank-based commercial loans, but their non-performing loan rates are not significantly higher than those for bank loans. This suggests that MFIs are more efficient than banks at finding borrowers that can deliver a high ROI.

However, while the role of MFIs appears important, it is also limited. The average MFI loan in the tourism sector appears to be around $6,000, and no loans are larger than approximately $20,000. An MFI loan can start a new pension or purchase a small number

[35] Official statistics show that Issyk-Kul is still one of the country's poorer provinces. However, a range of other statistics – from energy consumption to the number of new construction permits granted – suggest that economic activity and employment are at a much higher level than the official statistics would suggest.

of jet-skis, for example. But, it cannot finance a new twenty-room hotel, a conference center, or even a tour bus. Furthermore, the MFI sector as a whole has limited capital. The tourism sector must compete for this against potential borrowers from agriculture, manufacturing, and other sectors. Thus, MFIs alone cannot possibly satisfy the tourism sector's demand for capital.

Limited human resource capacity. Limited human resource capacity affects many sectors of Kyrgyzstan's economy, but it represents a particular constraint for tourism. There is an acute shortage of skilled and semi-skilled workers, and there is high staff turnover. Professional training is weak; professional standards do not exist, nor are there certifications for skilled positions, such as mountain guides or historical site tour guides. The level of cooperation between educational institutions and the private sector was found by the assessment team to be quite low. Hotels and travel agencies report tremendous difficulties in finding skilled workers. Every large hotel and travel agency interviewed stated that they had elaborate (and expensive) internal training processes, and that this was an ongoing necessity in order to assure that their workers had the required skills. A complicating factor is the steady loss of qualified workers from the Kyrgyz tourism sector to jobs abroad, especially in the CIS. As one travel agency manager put it, "a Kyrgyz [citizen] who has learned to be a competent hotel manager is a Kyrgyz who could be making three times more money in Moscow."

Taxation. The tourism sector is subject to several of the same broader taxation issues related to frequency of payments, potential for multiple annual audits, and corruption that afflict other businesses in Kyrgyzstan. However, the labor-intensive nature of the sector means that the administrative burden of labor-related taxes (e.g. Social Fund and medical) is a particular problem. Additionally, hotels and spas must pay special taxes. (The hotel tax is set higher than the spa tax, which is a complaint of the hotel association.)

Open skies and the EU blacklist. Kyrgyzstan has ten airports including four international airports (Bishkek, Osh, Issyk-Kul, and Karakol, with the last operating only intermittently). Fifteen local Kyrgyz airlines are licensed to operate within the country; most of these are small, but three are large and offer regular scheduled services between the country's major cities. Both domestic and international air traffic have seen very rapid growth since 2010, with arrivals at Manas Airport (Bishkek) alone increasing by about 40 percent between 2011 and 2012. However, flights in and out of the four international airports are relatively restricted. The Kyrgyz Civil Aviation Authority (CAA) has only allowed three foreign airlines to operate in Kyrgyzstan, and has sharply limited the number of flights that each is permitted. International flights only connect to Russia, Kazakhstan, Turkey, and the United Arab Emirates.

Unsurprisingly, this limitation on competition means that international fares to and from Kyrgyzstan are relatively high. In fact, fares are so high that many travelers prefer to fly in and out of Almaty. Even considering the time and cost of the Almaty-Bishkek trip, fares to and from Almaty are so much lower, and the selection of flights and destinations is so much greater, that traveling to and from Almaty becomes an attractive alternative.

One local travel agent estimated that "between a hundred and two hundred people per day" travel into Kazakhstan to catch flights there. The Ministry estimates that the economic loss to Kyrgyzstan is "about $30 million per year." While these figures are speculative, it is clear that the numbers are significant and the loss of opportunity is real. Given the high prices and relative inconvenience of flying to and from Kyrgyzstan internationally, air travel is a significant drag on the development of tourism in the country.

Kyrgyzstan has been considering whether and when to join the Open Skies system. To simplify, Open Skies would allow any international carrier to fly to or from Kyrgyzstan, and vice versa. If this came to pass, the likely outcome would be more flights in Kyrgyzstan combined with significantly lower airfares. However, the GOK is concerned that local carriers will not be able to compete under an Open Skies regime. "If the government adopts the project, within two years there will be not one Kyrgyz air transporter [left], regional airports will be closed and more than 1,000 people will lose their jobs," the Kyrgyz Civil Aviation Agency (CAA) stated in a 2012 report. The GOK's position is that this is not simply a question of the local airlines being subsidized or poorly managed. Kyrgyzstan is a mountainous country with bad roads and only a single rail line in the north of the country. Furthermore, even the best roads are frequently closed by winter conditions. The Bishkek-Osh road, connecting the country's two largest cities, often closes for weeks at a time. Regional air service is thus not a luxury but a necessity. However, given the relatively low volume of regional air service and the high fixed costs required to operate an airline, many local routes are unprofitable. Kyrgyz air carriers can cross-subsidize them with the profits from protected international routes into Bishkek. Under Open Skies, this would no longer be possible.

Kyrgyz airlines are blacklisted from flying to Europe, the result of a formal EU determination that the airlines in question do not meet EU standards of safety, maintenance, and other basic requirements. As such, Open Skies alone would put the Kyrgyz airline industry at a sharp disadvantage: it would not be able to fly to European destinations, but European carriers would be able to service Bishkek. As a result, accession to an Open Skies regime is unlikely to happen until and unless the EU blacklist is lifted.

GIZ has been addressing the issue of lifting Kyrgyzstan from the EU blacklist with the Ministry of Economic Affairs.[36] This appears to be a matter that could be resolved within a year or two with a moderate level of donor assistance to Kyrgyzstan's CAA.

Recommendations

It is recommended that USAID consider a package of coordinated technical assistance activities to address the constraints identified in the previous section. Illustrative activities are summarized below.

[36] GIZ produced a detailed report on these issues in early 2013: "The Practicability of Introduction of the "Open Skies" Policy in the Civil Aviation Sector of the Kyrgyz Republic". An English version is available from the Bishkek GIZ office on request.

Activity: Facilitate the development of a national marketing and information campaign

Facilitate brand development and a marketing campaign to attract new markets and expand reach into existing markets. Convene a stakeholder meeting, inclusive of the private sector and relevant government agencies, to develop a national branding message to highlight in a regional and international marketing campaign. Engage a market research firm to study regional and international target markets that would complement each other to address seasonality issues (e.g. cultural tourists from select Western countries that would visit throughout the year, as well as sun and beach goers from Xinjiang province of China) and bring in a sustainable volume of tourists. The marketing campaign should consider Kyrgyzstan's current capacity and service level, including considering phasing outreach to target markets. For example, the outreach effort should not attempt to bring in more visitors than Kyrgyzstan's tourism industry can accommodate until more capacity is developed. Demanding clientele, such as Western cultural tourists, could be targeted after the capacity has been built to accommodate higher end spending capacity and more rigorous industry standards for cleanliness, signage, etc.

Support the development of a tourism promotion website. Encourage and support government efforts to develop a portal for tourism in Kyrgyzstan. Encourage the participation and input of the private sector. The portal should include basic information about visas, travel to and from the country, attractions, officially registered operators, and explore integrating for the functionality for centralized booking.

Support the establishment of standardized Tourism Information Centers and signage. Facilitate the establishment of tourist information centers at major cultural sites, along popular attractions along the Silk Road, and in Bishkek. Smaller unmanned kiosks could be placed at the entrances to major hiking trails and near major resorts. Larger tourist information centers should include information about local attractions—including off-season attractions, cultural sites, and CBT venues — as well as national highlights, and they should comport with the country's national branding strategy. Each information center and kiosk should include discussion of appreciating and respecting the environment, and should promote a "tread lightly" philosophy. Those that are manned should provide basic training for personnel on hospitality/friendliness, knowledge of local and national sites, history, and standards of cleanliness.

Signage should be posted around primary and secondary sites in Kyrgyz, Russian, English, and possibly Chinese (if the market survey recommended above finds Chinese tourists an attractive target market), and should operate off a basic template to ensure uniformity (e.g. format, color, font) for each site or activity.

Facilitate training for Consular representatives in target markets. Kyrgyz diplomatic and consular representatives do not currently provide support for the tourism sector. Many countries make use of their representatives to market their country as a destination; to disseminate tourism-related information to prospective travelers and investors; to support

business-to-business (B2B) links; and/or to collect relevant commercial information on the target markets. USAID has supported commercial training for consular representatives in other small countries.[37] For example, USAID undertook a commercial training program for diplomatic staff of the newly independent Republic of Kosovo in 2008-2009. It was widely considered a success and is believed to have contributed to significant increases in tourism and FDI. A similar program might be considered for Kyrgyzstan.

Other Activities

Build the capacity of selected counterparts to increase the quantity and quality of tourism-related training. Establish basic professional standards for semi-skilled workers and an association-supported certification for high-skilled positions. Four options exist to improve the quantity and quality of training to tourism industry staff and potential staff: (1) collaborate with universities on advanced technical training (i.e., specialized training in hotel management); (2) enhance the capacity of vocational training institutes that offer tourism-related training; (3) enhance industry associations' abilities to provide training and services to members; and (4) enhance individual businesses' ability to provide on-the-job training and internal technical education. In the context of Kyrgyzstan today, vocational training and working with the associations would appear to be most promising options. Both of these purveyors of training appear to be areas where a modest investment by a donor could pay significant dividends. The T-STAR program has done some work in this area and met with some success, but there is more to be done. Additionally, USAID could work with some of the most inclusive tourism industry associations to develop basic professional standards for semi-skilled positions (e.g. standards of cleanliness for housekeepers), as well as a curriculum and certification for highly skilled positions (e.g. technical mountaineering guides and guides for select cultural sites). Training could be delivered through local affiliates, with certification centralized in the association's head office.

Facilitate the development of tourism "products" or packages that address seasonality. During Soviet times, Issyk-Kul was a major destination for off-season hiking, camping and boating. These activities could be revived, and the levels of investment and planning required appear low. In addition, development of one or more conference centers in the Issyk-Kul region could extend the season with business travelers and cultural event attendees. (This has been discussed by the private sector, but has not yet moved forward. Moreover, the existing winter season could be developed by enhanced marketing and could be extended by keeping the roads more consistently open. In general, the Issyk-Kul season could be extended by developing complimentary activities and diversifying highly focused activities into a larger portfolio of offerings (i.e., introducing mountain biking on existing ski trails). Cultural tourism and CBT offers another avenue to extend seasons. USAID could help industry associations and chambers of commerce to expand the

[37] Small country embassies and consulates usually do not have an Economic Officer or a commercial attaché. However, it is very common for a small country's diplomatic or consular staff to carry out multiple duties, often including technical and commercial duties in support of trade and investment.

abilities of their local affiliates to develop capacity around major cultural landmarks (e.g. tour guides, signage, pensions, and restaurants).

Explore the Issyk-Kul planning issue. The ADB project in Issyk-Kul appears promising, but it is targeted primarily at infrastructure enhancements in the large towns rather than at planning around the entire lake for the benefit of the tourism sector. It is possible that a modest donor effort here could achieve significant results, if it were to gain buy-in from the GOK and other relevant stakeholders. However, the complexity of the issue, and the failure of previous planning initiatives, suggest that a careful exploration should be undertaken before any activity is attempted.

Improve international linkages. This could involve a wide range of targeted activities for government officials in tourism related ministries, private business, and industry associations, including trips to conferences and fairs; support for membership and participation in international organizations such as CATA; and enhancing B2B linkages with tourism businesses abroad.

In addition to these recommendations above, the AMEG assessment team recommends that the following activities either be pursued with great care and caution, or not pursued at all.

*Law on tourism***.** There is some pressure within the Kyrgyz government, and from certain actors in the donor community, to draft and pass a new Law on Tourism. This should be approached with caution. There does not appear to be clarity about what the law would address, enable, or regulate. The private sector is profoundly suspicious of new legislation; they are concerned about the capacity to draft a "good law" and the Parliament's ability to pass it without dangerous amendments. There are also concerns about the capacity of the Kyrgyz government to implement or enforce a law.

This is not to say that a Law on Tourism should not be considered. But it should be advanced very cautiously, based on international best practices and the relevant experience of countries in a position similar to Kyrgyzstan's, and should involve as much stakeholder input as possible. Otherwise, the result is likely to be a law that is widely disliked and ignored as much as possible.

Tourism strategies. We recommend against any further investment in developing national tourism strategies. Research has turned up at least five strategies over the last decade in addition to the tourism section of the current National Sustainable Development Strategy. The assessment team received numerous comments that existing strategies have achieved few results, due in part to limited private sector input and consideration of the limited capacities of the relevant Kyrgyz government ministries.

It is possible to imagine a methodology that would develop a useful new strategy. It would originate from--or at a minimum involve--significant input from the private sector, include clear and achievable goals with relevant milestones, and would not rely heavily on speculative, "wish list" assistance from donors. However, even if such a model could

be developed and followed, we would still recommend against any new strategies in the short term, at least until the existing strategies have run their course and their impact measured.

Open skies/EU blacklist. AMEG does not recommend that USAID commit resources facilitating removal from this list as (1) other donors (GIZ and the EU) are already engaged, and (2) the issue is not only technically complex but highly political as well. However, any project or activity involving tourism should keep apprised of the status of Open Skies and EU blacklist negotiations, as these could potentially have a major impact on the development of tourism in Kyrgyzstan.

SECTION 3. BUSINESS ENABLING ENVIRONMENT SECTOR ASSESSMENT

The business enabling environment is a key contributor to a country's overall economic performance. From macroeconomic issues (e.g. trade policy and interest rates) to microeconomic issues (e.g. obtaining credit or construction permits), businesses can be constrained or buoyed by a number of exogenous factors that affect their competitiveness in international markets and vigor in domestic markets. Small- and medium-sized businesses account for approximately 44 percent of the Kyrgyz economy and employ 14 percent of the formal workforce[38], and are especially sensitive to the enabling environment. They have fewer resources to be able to respond to external forces.

Kyrgyzstan's private sector is helped and inhibited by the Kyrgyz enabling environment. The country ranks 70 out of 185 countries in the World Bank's Doing Business report — slightly ahead of the regional average of 73 — and scores well in particular areas (e.g. starting a business and accessing credit) and poorly in others (e.g. paying taxes and trading across borders).

