BACKGROUND

With just over 6 million people and gross domestic product (GDP) of about $7 billion, the Kyrgyz Republic is the smallest but one of the most integrated economies in Central Asia. After the dissolution of the Soviet Union in 1991, the country began its transition to an independent nation-state, with complex transition challenges. During the first half of the 1990s, the Kyrgyz economy experienced a catastrophic decline—the real gross domestic product fell by almost 50%, one of the sharpest contractions both in Central Asia and among the Soviet republics. As a “double landlocked” nation, the Kyrgyz Republic is one of the globe’s most geographically challenged countries, distant from the world’s major commercial centers.

Notwithstanding its complex transition challenges and its geographic isolation, the Kyrgyz Republic has many achievements as an independent nation-state. After a quarter century, per capita incomes and living standards have returned to at least those prevailing in the late Soviet era. Social indicators compare very favorably to those of countries at similar levels of economic development. The country is regarded as having the most open economy and society among the former Soviet republics in Central Asia. The Kyrgyz Republic is on the threshold of graduating to the ranks of the lower-middle-income economies.

The principal challenge now is to translate these achievements and opportunities into stronger, broad-based economic growth. The economy is not growing fast enough to meet the needs of its population. Almost one-sixth of the population is forced to seek employment abroad, one of the highest ratios in the world. While overseas employment and remittances on this scale contribute in the short term to poverty alleviation, they do not provide the basis for long-term economic development. What is needed is faster economic growth and employment generation, especially in the tradable goods sectors. This will require fundamental economic and governance reforms.

This diagnostic study presents an in-depth analysis of key sectors from which the needed economic and governance reforms can emanate and lead to comprehensive growth. The book presents evidence-based policy suggestions for trade, agriculture, tourism and finance, information and communication technology (ICT), energy, transport and logistics, and human capital.

KEY MESSAGE

Although the Kyrgyz Republic faces significant geographic barriers, a key message of the study is that faster economic growth can be achieved with comprehensive reforms. Diversifying export products and markets will sustain growth and minimize volatilities. Higher electricity tariffs and more effective targeting of social expenditures will create fiscal space for improvements in electricity and transport infrastructure, which in turn will help businesses integrate into global value chains. Harnessing the power of ICT in trade, business, and governance could address geographic barriers and boost the potential of all economic sectors. Strengthening finance and tourism will generate much-needed jobs and have ripple effects through the rest of the economy. Improving the quality of education will produce skilled graduates who are able to meet the demands of both the local and international markets, and are able to contribute to long-term economic development.

KEY FINDINGS

1. Trade, foreign direct investment, and labor migration
   - As a result of market-oriented reforms since the early 1990s, the Kyrgyz Republic has emerged as one of the most globally integrated economies in the former Soviet Union. However, the country’s patterns of global economic integration have so far been rather lopsided.
   - Rapid import penetration in the economy has not been accompanied by structural changes on the export front. Gold remains the biggest export, constituting about 30%
of total merchandise exports during 2000–2017. The trade deficit relative to GDP continues to widen, from about 5% in 2003 to over 27% in 2017.

- This has led to increased dependence on migrant workers’ remittances and external financing. Remittances have filled over two-thirds of the trade deficit during 2000–2017. Foreign direct investment (FDI) is expected to play a pivotal role in export-oriented production and structural adjustment but has so far accounted for only a small share of capital inflows. FDI accounted for 10% of gross domestic fixed capital formation in 2016, a significant decline from about 50% in 2011.
- The composition of external financing has begun to shift from grants and concessionary loans toward borrowing at commercial rates, thus potentially exposing the economy to additional external economic shocks.

2. Agriculture
- Since the Kyrgyz Republic’s independence, its agriculture has achieved remarkable progress owing to various reforms initiated by the government. The country was the first among members of the former Soviet Union in Central Asia to have its total agricultural value rebound to pre-independence levels. Since 2004, however, Kyrgyz agriculture’s growth has slowed and, from being an exporter, the country has become a net importer of agricultural goods.
- Agricultural productivity remains low possibly due to deteriorating irrigation schemes and outdated agricultural technology. Only about 61% of total cultivated cropland was irrigated in 2016, a significant decline from pre-independence levels of about 80%.
- Although overall agricultural productivity remains low, there are some emerging niche export subsectors. The development in Talas Oblast of kidney bean production—the country’s largest agricultural export product, valued at about $56 million annually—exemplifies good practice and demonstrates the importance of international knowledge and market access. Milk and dairy export from the country’s northern region to Kazakhstan and the Russian Federation also shows potential.

3. Services and tourism
- The services sector is currently the country’s largest and fastest growing sector, employing about half of the country’s workers and generating 57% of GDP. Increased financial sector development and tourism will further drive the growth of the services sector and will have ripple effects on the rest of the economy.
- Tourism’s contribution to GDP increased from 3.9% during 2006–2010 to 4.7% during 2011–2018 on the back of higher tourist arrivals mostly from Kazakhstan, the Russian Federation, and Uzbekistan. However, compared with most of its counterparts in the region, Kyrgyz tourism has progressed more slowly owing to constraints such as seasonality, shortage of qualified professionals, and insufficient and unreliable infrastructure.
- The deposit-to-GDP ratio stood at only 18% in 2016, mostly demand deposits. Only 26% of the country’s population owns a bank account, suggesting weak financial inclusion. In 2016, the financial subsector’s loan portfolio amounted to about 22.8% of GDP. A majority of the loan portfolio is concentrated in Bishkek and other cities, and in the trade and agriculture sectors.