This section examines some of the most influential exogenous forces affecting Kyrgyz businesses, discusses findings, and outlines recommendations. Significant general business enabling environment issues are discussed first, including corruption, the sovereign credit rating, and the informal economy. The section then discusses issues related to commercial law and associated institutions. It concludes that while most of the law and institutions needed for modern commerce are in place, a significant gap exists between them and successful execution. Issues related to labor and workforce development are discussed next, finding that Kyrgyzstan is lacking in adequate educational, training, and commercial opportunities, and as a result, labor migration and remittances have increased dramatically in recent years. Last, this section discusses issues related to trade policy and competitiveness, concluding that with the country's likely entry in the regional Customs Union of Russia, Belarus and Kazakhstan, improvements in various aspects of trade facilitation and in the ability to measure and meet product quality standards are imperative both to meet the country's membership obligations and to remain competitive.

Methodology

Research included a thorough desk review of reports, data, projects, and articles by international development organizations, industry associations, and media. The assessment team also conducted more than 100 personal interviews, including discussions with government ministries, government regulators, donors, multilateral institutions, private sector organizations, lending institutions, unions, courts, credit

[38] IFC (2010). Investment Climate in the Kyrgyz Republic as Seen by Small and Medium Enterprises. http://www1.ifc.org/wps/wcm/connect/4c2722804cc009beacb4edf81ee631cc/PublicationKyrgyzstanIC-2010.pdf?MOD=AJPERES

bureaus, NGOs, and others. The assessment team traveled to meetings throughout Osh, Jala-abad, and Bishkek to gather information. A list of relevant meetings is in Annex A.

Background

Kyrgyzstan's economic growth rate averaged 5.1 percent from 2007 to 2011, (official) unemployment in 2011 is estimated at 8.6 percent, and per capita income for 2012 is estimated to be $2,400 (purchasing power parity, current U.S. dollars).[39] The government's market-based orientation and positive approach to the business enabling environment following the dissolution of the Soviet Union has contributed greatly to the country's growth and poverty reduction. In many ways, Kyrgyzstan is already benefiting from modern laws and institutions. Indeed, out of 185 countries, the World Bank ranks the country favorably in major components of the enabling environment, including accessing credit (ranked 12th), starting a business (15th), registering property (11th), and protecting investors (13th).[40] Yet, outdated laws, weak implementation, and insufficient capacity within the government remain problematic. In areas like paying taxes (168th), trading across borders (174th), and resolving insolvency (155th), Kyrgyzstan has substantial room for improvement to enhance its economic growth, development, and job creation prospects.

General Business Enabling Environment Challenges

Corruption

Corruption in the Kyrgyz Republic is systemic and endemic. Interviewees from the textile, tourism, and other sectors of the economy consistently reported that corruption affected all facets of Kyrgyz business and life. International businesspersons interviewed for this assessment stated that the high levels of corruption were a disincentive to doing business in the country. Local businesspersons cited the additional time, energy, and money that having to deal with corrupt practices cost them.

[39] GDP growth figures were derived from the World Bank's World Development Indicators Databank, 2013 (http://data.worldbank.org/data-catalog/world-development-indicators). Unemployment figures and per capita income were derived from the World Factbook, 2013 (https://www.cia.gov/library/publications/the-world-factbook/geos/kg.html).
[40] World Bank Doing Business Indicators, 2013 (http://www.doingbusiness.org/data/exploreeconomies/kyrgyz-republic)

Table 5. Corruptions Perceptions Index[41]

Overall Country Rank	Regional Rank	Country / Territory	CPI 2012 Score
51	1	Georgia	52
54	2	Turkey	49
62	3	Croatia	46
69	4	Macedonia	43
72	5	Bosnia and Herzegovina	42
75	6	Montenegro	41
80	7	Serbia	39
94	8	Moldova	36
105	9	Armenia	34
105	9	Kosovo	34
113	11	Albania	33
123	12	Belarus	31
133	13	Kazakhstan	28
133	13	Russia	28
139	15	Azerbaijan	27
144	16	Ukraine	26
154	**17**	**Kyrgyzstan**	**24**
157	18	Tajikistan	22
170	19	Turkmenistan	17
170	19	Uzbekistan	17

According to Transparency International, the Kyrgyz Republic ranks in the bottom quintile globally of its corruption perceptions index, and in the bottom four countries of Eastern Europe and Central Asia.

Corruption exists in all sectors of the economy and all functions of the government. It has been widely reported as one of the fundamental causes of the political unrest in 2005 and 2010. Multiple interviewees related stories of corruption all the way down to elementary schools; some parents pay teachers to give their children grades. (During the field assessment, in fact, one member of the team observed a bribe taking place with only minimal efforts by the parties involved to hide their activities from observation.)

While corrupt practices exist throughout all facets of life in Kyrgyzstan, perhaps the most pervasive area involves taxes and tax administration, particularly with income taxes and customs duties. Kyrgyz citizens and businesses pay multiple taxes, at numerous times

[41] http://cpi.transparency.org/cpi2012/results/

during the year, and are subject to both regular and "spot" audits by tax authorities. This presents many opportunities for corrupt practices to occur and the sporadic schedule of payments challenges effective supervision. Given the pervasiveness of corruption, development interventions must carefully consider its impact, and incorporate appropriate responses into program design and goals.

Lack of a Sovereign Credit Rating

The Kyrgyz Republic is not rated by any of the three main sovereign credit rating agencies: Fitch, Moody's, and Standard & Poor's. This lack of a rating makes it more difficult and more expensive (via a higher risk premium paid for sovereign debt issues) for the country to borrow from organizations other than international donor agencies. While this donor support is important to the basic operations of the country, such funding does little to provide businesses with confidence that their investments in the country are secure and ultimately affects the borrowing rate of individual businesses and citizens. It should be noted that shortly before the political unrest of 2010, Kyrgyzstan had begun the process of applying for a sovereign credit rating.[42] While this effort was temporarily abandoned due to the 2010 revolution, it shows that obtaining such a rating is not beyond the realm of possibility.

The Informal Economy

There is little disagreement that the informal economy in Kyrgyzstan is significant, and one of the largest in the region; how large is debatable. Businesses operating in the informal economy generally avoid registration, taxes, employment contracts, and contact with government officials. The size of the shadow market is difficult to measure but the World Bank finds that more than 65 percent of firms are either unregistered or conducting business informally.[43] Most informal businesses are small enterprises or self-employed individuals. Sectors most commonly associated with informal businesses include agriculture, retail, transport, construction, services (e.g., tourism) and some industrial sectors (e.g., textiles). Perhaps one indicator of the depth of the informal economy is from a World Bank Enterprise Survey that shows that Kyrgyz businesses that begin informally operate in the informal sector for over four years, compared to one year for Eastern Europe and Central Asia as a whole.[44]

Reasons for the extensive size of the informal economy center on the desire of the private sector to avoid both legitimate and illegitimate government intervention into business affairs. In Kyrgyzstan, this often means, but is not limited to, avoiding taxes and minimizing the opportunity of corrupt officials to seek bribes. A UNDP survey reports that as much as 40 percent of business profits in Kyrgyzstan are hidden.[45] By remaining in the informal sector, businesses deprive the state of the revenue needed to improve

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[42] http://eng.24.kg/business/2009/10/13/9325.html
[43] World Bank. 2012. The Investment Climate in Kyrgyz Republic: Opportunities for Reform. World Bank – Europe and Central Asia, Department of Financial Market and the Private Sector. Pg. 8.
[44] http://www.enterprisesurveys.org/Data/ExploreEconomies/2009/kyrgyz-republic#informality
[45] http://www.undp.kg/en/resources/e-library/article/28-e-library/1709-the-shadow-economy-in-the-kyrgyz-republic-analysis-of-the-scale-and-nature.

services and infrastructure, which in turn would facilitate formalization. A further result of the informal economy is that reliable statistical information related to commerce is difficult to ascertain, as demonstrated by range in GDP above, but other important statistics such as unemployment are also affected.

Commercial Laws and Institutions

Most laws and many of the institutions needed to support a market economy are already in place. Many are on par, prima facie, with international standards. It is in the implementation of those laws, and the activities and operations of those institutions, where significant areas for improvement and reform remain. This "implementation gap" was a recurring theme throughout the assessment. The gap is further exacerbated as understanding of many laws and concepts related to modern commerce, such as intellectual property law, is lacking, and therefore their impact is limited.

Laws, Institutions, and Foreign Investment

Most of the nation's commercial laws have been redrafted since Kyrgyz independence from the Soviet Union in 1991, and most meet at least minimum international standards.[46] The assessment team found that, while there are specific areas of the commercial law system that are in need of reform or correction, there is not currently a need for sweeping or wholesale changes to the law. In this respect, discussions with legal practitioners and businesspersons were similar to such discussions in developed nations: the focus was predominantly on relatively minor amendments to resolve inconsistencies and unintended consequences in the law, rather than with systemic problems. Moreover, most interviewees in the private sector were satisfied with their ability to communicate any concerns with specific areas of the law with relevant government partners. That said, the distance between the quality of the laws on the books and their implementation remains vast.

The overall legal framework related to foreign investment is "investor friendly." More specifically, by law foreign investors are able to purchase and own property, are able to repatriate all profits, and, when structuring contracts, are able to insert clauses regarding choice of law and forums outside of Kyrgyzstan. In addition, the law provides for protection of foreign investors from discrimination, expropriation and nationalization of property in the country. On paper, foreigners are allowed to work freely in Kyrgyzstan. (In practice, this is not always the case; the work permit process may involve lengthy delays and is not synchronized with an employee's visa.[47])

Also important to international and domestic investors and businesspersons is the ability to pursue alternative forms of dispute resolution (ADR), such as arbitration. Kyrgyzstan is party to most of the major international arbitration-related documents,

[46] The EBRD has found that laws on secured transactions, insolvency, corporate governance meet "medium" international standards. Some laws related to specific sectors, such as energy and concessions of land, however, are inadequate. See: http://www.ebrd.com/downloads/sector/legal/kyrgyz.pdf.
[47] http://www.state.gov/e/eb/rls/othr/ics/2012/191179.htm

including the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, generally known as the "New York Convention," and the International Center for the Settlement of Investment Disputes (ICSID)[48].

At the domestic level, a framework for state arbitration exists within the oblasts that is associated with the court system. According to Article 4 of the law establishing this system, its purpose is to protect the rights and legal interests of both formal and informal small enterprises.[49] In addition, the Kyrgyz Chamber of Commerce, as a member of the International Chamber of Commerce and the International Court of Arbitration, also performs binding arbitrations. According to the Chamber, they perform approximately 30 arbitrations per year. Statistics related to the Courts of Arbitration are not known, but arbitration is generally regarded as effective and its use is increasing.

Other forms of ADR, primarily mediation and conciliation, are not regulated by Kyrgyz legislation and not used in the country.[50]

Generally, the institutional framework of the Kyrgyz Republic includes most of the legal institutions needed for a functioning market economy. Some of these appear to be functioning reasonably well. For example, the State Registry regarding property was frequently cited positively by businesspersons, banks, and others that rely on its services. It reportedly has more than 98 percent of the land in the Kyrgyz Republic accounted for, and is updating its technology and increasing its capabilities by incorporating GIS technology. Moreover, the State Registry also registers businesses, a service that has been cited as being easy, affordable, and quick since converting to a "one-stop-shop" system in 2008. Indeed, the World Bank Doing Business report indicates that Kyrgyzstan ranks 15th out of 185 economies for starting a business, which takes account of the number of procedures required to establish an enterprise (two procedures), time to fulfill all procedures (10 days), cost (2.8 percent of income per capita), and required minimum capital contribution (0.0 percent of income per capita).

Various interviewees did emphasize one particular reform: a greater ability for data-intensive institutions of government to be able to more easily share information. For example, tax administration officials cited their inability to easily access information from the property registry as an impediment to performing their basic functions. Similarly, representatives of the credit bureau discussed a need to have better access to tax information in order to more easily create and maintain credit information.

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[48] ICSID membership has been used at least once to overturn the decision of a Kyrgyz court. The case was *Sistem Muhendislik Sanayi Ve Ticaret A.S. v. Kyrgyz Republic*, ICSID Case No. ARB(AF)/06/1, Award of 30 September 2009, involving expropriation of a Turkish-owned hotel.

[49] http://www.libertas-institut.com/de/Mittel-Osteuropa/Law%20on%20the%20System%20of%20Arbitration%20Courts.pdf

[50] http://baseswiki.org/en/Kyrgyz_Republic

Court Structure and Administration, and the Legal Climate

For economic disputes, the Kyrgyz court system follows a simple and logical structure — local district ("rayon"-level) courts, and second level regional, or oblast-level courts review and decide on all cases, including civil, criminal, and commercial disputes. Appeals from these decisions are made to inter-district appeals courts that have specific divisions for criminal, civil, and commercial disputes. Final appeals on the merits are made to the Supreme Court, which also uses specific panels for commercial disputes. Within the Supreme Court, there is also separate panel for constitutional issues.

Despite a relatively clear structure, the courts are generally considered weak institutions suffering from corruption and, especially at the lower levels, a lack of capacity. As reported by numerous interviewees, selection of judges at all levels has proven highly controversial. Judgeships are reportedly bought and sold instead of being selected on individual and actual merits. Decisions at the lower levels are ignored at worst or used as stepping stones to higher level courts at best.[51]

Improvements are being made. The EBRD and the International Development Law Organization (IDLO), and to a lesser degree USAID and GIZ, have been involved in a multiyear project training judges at all levels as well as creating a sustainable judicial training center (JTC).[52] Surveys of judges who have completed this program show that it has had a positive impact on their capacity, and users of the court system acknowledge these improvements.

Improvements in court administration, however, lag behind. A visit to an inter-district appeals court showed a case management system completely lacking in modern technological capacities. Complete records of actual court proceedings are rare as court reporting is not a regular part of the court system. Case records consist primarily of the parties' submissions and court findings. Judge's offices consist of law clerks. Judges have little assistance in terms of court administrators or legal assistants. (In fact, there is little understanding of the concept of court administrators.) Current case management systems are not in line with modern standards. The system is slow, paper-driven, and complex. This leads to confusion, delays and opportunities for graft and corruption in court proceedings.

While training has been instrumental in developing the capacity of judges, multiple interviewees stated that legal education and lawyers are inadequate to meet the needs of a market economy. Law schools suffer from corruption as degrees are bought. For those lawyers that earn their degrees, interviewees stated they lack the skills needed for legal jobs and require extensive training.

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[51] This is to some extent deliberate. The Soviet system of justice allowed liberal use of appeal; in some republics, as many as 70 percent of all cases were appealed, and across the USSR the appeal rate probably approached 50 percent. In effect, the Soviets used courts of first instance as filters rather than as final decision-makers. This system survives in several Soviet successor states, including Kyrgyzstan.

[52] See, e.g., http://www.ebrd.com/downloads/research/law/lit11ef.pdf.

Beyond law school, there is no mandatory, regulated bar association for lawyers, and little continuing legal education. While associations of lawyers do exist, they are voluntary organizations and include only a small portion of practicing attorneys. Reportedly, there are on-going efforts to create a formal bar for criminal lawyers, but nothing for lawyers generally. As a result, while there is a *de jure* method of bringing ethics and malpractice complaints against lawyers within the Ministry of Justice, *de facto* very few such complaints are heard. Additionally, some capacity building programs have not been particularly effective (see text box at right).

A Need for Training in Context

While in country, the assessment team had the opportunity to observe a training session on intellectual property rights (IPR) law sponsored by the JTC, the Kyrgyz patent office, and the Commercial Law Development Program of the U.S. Department of Commerce, attended by approximately 40 Kyrgyz judges.

While discussions on the substance of IPR law were broad enough to be of educational value to Kyrgyz attendees, discussions on the administration of IPR cases was likely of little benefit. Presentations were made strictly from a United States perspective with no grounding or relation to the far different reality in Kyrgyzstan.

Taxes and Tax Administration

The tax system poses a significant challenge to Kyrgyz businesses. As noted, it is a major source of corrupt and rent-seeking behavior. Tax officials regularly seek "extra" payments not based in law, and there are reports that failures to pay these "taxes" have led to criminal charges.[53] A World Bank Enterprise Survey found that 39 percent of businesses expected to pay off tax officials, compared to 14 percent in Eastern Europe and Central Asia.[54] Taxpayers, particularly individual and small businesses, are complicit in the cycle of corruption as they regularly hide profits. Overall the relation between taxpayers and tax collectors is adversarial, with each side automatically assuming bad faith on the part of the other.

Beyond the issue of corruption, the actual number and amount of taxes to be paid is significant. Despite reforms and simplifications to both the tax code and tax administration, businesses still must pay various taxes monthly, quarterly, semi-annually, and annually. Nominally, tax rates are reasonable as there is a 10 percent flat income tax for persons and businesses, and a 12 percent value added tax (VAT), making them among the lowest in the region. The reforms in 2008 lowered these from a high (progressive) rate of 33 percent and 20 percent, for income and VAT, respectively.

[53] http://ipp.kg/en/

[54] http://www.enterprisesurveys.org/Data/ExploreEconomies/2009/kyrgyz-republic. Further, 48.4 percent of firms identified tax rates as a major constraint to business (compared to 39.9 percent, overall, in Eastern Europe and Central Asia), and 31.6 percent of firms identified tax administration as a major constraint (compared to 20.4percent, overall, in Eastern Europe and Central Asia). Id.

Tax payments into the Social Fund have a high nominal rate at 27.25 percent of payroll, and are the responsibility of employers. This rate alone leads to many businesses to avoid formalization. Interviewees also cited this tax as one of the main sources of corruption from tax officials, particular among small businesses.

A particularly troublesome aspect of tax administration is the system of tax inspections. These can be both scheduled audits and unannounced, "spot," inspections. It is these latter audits that provide the greatest opportunity for rent-seeking behavior, but even if these audits are in fact legitimate, they still create a burden on businesses – particularly as they can happen, on average, up to three times a year.[55]

Patent system. In an attempt to capture some of the tax revenue lost in the informal sector, the Kyrgyz Republic has created two non-incorporated business structures which allow for highly-simplified accounting and tax payments. These structures, known as sole proprietorships and a "patent" business, provide small businesses relief from the risks of operating informally, provide purchasers of these businesses greater protections, and allow the government to at least gain some of the lost tax revenue.

Sole proprietorships must only keep a simple log of income and expenses. These businesses then submit this to the tax authorities to have their taxes determined based solely on net income. A patent business license is obtained by application with the tax authorities. If it is approved, the license holder will pay a set amount on a monthly basis. Kyrgyz law lists over 100 different types of business activities that may receive a patent license, from courier services that use "a hand cart" (150 Kyrgyz som or just over $3) to servicing boats and yachts (50,000 som, or about $1,000). The vast majority of these licenses, however, are 4,000 som (approximately $85) and under.[56] Patent businesses are then free from other tax-related reporting requirements, but must re-apply either monthly, or if they pay ahead, yearly.[57]

On an annual basis, patent businesses must report if they have exceeded the income threshold for having to pay VAT taxes of 2.5 million som, or approximately $52,000. If they have, the business is no longer eligible for a patent license and must formally register. Interestingly but not surprisingly (given that 68 percent of Kyrgyz businesses feel they are competing against informal businesses[58]), a third-party request may be made that a business formally register with the tax authorities.

These two systems have succeeded in bringing businesses out of the shadows and accordingly have increased government revenues. They have also, however, created a new set of incentives and means for corrupt behaviors. On the one hand, sole proprietorships have an incentive to conceal income in their logs, and patent businesses to lie about their income so as not to not exceed the patent license threshold. On the other

[55] http://www.enterprisesurveys.org/Data/ExploreEconomies/2009/kyrgyz-republic#regulations-and-taxes.
[56] Resolution 733 of the Kyrgyz Republic, "On the approval of the base tax amount for voluntary patents, by types of business activity," December 2008.
[57] Kalikova and Associates Business Guide, http://www.k-a.kg/eng/business-guide (2012).
[58] http://www.enterprisesurveys.org/Data/ExploreEconomies/2009/kyrgyz-republic#informality.

hand, businesses that do exceed the threshold may offer or have demanded from them payments to patent-issuing authorities. Nonetheless, these structures appear to be a net positive; they have provided some additional tax revenue and have given many small businesses a useful "halfway house" between operating in the grey economy and full formalization.

Donor efforts. Over the past few years, a joint project of the ADB and the International Finance Corporation has made strides towards improving the overall tax administration system. The project's promoted reform efforts have covered a number of areas, including a simplified and more logical organizational structure for the Tax Department, more convenient methods of payment for businesses, and more transparent tax calculations, and a methodology for selecting businesses for audit. Employees are now given clearer job descriptions and the training needed to meet those requirements. They have increased the capacity for automated and electronic/online filings. Even small businesspersons who do not have easy access to the internet are able to electronically submit their payments through ATMs used only for tax payments. The program has also increased the capacity for online payments. In addition, as tax offices become more automated, more permanent and reliable paper trails are created, calculations of taxes are not left to individual accountants in far-away regional offices, and oversight by a more centralized authority is facilitated.

Finally, instead of allowing tax officials broad discretion in selection of businesses to be audited, the tax reform project has created a risk-based assessment for audit selection based on specific and clear criteria. While it is too early to assess the impact of these relatively recent reforms, the fact that all interviewees, in and out of government, with knowledge of this project were excited at the changes at least indicates that there is some momentum to see the reforms through.

Such improvements not only make paying taxes more efficient. In terms of ameliorating corruption, they remove at least some of the interactions between businessperson and tax officials, which is where rent-seeking behavior most often occurs. The ADB project, however, is due to end in September of 2013, and while many of the systems and gains it put in place are sustainable it is not clear whether there will be any follow-on activity.

Access to Credit

The Kyrgyz Republic has a relatively complete system of laws and institutions for individuals and businesses of all sizes, and particularly for small and medium enterprises, to seek credit. Despite this fact, many interviewees reported problems with accessing financing. There are several reasons for this; the most commonly cited included high interest rates, lack of interest on the part of the banks, and inability to meet collateral requirements. Only 20.4 percent of firms have a line of credit or loans from financial institutions, compared to 43.7 percent regionally.[59] Four types of institutions – commercial banks, microfinance institutions, credit unions, and

[59] http://rru.worldbank.org/BESnapshots/Kyrgyz%20Republic/default.aspx

guaranty funds – are able to provide financing or financial assistance in the Kyrgyz Republic.

Commercial banks are the largest of Kyrgyz lending institutions. They are also by far the most risk averse. Banks will normally only accept real property and/or permanent structures, such as houses or warehouses, as collateral[60]. Since many small businesses lack such property, this raises a significant barrier to accessing credit from the banks. Banks are also reluctant to lend to sectors that they perceive as high risk (e.g. tourism); sectors where they do not believe the ROI is high enough (e.g. agriculture); or sectors with which they do not have much experience. The geographic coverage of the banking system is restricted to the cities and large towns, and most banks show little interest in lending to borrowers (i.e., agricultural enterprises) in rural areas. Banks generally do not make loans to the informal sector.

Commercial interest rates are high, though not excessively so by regional standards. Most loans are short-term – a year or less – and few loans are longer than three years. The banks generally are quite liquid, with much of their capital kept in the form of Kyrgyz T-bills or short-term loans. Interbank lending exists but at a low level.[61]

The banking industry is quite heavily dollarized, with about 55 percent of all loans made either in dollars or dollar-denominated. All banks that accept deposits accept dollar deposits. Interest rates for dollar-denominated loans are usually significantly lower than for loans in som, since they do not have to take inflation (currently running around 7 percent) into account. Commercial banks can and do borrow abroad in dollars. It should be noted that this represents a systemic risk; if the som suddenly depreciated relative to the dollar, many commercial banks and borrowers with dollar denominated loans might have difficulty meeting their repayment obligations.

Microfinance institutions (MFIs) dominate the microlending economy in Kyrgyzstan. The MFI sector is the most vigorous in the region, with over 100 institutions providing very wide geographical coverage. At one point there were approximately 450 MFIs in Kyrgyzstan, though only about 200 were actually active with the rest existing merely on paper. One reason for the large number of MFIs is that capitalization requirements were low at just over $2,000 (100,000 som) and no expertise in microfinance or banking was required. As a result, many who joined the MFI sector were seeking a quick return through aggressive lending at high interest rates, and when that failed they abandoned their business. Subsequently, the government has undertaken an effort at closing fringe lenders and thus far has closed approximately 100 such lenders.[62] In response to predatory MFI lending, there is

[60] This is in part because of Central Bank regulations, which are quite conservative. However, most banks appear to go well beyond the requirements of the Central Bank, demanding real property as collateral even when they are well past their collateralization threshold. Also, overcollateralization is almost universal; if a loan is for$100,000, the bank will often require $125,000 or $150,000 of collateral.

[61] A bank associated with the former President's son went bankrupt after the 2010 revolution. It took two other banks with it into insolvency, in part because of interbank loans. This has been cited as a reason for the banks' current reluctance to loan money to each other.

[62] http://www.eurasianet.org/node/65527

currently a law being considered to cap annual interest rates at 40 percent (in contrast to the 90 percent rates of some lenders).[63]

MFIs are further divided into three subcategories – non-profit microcredit agencies (MCAs), microfinance corporations (MFCs), and microcredit companies (MCCs). The top four MFIs - FINCA, Bai Tushum, Kompanion (all MCAs), and Mol Bulak Finance (a for-profit MCC) – were all founded by international donors. Together, these four manage about 70 percent of the microfinance portfolio in the country. As a reflection of the MFIs sector strength, it should be noted that Bai Tushum "graduated" to become a full-fledged bank last year (though it still handles a significant portfolio of microlending). MFIs are able to accept more types of collateral in securing their loans, allowing creditors greater flexibility. On-time repayment rates are over 97 percent for the four major MFIs.

Credit unions represent a small but important segment of microlending in Kyrgyzstan. There are approximately 180 of them. Unlike MFIs, credit unions are able to take deposits. This adds to their lending capacity, but also requires them to be more carefully regulated.

Credit unions primarily lend in the smallest denominations of all lenders, and provide the greatest flexibility in terms of usable collateral and repayment. Like MFIs, they have a high on-time repayment rate, reportedly at 98 percent. One interviewee opined that this was due to the nature of credit unions: credit union ownership is made up of members of the community that use the institution. As a result, owners and lenders are part of the same community, fostering greater accountability. While credit union lending has proven beneficial to small and medium enterprises, at present leaders in this area are concerned that there is insufficient financing for long-term viability.

Finally, there are credit guarantees provided through the budgets of municipalities. With assistance from USAID's Local Development Program, this program started in the city of Kara-Balta**.** It provides funds to prospective borrowers to help them reach collateral requirements in securing funds from other lenders. These guarantees help lower the risk for lending institutions, and accordingly allow them to provide borrowers with more favorable terms. This program has met with success and is being expanded into other regions of the country. Concerns remain, however, that because these loans are part of municipal budgets they are subject to politicization and corruption.

Ways to improve shortcomings related to access to credit are perhaps the least obvious of other issues discussed in this section of the report. On the one hand, they are related to, and in many ways the product of, other issues in the business

[63] This draft "Law Against Usury" is roundly condemned by MFIs and the banks. (The banks would not be directly affected, but fear that such legislation could set a dangerous precedent.) The MFIs point out that they often make short-term loans with high nominal interest rates. For instance, a 90-day loan for $10,000 to bring in a container full of construction supplies might be negotiated at a flat rate of 10 percent, equivalent to an annualized rate of 46 percent.

environment, such as the existence of the informal economy. On the other hand, the system in Kyrgyzstan related to financing small and medium enterprises is legally and institutionally sound, and one of the more dynamic in the region.

Perhaps the most common issue related by interviewees interested in seeking financing was how banks treated collateral, particularly with respect to small and medium enterprises. This does not reflect a shortcoming in the law as the system of laws related to financing comport with international standards. Kyrgyzstan has a secured transactions law and a collateral registry. However, banks show a very strong preference for collateralizing loans with real property. MFIs and credit unions provide needed flexibility in collateral requirements, while commercial banks are more risk-averse and therefore tend to be more exacting in terms both of collateral type and collateral valuation.

The burden of closing implementation gap in this instance, therefore, would appear to lie more with the private businesses seeking loans themselves than the government or banks. Absent the basic business information that is gained from formalizing a business, it is not hard to understand why lending institutions are hesitant to issue credit. While going through the process of business formalization seems an easy solution, it will not relieve all capital demand and the reality is not so simple. Nonetheless, formalization remains the clearest path to eased access to credit. It is evident, however, that this is not a path many businesses in Kyrgyzstan are ready to travel.

Case Study: Access to Finance and the Textile and Apparel Value Chain

The textile and apparel value chain is predicated upon access to affordable supply chain financing. From fiber to market, access to credit facilitates transactions.

Cotton farmers must procure inputs (seeds, fertilizers) and incur labor costs three to five months before delivering their cotton to the gins. Because cotton prices vary by grade (variety of cotton and length of fiber), final prices cannot be determined until post-harvest grading. Though some gins will provide prepayment, or seeds at planting time, not all gins do so, and other inputs and labor must still be paid well before farmers are paid for their crops.

Spinners must purchase fiber 15 days to several months before they spin the fiber into yarn. Depending upon whether they spin to order or spin for inventory, there can be another of days to months before any payment is received.

Fabric manufacturers (weavers, knitters making cut-and-sew fabric) face a similar situation, with the magnitude of the delay varying significantly depending on whether the factory is producing to order or producing for inventory. Payment can run 30 days after delivery.

Finally, garment manufacturers face similar gaps between the time they must purchase their inputs (primarily fabric but also including findings such as buttons, zippers, labels, etc.) and the time they are paid (15-30 days after delivery of finished goods, but can be as long as 180 days in extreme cases).

Delays in payment vary according to the size and relationship of the suppliers to customers, shipping times involved (shipping even from Eastern seaboard of China, for example, to the West coast of the U.S. can run seven weeks door to door; in Kyrgyzstan there are reports of several days to a few weeks for Bishkek to Moscow by truck.

Credit Bureau

The Kyrgyz Republic is unusual in that it has a private credit bureau, no public credit reporting institution, and no law regulating credit information. Nonetheless, the credit bureau operates relatively smoothly while efforts to pass a law on credit information continue.

The private credit bureau, Ishenimopened, opened in 2003. At the time, there was no credit reporting of any kind in the country. In the ensuing decade, credit reports for over 24 percent of the population (which represents almost 50 percent of the economically active population) have been created and maintained. Various aspects of the work of the credit bureau are in need of improvement, however, such as exchanging information with other parts of government including the Ministry of Finance (and specifically the department of taxation), improving information technology systems, and greater and better trained staff. Nonetheless, interviewees for this assessment, particularly bankers, described the credit bureau's operations as adequate, but hoped for its continued development, both in terms of the data it maintains, and its operations.

In that regard, a draft law regulating credit information is currently being considered by the Kyrgyz Parliament. This is the third attempt at such a law in the past decade, as the prior two, in 2005 and 2010, were overtaken by the political upheaval that occurred in each of those years. Assuming that the country remains stable, interviewees felt that it is highly likely the law will pass in the next year. Worth noting is that representatives of Ishenim have been consulted on the drafting of this law. A key tenet of this law is to improve overall credit information and sharing of this information through encouraging broader membership by financial institutions. In addition, the new law would help with tracking parallel loans, or the securing of one loan in order to pay another.

Ending a Business

The laws regarding ending a business in the Kyrgyz Republic, whether by bankruptcy or voluntary dissolution, comport with international standards. As with other areas of commercial law, however, their implementation does not align with modern standards. The World Bank ranks Kyrgyzstan 155 out 185 economies on its index for resolving insolvency, well below the regional average of 80. Despite recent efforts to streamline the procedures for insolvency, paperwork and regulatory formalities still make the process overly complicated and time consuming, for debtors and creditors alike. In addition, the return recovery rate for creditors has declined by over 33 percent over the last two years, making an already burdensome process less enticing for creditors.[64]

[64]This has been tracked by the World Bank Doing Business indicators: http://www.doingbusiness.org/~/media/giawb/doing%20business/documents/profiles/country/KGZ.pdf. It should be noted that the Doing Business indicator for bankruptcy is notoriously erratic, as it involves filling out a long and complex questionnaire that only a few local professionals are competent to complete. That said, interviewees agreed that the recovery rate has certainly not improved and has probably gotten worse.

Most of these issues, especially regarding overly burdensome and time consuming bureaucratic requirements, apply to voluntary liquidation of business assets as well. According to one large business law firm in Bishkek, the liquidation process requires as many as nine different forms, each with their own set of requirements and each involving interaction with a different bureaucracy. Multiple interviewees cited this as an area in need of reform. While the Kyrgyz government resolved in 2008 to improve this process, interviewees and research did not show any concrete signs of progress.[65] As a result, many businesses "close" when owners simply walk away, trapping assets, leaving debts unpaid, and creating confusion with respect to tax administration.

The Insurance Sector

In many developing countries, the insurance sector serves as an important source of investment capital. This is not the case in Kyrgyzstan. There is no strong tradition of insurance, whether life, health, or otherwise, in Kyrgyz society. As a result, Kyrgyzstan's insurance sector is quite small. Officially, there are sixteen insurance companies in existence. However, several of these are very small, with just two or three employees, and several others appear to be inactive. As a practical matter, there are only four or five companies capable of offering more than a small handful of products, and most of these are concentrated in servicing the mining sector and associated industries. The total portfolio for the entire sector generates less than $30 million in premiums per year. This money does not generate significant investment capital for Kyrgyzstan because of the relatively small sums and because approximately 70 percent of it immediately flows out of the country in the form of reinsurance payments to insurance companies in Russia, Kazakhstan, and Pakistan.

A draft law currently before the Parliament would make automobile insurance mandatory. This would result in a dramatic expansion of the insurance industry.[66] However, it is unclear whether the current insurance industry would be able to support such an expansion. Both of the insurance companies interviewed expressed reservations, including about the quality of the law and whether the sector would be able to deal with such a massive influx of clients.

Pension Funds

Pension funds are another important source of long-term capital in a developing country. Kyrgyzstan currently has two pension funds: a small, relatively new private fund and the much larger state pension fund, generally known as the "Social Fund." The Social Fund has been growing rapidly in recent years; its capital has increased 64 percent from 22 billion som (about $420 million) at the beginning of 2011 to approximately 36 billion som (about $750 million) today. The bulk of this money is invested in Kyrgyz T-bills, though some is deposited in local commercial banks.

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[65] Resolution No. 126 of the Government of the Kyrgyz Republic, April 4, 2008.

[66] It has been suggested that a number of the small or inactive insurance companies were created by Kyrgyz businessmen as speculative ventures against the passage of the law.

At the moment, the Social Fund appears to be reasonably well managed and solvent. However, it faces a number of long-term challenges, most notably the rapid aging of the Kyrgyz population after 2020. Also, the fund is under political pressure to agree to reduce the level of social contributions (the payroll taxes that support the fund). These are perceived as quite high, and thus as a disincentive to formalization. The Fund also faces human resource challenges: pension fund management is a highly technical field that requires a fairly advanced set of financial skills. The fund reported that it regularly loses mid- and high-level employees, both to the private sector and to ministry-level political appointments.

The fund is not currently receiving any donor assistance. In the short term, the Fund would like technical assistance with the issue of cash reserves – their appropriate level and correct management. (It is currently engaged in a dispute with the World Bank on this point.) In the medium term, it needs assistance with software development and with physical infrastructure. It would also like to expand its internal training system, as it regularly has to train up employees to replace those that it loses. Each of these request for assistance is addressed in the recommendations section.

Stock Exchange

Kyrgyzstan has a small but fully functional stock exchange. Eighteen companies are currently listed with a total market capitalization of approximately $190 million. There are 16 registered stock brokers, of whom six are currently active; all but one of these are banks. The exchange carries out a range of activities, including training specialists and brokers at banks.

The stock exchange is not currently receiving any donor assistance, though a USAID program helped establish the exchange in the 1990s. The stock exchange management expressed needs for various types of technical assistance, including software development and training. While there do appear to be needs in these areas, the exchange's needs appear to be relatively less pressing (and its resources relatively greater) than those of some other relevant institutions such as the State Pension Fund and/or the Credit Bureau.

Financial Literacy

A common theme raised repeatedly by both banks and MFIs was the low level of financial literacy across much of the country, especially in rural areas. Most Kyrgyz citizens have only a vague notion of the obligations and responsibilities involved in a modern credit system. Basic concepts such as compound versus simple interest rates are not widely understood. Very few Kyrgyz have even a passing familiarity with basic accounting or bookkeeping principles. The educational system does not teach any of these concepts at the primary or secondary levels, and familiarity with them has not yet spread widely across Kyrgyz society.

This is a cross-cutting issue that has a major impact on access to credit. Banks and MFIs regularly report that potential business borrowers are unable to generate coherent business plans. MFIs in particular spend a great deal of effort on basic financial education. For some larger MFIs, these efforts have become formalized; several large MFIs periodically offer free or low-cost classes and workshops to potential clients.

Low levels of financial literacy are particularly marked among ethnic Kyrgyz, as compared to ethnic Uzbeks. To simplify a complex history, the Uzbek minority was traditionally more urban and, even during Soviet times, more involved with trade, shopkeeping, and other market activities. As a result, levels of financial literacy appear to be significantly higher among ethnic Uzbeks. This has been a contributing factor to tensions between the two groups in southern Kyrgyzstan; for instance, there is a widespread perception that "wily, unscrupulous" Uzbeks manipulate lending and trade to take advantage of "naive, honest" Kyrgyz.

It is not clear whether levels of financial literacy are lower among women. No relevant study appears to have disaggregated gender data. Anecdotal evidence suggests that women in urban areas do form and manage small businesses at a fairly high rate, but have very limited access to credit.

Labor

Employment and the Kyrgyz Labor Market

In Kyrgyzstan, there are relatively few reasonably paid employment in higher-productivity activities in the formal sector. Informality, underemployment and the dominance of low-productivity sectors are barriers to rising wages and economic growth. The poor tend to be underemployed –they work fewer hours per week than they are willing and able –in low-productivity activities, especially in the agricultural or services sectors. For Kyrgyzstan to address longstanding issues of poverty and stagnation, formal sector jobs with higher wages and improved working conditions are essential.

The official unemployment rate in Kyrgyzstan is estimated at 7.7 percent for 2012,[67] although the last official calculated figure available set this rate at 8.7 percent in 2010.[68] According to the ILO, the actual unemployment rate can be 2.5 to 3 times more than the official rate. Although estimates vary greatly as to the exact size of the informal sector, it is estimated at somewhere between 60 and 70 percent, suggesting that underemployment is a major issue in Kyrgyzstan. Several labor-related factors influence firms' decision about formalization. For example, under Kyrgyzstan's inflexible labor code, severance packages in Kyrgyzstan are roughly two to three months' salary. Though this is not excessive by international standards, even this type of severance is perceived as a constraint to doing business.

[67] International Labor Organization (ILO) interview
[68] Asian Development Bank (ADB), Key Indicators for Asia and the Pacific 2012, 43rd Edition

Labor and the Informal Sector

The informal sector refers to the share of the economy that exists outside of the formal legal environment: taxation, labor laws, and other enterprise regulations do not apply. Informal sector jobs are typically small-scale operations, family and household jobs, and include individuals who run, as employers or self-employed, an unregistered firm or activity, or individuals who are employed in such firms. Informal sector work can also include those who are employed in the formal sector. Being informally employed in the formal sector means individuals are employed in a registered and legal activity, but are employed under a verbal contract only (see textbox).

Informal and Formal Sector Collide in the Garment Industry

In Kyrgyzstan, garment and clothing manufacturers will frequently hire temporary workers during high-volume periods – usually coinciding with increased demand for seasonal clothing at specific times of the year – but will not provide formal contracts or benefits to those workers. These 'day workers' are easily hired and released when the work is completed, allowing companies to maintain a flexible labor force and respond to increased volume of orders while avoiding the appearance of company growth and labor force expansion that might attract unwanted government scrutiny, taxes, and regulation. Employing workers in this manner also allows both firms and workers to avoid mandatory contributions to social and other government funds, maximizing net pay to workers and profits to firms.

Informal employment and its many implications – job insecurity, low pay, few benefits, irregular and unpredictable opportunities – are strongly linked to workers' education and income levels. The ILO estimates that as many as 86 percent of employed workers with no education are employed in the informal sector. Women appear to be more prone to work in the informal sector, as they are more represented in the labor force working in the agricultural sector, which employs a large share of the informal labor market.

Labor Migration

There are several likely factors contributing to the rise in emigration and subsequent increased reliance on remittances to supplement household income, including better paying jobs abroad as well as skills mismatch between education and the labor market. According to the ADB, more than 16 percent of households in the Kyrgyz Republic received remittances in 2006, although the share of households receiving remittances is likely higher in the present day. The average annual remittance income in 2012 was estimated at $1,331 per annum per household, while average household domestic earnings are only about $400 per month.

The Kyrgyz Republic's economy has become more dependent on remittances over the past decade. In 2001, remittances comprised only 1.9 percent of GDP, but by 2011 the proportion had increased to 25.3 percent.[69] Roughly 500,000 migrants work predominantly in Russia (80 percent) and Kazakhstan. Although remittances in 2010

[69] ADB 2012

were estimated at $1.275 billion[70], 2011 is expected to be even higher, some estimating up to $2 billion.

It is estimated that more than 60 percent of Kyrgyzstan's migrants work illegally. The average age of a labor migrant from the Kyrgyz Republic is 32, and more than half of migrants have secondary or university education. Ethnic Kyrgyz comprise 79 percent of all labor migrants from the Kyrgyz Republic, followed by Uzbeks (9 percent) and Russians (7 percent). Osh oblast provides the single largest group of migrants; roughly 35 percent of all Kyrgyzstani migrants are from Osh. (Put another way, every fifth Osh resident of working age leaves the country to find work.) Currently, the International Organiation on Migration (IOM) actively works with the Government of Kyrgyzstan on these types of activities and partnering with IOM or supporting continued funding of similar programs may be a valuable investment for USAID.

The Education Sector/Skills Mismatch

Based on interviews with stakeholders from the private sector, an oft-cited reason for businesses' inability to fill jobs was a lack of applicants with appropriate skills. This so-called 'skills mismatch' results when graduates of universities are trained for professions not necessarily matched with the skills demanded by the job market. Urban areas such as Bishkek are saturated with private universities teaching liberal arts rather than applied subjects, and apart from a few select universities, such as the American University of Central Asia (AUCA), the quality of education taught in most universities varies tremendously (reportedly degrees can even be "bought" from certain universities). With regard to subject matter, many students choose to study economics, law and politics, while very few students choose to enroll in technical departments, resulting in thousands of new university graduates unable to find jobs locally. At the same time the country severely lacks individuals with technical skills such as information and communications technology (ICT) software engineers and building trades, including more basic skills such as plumbing, masonry, electrical engineering, or carpentry. Frequently, interviewees noted that problems with the both the quality and quantity of vocational training programs available in the Kyrgyz Republic. Another obstacle is the relatively low prestige assigned to learning trades and technical vocations, resulting in fewer students enrolling in these types of programs overall.

Other donors working in the area of vocational and educational training include ADB and GIZ, but it is unclear how targeted their programming is, nor if there is any discernible strategy tying specific vocational training programs with the labor market. For example, ADB's program is very small (only approximately $23,000), and a USAID-supported program that complements these existing efforts as well as develops a component tied to connecting training directly to the labor market may be timely. GIZ also implementing some entrepreneurship-oriented programming, but their project ends in 2013, and it is not yet clear whether this type of project will be prioritized in the coming years.

[70] World Bank Migration and Remittances Profiles, 2011

Gender and Labor

Gender gaps in job and income opportunities are pronounced in the labor market. Women have lower participation rates, higher unemployment rates and longer unemployment spells. Among women inactive in the work force, a significant share is made up of discouraged workers, and poor women are worst off in labor markets of all groups in the Kyrgyz Republic. While the causes behind these conditions is beyond the scope of this assessment, based on anecdotal information from interviews, several likely sources may include lack of affordable child care and that women appear to be overrepresented in lower-wage sectors like agriculture, education and health, earning significantly less than their male counterparts.

Trade

Though Kyrgyzstan is small, landlocked, and mountainous, it is situated between four massive, growing markets: the EU, Russia, China, and India. The vast majority of trade is by road, and to a lesser extent, rail and air. Several important road and rail networks pass through Kyrgyzstan, although winter and mountainous conditions can make passage difficult, slow, and expensive. Kyrgyzstan has two large airports, including Manas, which serve as the basis for troop and commodity transfers to Afghanistan.

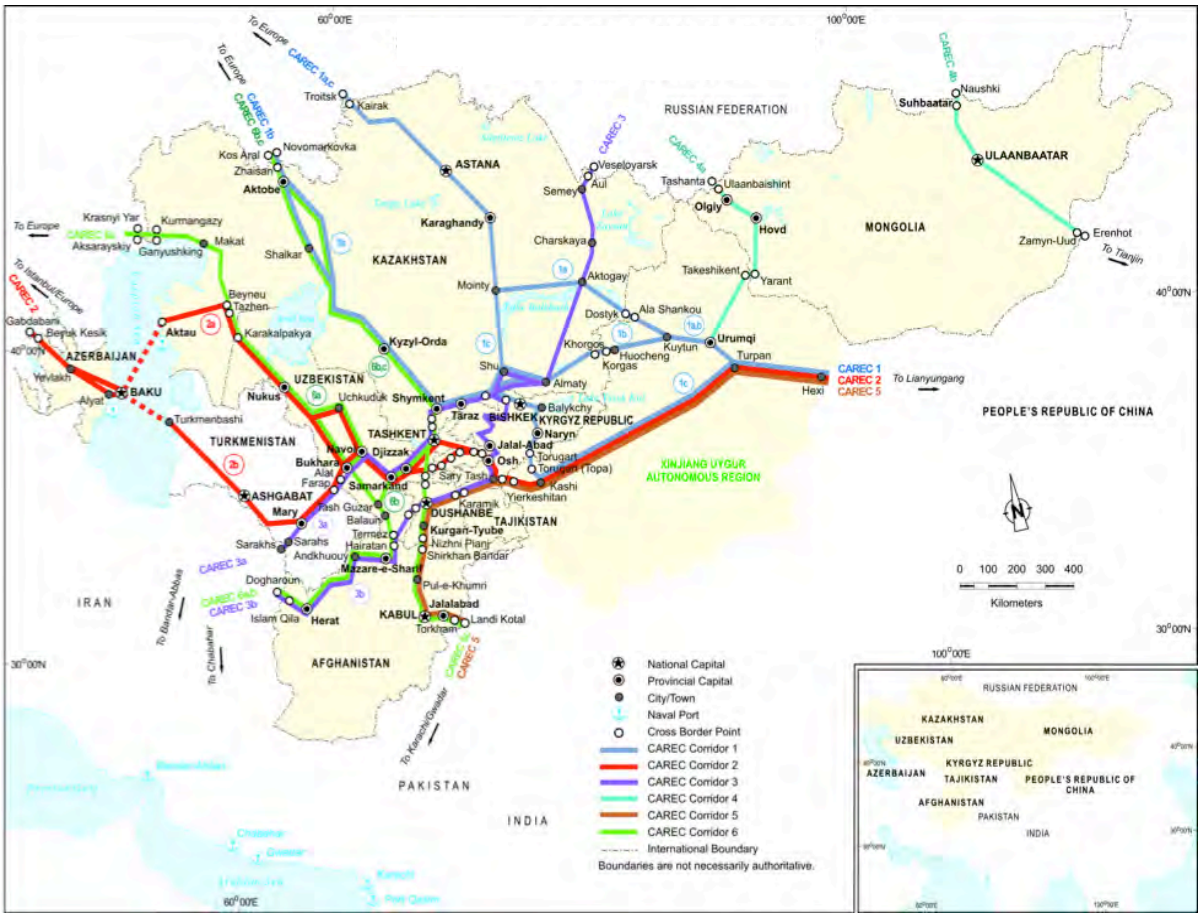
Kyrgyzstan's national sustainable five-year development strategy will become its central organizing principle for the 21st century. As the Minister of Transport stated recently at an event sponsored by the ADB, "Kyrgyzstan is going to be a transport country."[71] The national strategy emphasizes the development of transit infrastructure, the development of domestic industries for export, and the improvement of the investment environment.

As such, Kyrgyzstan is working closely with international donors to complete the Central Asia Regional Economic Cooperation (CAREC) road system. CAREC is a partnership of 10 countries collaborating to enhance development through regional cooperation. The group is supported by six multilateral institutions, and is currently prioritizing trade corridors. Kyrgyzstan is part of CAREC Corridors 1, 2, 3, and 5, which links Europe, Russia, China, and Southern Asia (see Exhibit 4). With more than 13,500 km of roads, 12,000 km of railways, and 3 airports, this prioritization represents a major trade promotion effort by CAREC's member countries.

Additionally, international donors have been working in Kyrgyzstan since the fall of the Soviet Union to promote trade, including EBRD, IFC, IMF, USAID, and GIZ. Presently, the ADB is taking a leading role in collaborating with stakeholders throughout the region on transport, energy, trade policy and trade facilitation.

[71] Minister of Transport Matsatbek Dyikanov stated that the country intends to become a transportation-based country at a consultation meeting of the Central Asian Economic Regional Cooperation consultation in Bishkek on April 16, 2013.

Exhibit 4. Six Central Asian Regional Economic Cooperation Corridors



Source: CAREC (Central Asia Regional Economic Cooperation Program)

Trading Partners and Volumes

Although trade has been growing, Kyrgyzstan is running a trade deficit and is highly dependent on gold mining and gold ore export. For products and services in which it enjoys a comparative advantage, the country has seldom leveraged its strengths.

Kyrgyzstan's principal trading partners include Switzerland, Kazakhstan, the Russian Federation, France, Turkey, China, Tajikistan, and the United States (see Top Ten Trade Partners on following page). With very little direct trade with Southern Asia, Kyrgyzstan imports primarily from the Russian Federation, Kazakhstan, Turkey, China, Germany, and Belarus. Exports to the United States are largely in support of Afghanistan. And although Kyrgyzstan's limited trade with its Central Asian neighbors is growing, the country's focus remains on more distant, larger, and more lucrative markets.

Top Ten Trade Partners for Products Commercialized by Kyrgyzstan - 2011 (Thousands of Dollars)			
Trade Partner	**Exported value**	**Imported value**	**Balance in value**
World (all trade partners)	1,978,932	4,260,687	-2,281,755
Switzerland	873,636	14,433	859,203
Kazakhstan	289,705	410,861	-121,156
Russian Federation	284,419	1,429,569	-1,145,150
United Arab Emirates	149,981	8,705	141,276
Uzbekistan	124,437	84,314	40,123
Turkey	54,492	117,090	-62,598
China	42,040	923,544	-881,504
Tajikistan	36,261	1,029	35,232
Afghanistan	23,536	69	23,467
India	18,295	28,319	-10,024

Exports grew at a rate of 9 percent between 2007 and 2011 (see Top Ten Exports from the Kyrgyz Republic on following page). As previously noted, a disproportionate amount, roughly 50 percent, of exports have been driven by the country's gold mining industry and remain the primary reason why Switzerland is Kyrgyzstan's top export destination. Gold exports constitute about 12 percent of the country's GDP, providing foreign exchange and government revenue. As a result, trade income and government revenue reductions stemming from a slowdown in gold exports will reverberate throughout the economy. These issues are further discussed in Annex F.

Top Ten Exports from the Kyrgyz Republic Source: International Trade Centre				
Industry	**Export value**	**Exports as a share of total exports (%)**	**Net trade**	**Growth of exports in value (% per year)**
00 All industries	1,978,879	100.00	-2,281,395	15
71 Pearls, precious stones, metals, coins, etc	1,017,084	51.4	1,011,243	45
27 Mineral fuels, oils, distillation products, etc	184,334	9.32	-787,485	-10
62 Articles of apparel, accessories, not knit or crochet	105,205	5.32	-1,580	9
07 Edible vegetables and certain roots and tubers	95,242	4.81	91,915	19
87 Vehicles other than railway, tramway	65,665	3.32	-374,134	14
99 Commodities not elsewhere specified	60,092	3.04	35,993	29
08 Edible fruit, nuts, peel of citrus fruit, melons	39,197	1.98	17,941	7
61 Articles of apparel, accessories, knit or crochet	36,670	1.85	-35,294	60
52 Cotton	33,050	1.67	27,107	1
85 Electrical, electronic equipment	31,002	1.57	-173,878	-1

Kyrgyzstan trade deficit is largely fuelled by its import needs. The country imports almost all of its fuel, chemicals, manufacturing equipment, electronics, raw materials for apparels, and processed food (see Top Ten Imports to the Kyrgyz Republic on following page). The bulk of its official imports are fuel from Russia, Chinese goods, and textiles from Turkey. However, the picture is somewhat complicated by the fact that Kyrgyzstan is an entrepot country; many imports are Chinese goods that are promptly re-exported, mostly to other CIS countries.

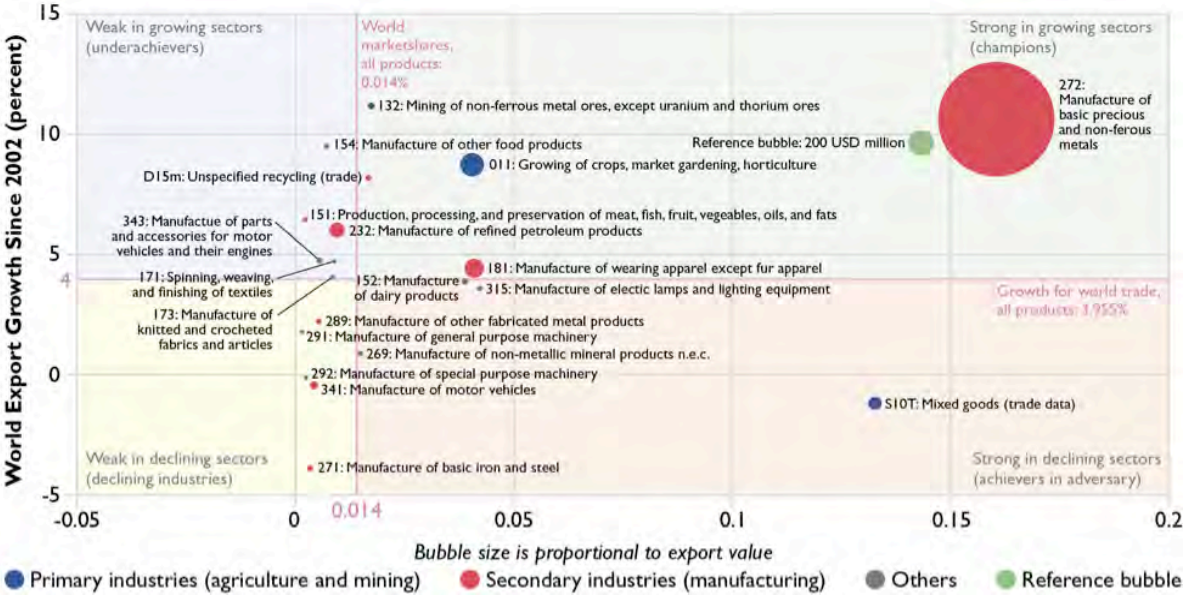
Top Ten Imports to the Kyrgyz Republic Source: International Trade Centre				
Industry	**Import value**	**Imports as a share of total imports (%)**	**Net trade**	**Growth of imports in value (% per year)**
00 All industries	4,260,274	100.00	-2,281,395	15
27 Mineral fuels, oils, distillation products, etc	971,819	22.81	-787,485	7
87 Vehicles other than railway, tramway	439,799	10.32	-374,134	40
84 Boilers, machinery; nuclear reactors, etc	280,715	6.59	-256,042	8
85 Electrical, electronic equipment	204,880	4.81	-173,878	10
30 Pharmaceutical products	163,274	3.83	-160,333	19
72 Iron and steel	111,602	2.62	-81,613	16
39 Plastics and articles thereof	107,461	2.52	-95,144	18
62 Articles of apparel, accessories, not knit or crochet	106,785	2.51	-1,580	115
44 Wood and articles of wood, wood charcoal	100,709	2.36	-100,382	17
73 Articles of iron or steel	100,065	2.35	-95,456	23

It is important to note that this trade data should be treated as suggestive, not precise. It is systematically biased by the sheer size of the informal "shadow" economy and limited government capacity. If anything, imports, exports, GDP, average per capita income, and cash circulation are greater than indicated in official trade and monetary statistics. Wright (2013) estimates that trade through the Bazaar Channel in 2010 was $3.5 billion. Of that, $2.5 billion was the re-export of imported goods, $837 million was in apparels, and $90 million was in fruits and vegetables. Much of the trade is based on U.S. dollars, which are partly supplied by remittances. In comparison, official exports were estimated to be $765 million in 2012. Thus, officially reported trade was potentially less than the total amount of apparel trade in the Bazaar channel.

Competitiveness

The competitiveness of Kyrgyzstan's businesses tends to suffer even when they enjoy a comparative advantage. A structural analysis of Kyrgyzstan's exports shows only three sectors in which Kyrgyz exports outpaced the growth of competitors since 2002: mining, agriculture, and textiles (see Exhibit 5). Mining exports—dominated by gold—grew in volume, value, and percentage of global market share. Agricultural goods and dairy products also grew to a lesser extent. While textiles/garments grew along with machinery, their growth was weak relative to other countries. As a result, the economy is disproportionately dependent on gold mining (see Annex F for a more complete discussion of gold mining).

Exhibit 5. Kyrgyzstan Exports 2011
Structural Analysis



Trade Facilitation

As discussed in other sections of this report, there are many causes for Kyrgyzstan's relatively poor competitive position. Stakeholders interviewed for this assessment quickly identified what they considered to be the most binding constraints beyond, at, and behind borders (see Stakeholder Feedback on Priorities for Promoting Trade).

Stakeholder Feedback on Priorities for Promoting Trade

Beyond the Border	At the Border	Behind the Border
• Customs union membership • Foreign direct investment • Bilateral trade facilitation agreements with neighbors • Promote exports and foreign direct investment	• Modernize and align customs operations • Reduce corruption • Reduce customs documentation • Improve border facilities • Formalize SME trading	• Improve the investment climate (bank reform, property rights, travel) • Invest in human capital (vocational, education, on-the-job training and management training) • Government capacity building (understanding, policies, facilities, and practices) • End corruption among public officials • End predatory tax inspections • Stabilize government policy • Enhance access to finance for all companies • Build quality infrastructure • Promote the formalization of businesses

Trade Facilitation beyond the Border

The Kyrgyz economy is sensitive to both tariff and non-tariff barriers to trade. Kyrgyzstan's tariff structure is the result of the negotiations with the World Trade Organization and bilateral rates negotiated with neighbors. China looms large because it is among the largest goods exporters in the world and is the second largest trade partner of Kyrgyzstan. Russia and Kazakhstan are important as exporters of fuels and importers of food and garments.

In many instances, the tariff and non-tariff barriers to trade impose real costs and risks to domestic business. The precise effect of tariff barriers to trade is challenging to estimate. Because there is systemic corruption at the borders, calculations of effective tariffs are skewed; people pay less than officially required for imports. There is no doubt, however, that differences between applied and faced tariffs open up arbitrage opportunities which local traders exploit in bazaars where they may re-label products, resell, or produce final goods that will be sold in countries where they have a pricing advantage, such as Kazakhstan or Russia. These factors contribute to the size of the shadow economy.

Stakeholders in Kyrgyzstan understand that non-tariff barriers to trade, such as Hazard Analysis and Critical Control Points (HAACP) and Sanitary /Phytosanitary certification, may be far more damaging than tariffs. This was driven home in May 2011, when Kazakhstan abruptly shut down all imports of meat from Kyrgyzstan, and also imposed severe restrictions on dairy and agricultural products.[72] In addition, food producers are under increasing pressure from trade partners—including the United States—and multinational companies to certify food safety.

The effects of non-tariff barriers on Kyrgyzstan's businesses are severe. They are challenged by certification requirements, regardless of size, composition or registration status. Only two Kyrgyz companies are able to export milk to Kazakhstan. Some send their products to laboratories in Russia, Europe, or elsewhere for certification at higher prices than would likely be charged domestically if a qualified testing center existed. The vast majority of small and independent exporters must use the bazaars to sell or bribe customs officials to deliver products.

Going forward, Kyrgyzstan will have to certify its products to remain competitive. As explained earlier, the major problem that all of our interviewees point to is the country's lack of registered testing laboratories that can certify food and beverage products. Laboratories do exist, but they do not meet international standards. As discussed in Section I, the country's only textile and apparel laboratory does not meet contemporary requirements. Non-domestic certification makes compliance more expensive and less profitable for ordinary commodity goods. Kazakhstan, relying on U.S. government assistance, is on the verge of establishing a laboratory in Almaty qualified as a testing facility. It has offered to provide testing services at market rates. For Kyrgyzstan, the

[72] Kazakh authorities said this was for sanitary and health concerns. Many of the Kyrgyz interviewees were convinced that this was really a political maneuver intended to placate local Kazakh producers. The ban has been slightly relaxed.

costs involved in creating a national quality infrastructure that can help them meet international quality standards are simply beyond the country's capacity to fund.

The Customs Union

The most important trade policy issue confronting the Kyrgyz government is whether or not to join the Customs Union with Russian, Belarus, and Kazakhstan. Negotiations are ongoing. The question they must answer is, "What are the consequences for the Kyrgyz economy?" If the analysis by Wright (2013) is correct, the Customs Union may have several effects.

1. Enable Kyrgyzstan to continue purchasing Russian fuel without markedly higher tariff rates.
2. Generate additional income for the government of Kyrgyzstan through increased customs duties.
3. Decrease some of the informal shuttle trade within the Bazaar channel of the shadow economy, while increasing government revenues through the formalization of the businesses.
4. Increase the importance of agriculture and clothing manufacture, assuming that companies can get certification for their products.

If Kyrgyzstan joins the custom union, Wright suggests there is reason to believe that the country will lose its ability to arbitrage between Chinese and Russian and Kazakhstan's markets. Despite that loss, Kyrgyzstan is likely to join the Customs Union in order to avoid the imposition of tariffs on Russian imports of fuel. Those tariffs alone could reduce Kyrgyzstan's GDP growth rate by between 3.6 to 6.0 percent.

The Implications of the Changing Trade and Customs Regimes for the Bazaars and the Informal Markets

The shadow markets and bazaars dominate the country's economy. Since virtually none of the interviewees of this assessment were operating in the shadow economy, additional analysis was conducted to consider statements made by independent consultants, online interviews, and the literature on bazaars.

Government officials and business persons know that cross-border trade via bazaars has already been diminished by the inability of the agribusinesses and the business community to meet SPS and HAACP compliance. Similarly, reduced credit availability for informal firms and government demands on the informal business community to formalize are also affecting bazaar trade. These forces will probably intensify. The Director of the Customs Service of the Government of Kyrgyzstan stated in an on-line interview on April 16, 2013 that it intends to pursue illegal, informal trade at bazaars.[73] It regards the unregulated trade at the borders and in the bazaars as foregone state revenue. Indeed, given the importance of trade and the relatively low tax levels, customs could become a very important element of state income. Another customs official stated that he

[73] 17-04-13, 12:15, Глава ГТС Кубанычбек Кулматов ответил на вопросы читателей Tazabek.

expected the size of the bazaars to diminish as a result of accession to the Customs Union and the formalization of businesses. This process is already underway.

There may be ample reason to support the bazaars, while also enabling them to meet international safety and domestic administrative and tax obligations. As Kaminski and Mitra suggest in their study of borderless bazaars,

> *The analysis conducted in this work is of policy interest: rather than treating bazaars as unorganized and undesirable in a modern market economy, national authorities should foster the development of bazaars in view of the growth, employment-generation, and poverty-fighting characteristics of bazaars and their supporting businesses. In addition to their income-generating effects, bazaars also contribute to the welfare of end users, as without bazaars, goods would be unavailable or more expensive.*[74]

This approach seems appropriate in light of the low levels of competitiveness for Kyrgyz businesses in international markets, relatively constrained employment requirements, and the short-term potential consequences of both accession to the Customs Union and the decline of revenues from gold mining.

Trade Facilitation at the Border

Kyrgyzstan's government is reforming the administrative processes and organizations that oversee trade at the border. Nevertheless, businesspersons reported a desire for simplified documentation procedures, reduced costs, and increased operational efficiency because simpler and quicker trade processing reduces the costs for companies and consumers alike. Interviewees expressed that time constraints, both before and at the border, are one of their greatest concerns. To illustrate, consider that exporters must on average submit eight documents to export. It takes an average of 63 days and costs an average of $3,210 to export a container over the borders. Importers must submit nine documents and wait 72 days[75]. Queues require the most time, which suggests changes in infrastructure will help speed cross-border movement. A recent EBRD report suggests the importance of this effort: the time required to cross Kazakhstan's border has increased by 47 percent (Isakova, Koczan and Plekhanov, 2013:18). These trade times all substantially inhibit formal attempts to export perishable goods.

Customs officials report their desire to modernize facilities, implement the "single window", eliminate corruption, hire and train new cadets, and collect customs duties. To speed shipments, Kyrgyzstan is creating a "single window" which will provide exporters and importers with the documents they need to process their trade before shipment. The new system will be launched in July 2013. It is not yet linked to Customs processing, which is building its own on-line system and intends to launch it within the year.[76] The

[74] Kaminiski and Mitra, 2012.
[75] World Bank Doing Business 2013.
[76] This is an ADB initiative. The ADB and the Kyrgyz Customs service were both very enthusiastic about the single window; businesses interviewed expressed cautious optimism. However, it is not clear how the window will fund or sustain itself after the ADB activity ends.

Customs Service will follow with its own on-line system by September. The projects will have to be reconciled, institutionalized, and expanded so they are functional at all 160 import/export and customs locations.

Trade Facilitation behind the Border

All interviewed stakeholders agreed on a core set of domestic problems that inhibit trade, particularly export (see Stakeholder Feedback on Priorities for Promoting Trade above). These include: corruption, lack of professional skills in both the public and private sectors, lack of adequate financing, unstable public policies, fragmented infrastructure, and disincentives for the formalization of businesses. We will not review these here because they are consistent with and more thoroughly described throughout this report.

Summary of Kyrgyzstan's Current Trade Conditions

Transport and trade is critical to the stability of the Kyrgyz Republic and the well being of its citizens. Its small domestic market and the relative cost of modern trade regimes means that it cannot finance the modernization of its customs and single trade document processing without assistance. Improving the quality of the country's infrastructure will also require assistance. Donors will have to help the country invest in the systems that will enable businesses and its government to operate in accordance with trade regimes – whether they are the WTO, EU, the Association of Southeast Asian Nations (ASEAN) or the Customs Union.

That is a difficult, long-term task under any circumstances, but Kyrgyzstan may have to make changes within the next five years to remain competitive. Kyrgyzstan has enjoyed modest growth in trade, partly because of its ability to arbitrage between Chinese and Russian markets and partly because many developed country investors have engaged in a "flight to gold" since the 2007-2008 financial crisis, which drove up gold prices and the profitability of gold mining operations. Those days may be at an end. Worse, they could occur just as the country considers joining the Customs Union, and using the opportunity to "battle the informal sector."

Recommendations

We present below a summary of activities to address the constraints to the business enabling environment identified in the previous sections. We have prioritized recommendations based on an assessment of other donor interventions in these areas and opportunities in which USAID can build on existing efforts and specifically, close the "implementation gap" through targeted development interventions.

General Business Enabling Environment Challenges

Lack of a Sovereign Credit Rating

Encourage government efforts to obtain a sovereign credit rating: a sovereign credit rating would allow the government to more easily and cheaply borrow from abroad

during lean times or for strategic expenditures and would contribute to lower commercial and consumer interest rates. USAID could encourage the government to pursue a credit rating and, as needed, provide technical assistance and guidance to the government ministry leading this effort.

The Informal Economy

Support programs that facilitate the formalization of businesses: identify opportunities to incentivize businesses to step out of the informal realm. Capacity building efforts to educate entrepreneurs and business owners through industry associations and local chambers of commerce on the benefits of formalization is one approach.

Commercial Laws and Institutions

Support for the development of a national Bar Association for all attorneys: build upon current progress made to create a criminal lawyers' bar association, to include all attorneys, especially considering that the majority are civil lawyers. A Bar Association also provides a means for bringing about ethical and malpractice claims.

Support for development of an ethical code of conduct for attorneys: a national Bar Association is an effective vehicle for maintaining the quality and reputation of the legal profession. A code of conduct can impose consequences for violation such as losing one's license to practice law. This mechanism will help create a culture of accountability in the legal profession

Comprehensive bar examination: to replace the existing certification examination that is perceived as merely pro forma. A bar examination ensures that lawyers meet minimum qualifications to practice law and deter corrupt practices for obtaining these credentials.

Court administration reform: consider replicating other USAID court system modernizing projects as in Serbia, for example. [77] Consider implementing automation services that create more reliable records and strengthen the functionality of the entire system, working toward increasing public trust in the institution.

Training for court system employees: efforts to improve the basic capacity of those who work in the courts, such as law clerks, paralegals, legal assistants and secretaries, and court and case administrators, would help improve the overall capacity of the courts.

Social Fund capacity building. Provide technical assistance to the Social Fund on effective cash management and appropriate loan loss reserves through the provision of training and technical assistance for portfolio managers.

[77] http://serbia.usaid.gov/program-updates/latest-news-and-events/serbia.618.html

Government institution capacity building. Provide technical assistance for government institutions that collect, apply and/or share data. For example, provide training to National Statistical Committee to develop improved methodologies for data collection and analysis. To ensure policymakers have rigorous data from which to base decisions, provide guidance to statistical agencies on coordinating and harmonizing data collection techniques and reduce the probability of conflicting statistics across agencies. Ensure that government agencies are able to share data effectively (i.e., tax authorities and the business registry).

Court Structure and Administration, and the Legal Climate
Taxes and Tax Administration

Continue support for tax reform: includes building upon or continuing progress made through the existing ABD/IFC tax reform project scheduled to conclude in September 2013. Many needs remain, including long-term sustainability planning, IT infrastructure development, and focus on customer service. [78] Consider partnering or supporting subsequent ABD/IFC efforts.

Consider technical assistance to court administration. Courts lack equipment, software, and trained clerks and court administrators. There is clearly a need for restructuring of processes, particularly the flow of documents through the system.

Access to Credit

Access to finance programming: invest in the implementation of MFI laws to reduce cost of capital; improvement of mandatory credit bureaus; improvement of cadastres; facilitate ability of banks to use non-land collateral. Outcomes include an expanded line of financial products offered, including insurance, factoring, mortgages, working capital loans, and cash management.

Coordinate with the World Bank. The Bank is planning to launch a large Financial Sector Deepening project in early 2014. Any activities in the financial sector should be coordinated with this project, which is already well into the planning stage. Bank staff have stated that they would like to engage with other donors, but so far this has not gone past the discussion stage.

Credit Bureau

Provide targeted technical assistance to the Credit Bureau. This could include:

- conducting a short needs assessment and responding with appropriate activities and capacity building. One area is to explore the utility of MFIs reporting credit information to provide a credit history that might ease microfinance borrowers moving from micro-credit to a commercial loan;

[78] Many of the interviewees involved with this project have worked with USAID previously and thought highly of its work

- technical assistance with implementation of the Credit Bureau Law if it is passed, i.e., helping ensure that the Bureau is able to collect all legally required information (particularly from MFIs) and process it appropriately; and
- facilitating participation of Credit Bureau members in International Credit Bureau Association sponsored-events and pertinent regional conferences and workshops abroad to strengthen the Bureau's international contacts and networks and acquire best practices.

Financial Literacy

Provide technical assistance to strengthen financial literacy. The technical assistance could be delivered in collaboration with MFIs or industry associations after a short assessment to identify specific needs and the most effective mediums of delivering technical assistance (i.e. workshops, communication campaigns, etc). MFIs have a large geographical reach, more customers, and serve relatively unsophisticated customers that could benefit from literacy training. While several of the larger MFIs are already providing workshops and trainings, there is considerable room for expanding these programs.

Stock Exchange

The assessment team recommends that the Stock Exchange need not be a priority at this time, as the Exchange seems to have sufficient resources to be able to carry out its duties. However, since the Exchange does train financial specialists, any project involving finance should liaise with the Exchange to investigate possible areas of cooperation.

Labor

Training:

*Targeted technical skills training programs***:** target specific technical skills that the Kyrgyz economy demands, including training programs that enhance technical and basic skills training (ICT as well as crafts such as tradesman, electricians, and plumbers), either through established vocational and trade schools, or through other institutions operating outside of the Kyrgyz education system.

Entrepreneurship training: continue supporting initiatives that enhance entrepreneurial skills of recent graduates as well as others who seek to open new businesses. Programs that incorporate skill development related to business plan formulation and financial literacy as well as building upon mentorship programs that match entrepreneurs with financial sector specialists would also be useful, such as the model currently implemented by USAID partner International Youth Foundation. The training should include information on the benefits of formalization.

Apprenticeship/internship programs: support programs that assist with the transition to the job market and programming that engages secondary schools, vocational schools, and universities to provide career guidance and training for entering the workforce. Skills development in resume writing and job interviewing) may also assist students, the

unemployed, as well as the underemployed to better connect with jobs that fit their training, skills, and the labor market.

Migrant Services:

Support services for migrants: support for Kyrgyzstani émigrés to adapt to the cultural and linguistic challenges that face them upon arrival and to help them obtain legal labor status by providing support before they even leave the Kyrgyz Republic could include vocational training as well as practical information on job placement and housing in destination countries.

Incentivize saving money: provide support for the Kyrgyz government to encourage migrants to save money by popularizing the use of savings accounts in micro-finance institutions and making it easy for migrants to invest in education, health and housing. Programs that can help migrants return home to help rebuild Kyrgyzstan would also be encouraged, building upon work being done by IOM.

Policy and Government Reform:

Occupational health and safety standards: support programming that encourages government-level policy that strikes a balance between a free-market-oriented business sector and the necessary regulations that protect businesses and employees alike would be a valuable addition to BEE-oriented programming.

Trade

Stakeholders in the private and public sectors that are involved in trade expressed support for Customs Union membership, modern and efficient customs operations, better border facilities enhanced ability to formalize, and reduced corruption. The following recommendations take these preferences into account where possible. A detailed table containing possible partners, mechanisms, and timeframes for trade-related recommendations can be found in Annex E.

Competitiveness

National Quality Infrastructure:

National quality infrastructure, standards and certification: support programming that targets adopting standards, utilizes training programs for use among producers and regulators, and works toward construction of labs and administrative facilities. Ideally there would be two functioning labs (one for apparel and the other for food/beverage), in order to provide certification of products from Kyrgyzstan's 10 leading exporters.

Trade Facilitation Beyond and at the Border

Trade promotion: encourage increased exports among business enterprise groups, possibly through expansion of existing USAID programs in the region. Consider within

the framework of the new Export Promotion plan. Consider outreach to Trade Promotion Agencies in the region (but if so, coordinate with GIZ, since they have already worked on developing a Kyrgyz TPA).

Customs capacity building: support technical consultation, training, and improved facilities to ensure that the single window and customs windows are functional, effective, and extended.

Customs Union: support to government ministries most heavily involved for Customs Union negotiations, to ensure Kyrgyzstan has favorable terms upon entry.

The Implications of the Changing Trade and Customs Regimes for the Bazaars and the Informal Markets

Improved SME competitiveness: support programming that targets implementation of laws promoting bazaars, including providing exemptions from international quality requirements.

Borderless bazaars and entrepreneurs: Support programming that results in increased formalization of businesses. Invest in programming that supports the adaptation of business registration, customs, and finance administration in order to increase the number of legal, formalized SME traders in bazaars. Consider working with one or more government agencies on one-time amnesty or similar programs to encourage formalization. Promote support of local business organizations to reach out to the informal sector to spread financial literacy and information about the advantages of formalization.

ANNEX A

Interviews

International Organizations: Multilateral, Bilateral, Implementing Partners

Aga Khan Foundation
Asia Development Bank
Delegation of the European Union to the Kyrgyz Republic
Embassy of Switzerland in the Kyrgyz Republic
Embassy of the United States of America, Political Affairs, Economic Affairs
Embassy of the United States of America, Resident Legal Advisor, U.S. Department of Justice
European Bank for Reconstruction and Development
German Development Cooperation (GIZ), Kyrgyzstan
Food and Agriculture Organization of the United Nations
Helvetas Swiss Intercooperation
International Center for Not-for-profit Law
International Finance Corporation
International Labour Organization
International Monetary Fund
International Trade Centre
Japan International Cooperation Agency (JICA), Kyrgyzstan
Swiss Development and Cooperation
Turkish International Cooperation and Development Agency (TIKA)
Turkish Embassy
United Nations Development Programme
USAID Local Development Program (LDP), Chief of Party
USAID Parliamentary Strengthening Program (PSP), Chief of Party
USAID REFORMA Project, Chief of Party
USAID Kyrgyz Republic, Mission Director
USAID Kyrgyz Republic, Deputy Director
USAID Kyrgyz Republic, Office of Transition Initiatives
USAID Washington, Gender Specialist
World Bank

Government Agencies

Business Development Investment Council of the Kyrgyz Republic
Center for Standardization and Metrology under the Ministry of Economy
Customs Agency of the Kyrgyz Republic
International Court of Arbitration under the Chamber of Commerce
Ministry of Culture and Tourism, Deputy Minister
Ministry of Economy, Deputy Minister
Ministry of Justice, State Secretary

National Institute for Standards and Metrology "Kyrgyz Standard" Bishkek Center for Testing and Certification
National Bank
Office of the First Vice Prime Minister of the Kyrgyz Republic
State Registration Service, Department of Cadastre
State Service of Intellectual Property and Innovation
State Tax Service under the Government, Deputy Chairperson

Textiles / Garment, Fabric, and Fiber Producers

AIGUL Joint Stock Company
AIGUL Textile LLC
Ak-TEX (cotton gin)
E-Line Moda
Emcek Bereski, LLP (weaving factory - Jalalabad)
Ilbirs (knitwear garment factory - Tokmok)
InterCotton Group (ICG) (cotton gin)
Kyrgyz Worsted-Woolens Factory
Kyrgyzjipteks Ltd. (yarn factory - Osh)
Lila Style
Nissy Ltd.
Organic Cotton Farmers (8, unnamed - Jalalabad)
Primavera Fashion
TextilShik (yarn factory – Osh)
Traditional Kyrgyz felt hat producer – Osh
Sakura Factory (women's garments)
Ms. Mirgul Nazirova, Owner, Perizot LLP (women's garments)
Ms. Ainura Kadurbekova, Owner (women's garments)
Ms. Imaelovqa, Owner (women's garments)
Ms. Jolonova Barkan, Owner (children's wear)
Ms. Elyada, Owner (women's garments)
Ms. Zinagur Owner (women's garments)
Ms. Dinara Omonova, Owner (women's garments)

Textiles / Industry Organizations / Private Sector Operators

Ms. Altynai Osmoeva, Kyrgyz Fashion Design Student (Graduating 5/13), Central Saint Martin's, London
Association of Light Industry Enterprises of the Kyrgyz Republic (LEGPROM)
Association of Light Industry Enterprises of the Kyrgyz Republic (LEGPROM) South (Osh)
BioFarmer Agricultural Commodity Service Cooperative (ACSC)
BioService Public Foundation
Cashmere Producers Association (Osh)
Central Asian Craft Support Association (CACSA)

Ms. Dilbar Ashimbaeva (fashion designer)
Dordoi Market (Bishkek)
Karasul Market (Osh)
Madina Market (Bishkek)
Odessa Centre UK, Dr. Carol Kerven
Osh Business and Training Center
Public Foundation Kyrgyz Mountain Societies Development Support Programme – Osh Region
Trade Union of Textile and Light Industry Workers
Union of Kyrgyz Textile Industry (SoyuzTextil)
ZAMAT Cargo

Textiles / Educational Institutions

Kyrgyz Russian Slavic University
Kyrgyz State University
Lyceum 18
Lyceum 94
Shvei Profi Training Center
Technical Professional Education Agency – Scientific Methodological Center
University of Central Asia
University of Management and Design (UMD)

Tourism

Asia Mountains International Travel Center
Celestial Mountains Tour Company
Community Based Tourism Association
Ecotourism Information Resource Centre
Edelweiss Tourism Company
Entrepreneur's Union of Kyrgyzstan Tourism Council
European Centre for Eco-Agro Tourism
Guest House Mila Daudova
Hospitality Kyrgyzstan
Kazakhstan Association of Hotels and Restaurants
Kazakhstan Tourist Association
Kyrgyz Alpine Club
Kyrgyz Concept Travel Agency
Kyrgyzstan Association of Tour Operators (KATO)
Kyrgyzstan International Travel Center
Novi Nomad Tourism Development Company
Shepherd’s Way Trekking
Silk Road Hotel
Silk Road Tourism Association
Sunrise Guest House
TES Guest House

Tian Shan Travel
TSC "Kyrgyz-Uz"
Uzbekistan Association of Tourism Organizations
Vocational Education Center

Business Enabling Environment / Business Associations or Labor

American Chamber of Commerce (AmCham)
Bishkek Business Club
International Business Council
International Youth Foundation
Kyrgyz Chamber of Commerce
Solidarity Center

Business Enabling Environment / Microfinance, Insurance, Bank, Credit and Law-related

American Bar Association
APEX Microfinance
Association of Attorneys of Kyrgyzstan
Association of Microfinance Institutions
Baitushum & Partners Microfinance Bank
Commercial Law Firm Alymbaev
Deloitte
Demir Bank
Federation of Trade Unions
FINCA
Ishenim Credit Information Bureau
Insurance Regulatory Agency
Judicial Training Center
Kalikova and Associates (Law Firm)
Kyrgyz Investment and Credit Bank (KICB)
Kyrgyz Stock Exchange
London Bishkek Insurance Company
National Bank Credit Department
Partner Law Firm
PriceWaterhouseCooper
OJSC Insurance Company Kyrgyzstan
TULPAR Single Window system
UniCredit Bank
Union of Entrepreneurs

ANNEX B

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ANNEX D

Textile Recommendations – Decision Matrix

Assistance	Importance	Cost	Urgency	Market Demand	Job Creation	Implementing Partner	Leverage Other Donors	Beyond Bishkek	Women/Rural
Cost: L = estimated under $15,000; M = estimated $15,000-$60,000; H = estimated over $60,000; VH = estimated over $100,000 X = applicable									
Tractor to BioFarmer Coop	H	M	M	X		X	X	X	X
Grant for YouTube video to differentiate Kyrgyz cotton	H	L	M			X	X	X	X
MiniMill – cashmere (PPP)	H	M	M	X				X	X
Technical Assistance – 2nd elite breeding herd - cashmere	H	M	M			X	X	X	X
Equipment grants – LEGPROM South (CAD/CAM & Plotter)	H	L	M	X	X	X	X	X	X
Technical Assistance grant – LEGPROM to develop searchable database to facilitate market linkages	M	M	M	X	X	X	X	X	X
Equipment grants to individual factories	M	L-M	M	X	X			X	X
Compliance/ Fire Safety training to factories (apparel & textile)	H	M	H			X		X	X
Cost-Sharing 3rd Party Social Compliance Auditing & Certification (WRAP or other)	H	M	M	X		X	X		X
Study tours – Tech Professional Agency & VoTech training instructors	H	M	H	X		X	X		
Training: QC Inspectors	M	L	M	X	X	X	X	X	X
Training: Sewing Machine Mechanics	H	M	H	X	X	X	X	X	X
Training: Middle Managers, Senior Production Managers	H	M	H	X	X	X	X	X	X

Assistance	Importance	Cost	Urgency	Market Demand	Job Creation	Implementing Partner	Leverage Other Donors	Beyond Bishkek	Women/Rural
Laboratory (Design, equipment specifications, equipment, training)	H	VH	H	X				X	
Access to affordable financing	H	H	H	X	X		X	X	X
Case study: USAID Haiti Apparel Center to inform future training center decisions (especially Technopolis)	M	M	M				X		

ANNEX E

Business Enabling Environment Recommendations – Detail on Trade

Program Project Potential	Recommendations Detail for Trade				
Project Focus	**Partners**	**Output**	**Outcomes**	**Mechanisms**	**Years**
National Quality Infrastructure, Standards and Certification	WB, ADB, IFC, ITC, MinAg, Min Ec, Fed. Trade Unions, DOD (MANAS)	Adopted standards Training programs for use among producers and regulators Construction of labs and administrative facilities	Two functioning labs (apparel and food/beverage) Certification of products from country's 10 leading exporters	New contract designed in consultation with partners	5
Access to Finance for Trade	WB, IFC, ADB, EDRB Central Bank of Kyrg., Union of Banks, Non-Fin. Inst. Regul.	Implementation of MFI laws to reduce cost of capital. Improvement of mandatory credit bureaus Cadastres improved Banks can use non-land collateral Strengthens trade and working capital financing	Expanded line of financial products offered including insurance, factoring, mortgages, working capital loans, cash management Decreases in the cost of capital among MFIs Longer tenors for commercial loans Decreased interest rates Increased borrowing Decreased bank liquidity	New contract	5
Formalization and improved competitiveness of individual and SME businesses in the textile, apparel, agriculture, and food-beverage sectors	Federation of Trade Unions, Ministry of Economics, Textile, Apparel associations, ITC,	Laws promoting bazaars, perhaps providing exemptions from international quality requirements, improving finance, and improving local market performance.	Increased registration of businesses. Increased investments in new companies Increased production Increased jobs	New contract	5
Borderless Bazaars & Entrepreneurs	Dept. State, MinEc., Customs, Min. OSCE, IFC, WB,	Adapt Business Registration, customs, and finance laws, regs, systems and activities	Increased # of legal, profitable SME traders in bazaars. Robust use of bazaars	New contract	5
Trade Promotion	Chambers of Commerce, MinEC, DOD		Increased exports among business enterprise groups	REC expansion	3
Customs Capacity Building	ADB, OSCE, Customs Service, MinFin	Technical consultation, training, facilities to ensure that the	Increase use of the window	New Contract	3

Program Project Potential	Recommendations Detail for Trade				
Project Focus	**Partners**	**Output**	**Outcomes**	**Mechanisms**	**Years**
		single window and customs windows are functional, effective and extended			
Customs Union Negotiations	MinEC	Consultation on Customs Union options	Improved terms of accession.	New contract	3

ANNEX F

Possible Effects of a Gold Shock

The Kyrgyz Republic's near-term economic prospects are intimately tied to the price of gold. The gold sector accounts for approximately 12 percent of formal GDP and approximately half of formal exports. About 25 percent of government revenues are derived either directly or indirectly from gold. Taken together, fluctuations in the world gold price can impact the Kyrgyz Republic's private and public sector employment rates, exchange rates, commercial interest rates, and the availability of credit, particularly for sectors that are perceived as high risk such as textiles, tourism, and agriculture. Each of these considerations is discussed in detail below.

Between April 1-20, 2013, the price of gold on world markets dropped from about $1,600 per ounce to about $1,450 per ounce – a decrease of about nine percent in just three weeks. As of this writing, gold prices have stayed low for nearly a month. An extended period of depressed gold prices could have significant economic consequences, which we briefly discuss here.[79]

Direct Effects

The structure of the Kyrgyz gold extraction industry is unusual. More than half of the country's gold production is attributable to a single mine: Kumtor.[80] Kumtor's production accounts for over eight percent of formal GDP and over a quarter of all formal exports. Taxes and fees from Kumtor provide more than 10 percent of government revenue. This means that there are, broadly speaking, three possible scenarios.

1) The price of gold recovers and stabilizes above $1,450 per ounce. If it remains well below its former level of $1,600 per ounce, Kyrgyzstan will feel some negative effects, but these will not be severe in and of themselves. This is the "no gold shock" scenario.
2) The price of gold stays below $1,450 per ounce, but remains above Kumtor's production price. In this case, Kyrgyzstan will suffer a moderate, negative gold shock—the "gold shock" scenario.
3) The price of gold drops below Kumtor's production price.[81] This represents the point at which Kumtor would no longer be profitable to operate. If a prolonged

[79] Due to recent changes in the price of gold and the influence the gold sector could have on other sectors of Kyrgyzstan's economy, AMEG addressed the potential effects of a gold shock in this annex.
[80] It is difficult to obtain recent, reliable statistics on gold production. However, the Kumtor mine is by far the largest, and has dominated the sector for the last several years. In terms of formal GDP, Kumtor is nearly as productive as Kyrgyzstan's tourism sector and textile sectors combined.
[81] It is not clear what this figure is. One source familiar with Kumtor's production stated that it was "about $1,200" per ounce; another stated, with equal confidence, that it is "a little over $900." Also, it must be noted that the fate of Kumtor may not only determined by the world market price for gold: the Kyrgyz government is currently in the process of attempting to renegotiate the country's Bakiev-era agreement with Centerra, the operator of the Kumtor mine. If the parties cannot reach a new agreement, it is possible that Kumtor could close.

and severe depression in prices pushes the world gold price below its production costs, Kumtor could close. Given its contribution to total Kyrgyz economic activity, this event would trigger a "severe gold shock" scenario.

The following discussion assumes the second, most likely scenario, with gold stabilizing in the range of $1,400 to $1,450 over the next six to twelve months. In this case, simple macroeconomic modeling suggests a contraction in the Kyrgyz economy of about 1.5 percent over the next year; a drop of about 10 percent in formal exports; and a shortfall in government revenue of about 2.5 percent, on top of the already anticipated government deficit.[82] How this will impact the Kyrgyz economy at the micro-level is more difficult to model. The effects would be sensitive to decisions taken by the Kyrgyz Central Bank, the Kyrgyz government, and international financial institutions (IFIs) such as the IMF and the World Bank.

Policy Responses and Knock-on Effects

A drop in gold exports would increase Kyrgyzstan's trade deficit. This, in turn, would place downward pressure on the Kyrgyz som: as exports fall, market demand for the som would decrease, causing it to fall against other currencies. The Central Bank would eventually be faced with a difficult set of choices. To simplify, the Bank could (1) allow the som to depreciate by not intervening; (2) support the som indirectly by raising the interest rates on T-bills; or (3) intervene to support the som directly by using its hard currency reserves to purchase som on the market. Each option carries consequences.

Allow the som to depreciate. Allowing the som to fall would make imports more expensive and exports less expensive. Given that the Kyrgyz economy relies heavily on imports (82 percent of GDP), particularly imported fuel, compared to exports (55 percent of GDP), the net short and medium term effect of a depreciated som would be negative. The price of imported goods, and of services dependent upon imported fuel, would rise. The likely result would be an increased tendency towards inflation and a slight drop in the standard of living. The Central Bank is under pressure from the IMF to keep inflation down, and it is also under pressure from the Kyrgyz government to avoid politically painful drops in real wages. As a result, it seems likely that the Bank would try to avoid a rapid fall in the som., making this policy option less likely to be realized. The Bank would probably either attempt to keep the som stable or would try to manage a gentle, slow, controlled devaluation over time. Either of these strategies would require intervention.

Support the som indirectly. The Bank could intervene by raising the interest rate on som-denominated T-bills. This would make these bills more attractive, encouraging banks and other investors to purchase them. This would tend to drive up market demand for som, thus maintaining the exchange rate. However, this strategy has two dangers. First, T-bills

[82] This estimate is complicated by the fact that in the last six months, Kumtor appears to have been making advance payments against its anticipated tax liabilities. The size and scope of these payments is unclear. However, if they have been large, then in the second half of calendar year 2013, Kyrgyz government revenues will take a double hit: Kumtor's payments will be smaller because of lower gold prices, and will be smaller still as the advance payments are credited.

are government debt. A higher interest rate means the Kyrgyz government would be paying a higher price for debt. Effectively, the state would be committing to larger interest payments in the future in order to shore up the som today. Second, commercial bank lending is sensitive to T-bill rates. As the interest rate on T-bills increases, banks will begin moving more of their money into T-bills instead of lending it out.[83] The Central Bank would thus face the danger of triggering a credit crunch. Because of the risks and costs of this strategy, it seems likely that the Bank will prefer to avoid it, and will keep T-bill rates stable or raise them only slightly unless there is no alternative.

Support the som directly. The other method of stabilizing the som would be for the Central Bank to purchase large amounts of som on the open market. This would tend to reduce the supply of som and thus maintain the price. The Kyrgyz Central Bank has the ability to do this, because it is sitting on a large supply of hard currency reserves: nearly US$2 billion. This money could be used at any time to purchase som and thus stabilize the exchange rate.

This strategy does have long-term potential costs. It draws down the country's foreign currency reserves, thus reducing its ability to perform similar interventions in the future. If the open market operations go on long enough, and reserves drop low enough, it also opens the som to potential speculative attacks. However, these are long-term concerns that might not come to pass. In the short to medium term, this strategy would be the least politically and economically damaging. As a result, it is the most likely strategy for the Bank to pursue.

Regardless of which strategy the Central Bank pursues, in the medium term Kyrgyzstan is likely to see a moderate credit crunch resulting from depressed gold prices, because Kyrgyzstan's commercial banks are likely to perceive the fall in gold prices as a threat to economic stability. This perception will tend to make the banks more cautious, particularly with regard to certain types of lending: large loans, long-term loans, high risk loans, and loans that are dollar-denominated.[84] Banks will not stop lending entirely, but they will shift towards smaller loans, shorter-term loans, loans in sectors that are perceived as low-risk, and loans that are som-denominated. They will also prefer to remain relatively liquid in anticipation of increased risk from their current loan portfolios, possibly well in excess of Central Bank requirements. In sum, banks will become more risk-averse. The result will be to make credit more difficult to obtain, especially for

[83] This is not a smooth or linear effect. Instead, there tends to be a "tipping point" at which keeping money in T-bills is more attractive than using it to make commercial loans. For example, if a bank's net ROI on its loans is 7.5 percent, and the T-bill rate is six percent, then raising the rate to seven percent will have only a moderate effect on bank lending. But raising it to eight percent will have a very dramatic effect, as it will now make economic sense for banks to move all their available cash into T-bills. This is a common problem in developing countries, where T-bill rates tend to be high.

[84] Roughly 55 percent of commercial loans in Kyrgyzstan are dollar-denominated. This is an attractive option to borrowers, since the interest rates on dollar loans tend to be much lower. However, dollar-denominated loans are subject to exchange rate risk. Most borrowers are local Kyrgyz businesses: they are taking the and repaying them in dollars, but conducting their business in som, exchanging som for dollars to make loan payments. If the som falls against the dollar, it will become more difficult for these borrowers to repay. Thus, if banks suspect that the som may fall – a reasonable concern if gold prices remain depressed – then they will become more reluctant to make dollar-denominated loans.

sectors where ROI is low (i.e., textiles) and/or where risks are perceived as moderate to high (textiles, tourism, and agriculture).

Overall, the effect of a prolonged, negative gold shock on Kyrgyzstan's economy generally is likely to be contractionary, and would include a decrease in local investment,[85] a decrease in government spending, increases in public debt and in the current account deficit, stagnant or falling wages, and rising unemployment. The country's "brain drain" is likely to be worsened, as a weak economy will encourage emigration.

The exact details will depend sensitively on the GOK's policy response and on the willingness of IFI's to support that response.[86] For instance, the government may want to maintain government salaries and government spending, at the cost of accepting a larger deficit. If the IFIs are willing to support this approach, it will tend to mitigate the impact of the gold shock in the short to medium term, at the cost of a larger public debt in the long term. On the other hand, if the government responds by sharply cutting public spending and the state payroll, this will tend to amplify the impact of the shock in the short term.

We recommend that USAID remain vigilant of the price of gold, and monitor Kumtor's and the government's policy response if a gold shock occurs. A moderate gold shock could potentially have an impact on donor priorities. For instance, if formal unemployment rises, donors may wish to place a greater emphasis on policies and programs that create jobs and enhance livelihoods. Meanwhile, the likelihood of a credit crunch may raise the priority of programs that increase access to credit. Overall, donors have a range of tools available to respond nimbly to a gold shock, including existing programming, development of new programming through rapid response mechanisms, collaboration with government counterparts, and partnership with civil society.

[85] FDI is not likely to be directly affected, and might even be slightly encouraged if the som is allowed to fall. However, FDI in Kyrgyzstan is relatively low.

[86] IFIs provide loans, credits, and technical assistance to the Kyrgyz government, but at the cost of imposing "conditionalities", policies and programs that the GOK is expected to carry out. In the moderate shock scenario, the Kyrgyz Republic will almost certainly have to renegotiate its conditionalities with the IFIs.

ANNEX G
Assessment Team Itinerary

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
April 2013	1 **Team Arrives in Bishkek**	2 Bishkek In-briefing with USAID	3 Bishkek	4 Bishkek	5 Bishkek G. Helf, USAID/Washington joins team in field	6 Bishkek
7 Bishkek	8 Bishkek	9 Bishkek	10 Team 1: Osh	11 Team 1: Osh	12 Team 1: Jalalabad	13 **Team 1 Returns to Bishkek**
			Team 2: Bishkek	Team 2: Bishkek	Team 2: Bishkek	Team 3: Karakol
					Team 3: Osh	
14 Bishkek	15 Bishkek	16 Bishkek	17 Bishkek	18 Bishkek Presentation with USAID	19 Bishkek	20 Bishkek D.Dukowicz, USAID/Washington departs Bishkek
Team 3: Karakol/ Issykul	Team 3: Issykul					
21 Bishkek	22 Bishkek	23 Bishkek	24 Bishkek	25 Bishkek	26 Bishkek Outbriefing with USAID	27 **Team departs Bishkek**

AMEG Assessment Team: Douglas Muir, Chemonics (Team 1), James Newton, Chemonics (Team 1), Margaret Bishop, Banyan Global (Team 2), Michael Fox, William Davidson Institute (Team 3)USAID Washington Participants: Danielle Dukowics (Team 1)USAID CAR Participants: Bryan Byrne (Team 1)