4. Information and communication technology
- The Kyrgyz Republic has made considerable effort to develop ICT, creating the relevant legislative framework, implementing programs, and building human capacity for ICT. Value added of the ICT sector grew at an estimated 9.5% in 2016, contributing about 1.9% of the country’s GDP.
- The country has very high mobile cellular subscription, at 131.4 per 100 inhabitants, greater than Azerbaijan, Tajikistan, Uzbekistan, and the world average. Owing to topographic challenges and the increasing popularity of mobile phones, fixed telephone lines subscription remains low at 6.6 per 100 in 2017, the second lowest in Central Asia.
- Despite the high level of literacy and the relatively low price of internet connectivity compared with peers in Central Asia, only 38% of the adult population had used the internet in 2017. ICT availability in schools remains low—only about 6% of schools had an internet connection in 2014. In business, many firms have their own website and use e-mail for communication but significant gaps remain between small and large firms, with the later utilizing ICT more than the former. ICT usage is also picking up in finance (e.g., mobile banking); health (e.g., telemedicine); and governance (online services).

5. Transport and logistics
- As a “double landlocked” country, the Kyrgyz Republic faces the dual problem of poor connectivity and inadequate market integration domestically and internationally.
- The transport sector’s role in the economy remains small. In 1996, transport contributed just 0.4 percentage points to GDP growth and in 2017, figures were almost unchanged at 0.3 percentage points.
- There have been major improvements in the road network since the turn of the century, although maintenance and road safety remain issues. About 33% (2013) of international and national roads are in poor condition and needed rehabilitation.
- The domestic rail network has not changed and remains minuscule despite plans for north–south links. The passenger share of total rail traffic volume remains small at about 1%, while freight share increased from about 2% in the 1990s to 6.1% in 2017. Air transport, especially international routes, is limited.
- In logistics measures, the nation ranked 108 out of 166 countries in the World Bank’s Logistics Performance Index in 2018, with its lowest ranked performance in international shipments and quality of infrastructure.

6. Energy
- The energy sector in the Kyrgyz Republic is vital to production and for generating heat necessary to survive the cold winters. In 2015, the country’s total energy production was 1,798 kilotons of oil equivalent (ktoe). However, domestic production accounted for only 45% of the 3,981 ktoe of total primary energy supply. The electricity system is small and heavily dependent on a few hydropower generation facilities and two cogeneration plants (during winter), making it vulnerable to breakdowns and disruptions.
Despite its immense hydropower potential, high potential for wind and solar power, and substantial coal reserves, the sector has struggled to meet the growing demand for energy owing primarily to difficulties with attracting investment in energy. This has resulted in very old and inefficient generation, transmission, and distribution assets.

A key reason for the lack of investment is the challenges in adhering to tariff changes proposed by the regulator. The low tariffs for residential users place significant financial strain and greatly restrict resources for investment, both by public and private sector actors. Low tariffs also discourage energy efficiency—the Kyrgyz Republic has among the highest energy intensities in Central Asia.

The implicit subsidy on electricity and heating is regressive, benefiting better-off and urban households much more than rural and poor households. In 2016, social assistance stood at 7.1 billion som while energy subsidies amounted almost double that, at 13.8 billion som.

7. **Human resources development**

- The labor market is undergoing a structural shift, with labor moving from agriculture to services. The quality of jobs in terms of stability and security is declining because of the presence of a large informal sector, which constituted about 70% of total employment in 2015.
- The unemployment rate has been relatively high especially among the youth, although the extent of underemployment has improved somewhat. The female labor force participation has declined due to childbirth, lack of jobs, migration, and cultural factors.
- The number of labor migrants is significant and is likely to grow in light of the country's membership in the Eurasian Economic Union in 2015. A majority of migrants work in the Russian Federation and mainly hold blue-collar jobs; about 25%–39% of migrants are female.
- The education preference has undergone notable changes since the early 2000s, with more young workers opting to enter the labor market earlier or to pursue vocational education, and a lower proportion of high school graduates attending higher education.
- The education system lags in equipping graduates with the skills demanded by the knowledge and innovative economy, and the school curricula do not sufficiently address gaps in teaching ICT and life skills.

**KEY RECOMMENDATIONS**

The Kyrgyz Republic is at a crossroads—the decisions to be made in the coming years will determine whether the sluggish growth of the past will persist or whether momentous growth will finally be achieved. A major priority is the need to develop capabilities for cost–benefit analysis of major infrastructure projects as public sector indebtedness is already high. Second, more effective targeting of social expenditures is needed to create fiscal space for infrastructure and reforms in electricity and taxation. Third, democratic progress needs to be matched by more effective governance to foster enterprise growth that will in turn produce more jobs. Last, greater analytical work is needed with all economic partners, to draw win–win agreements. The specific recommendations are as follows:

1. **Trade, foreign direct investment, and labor migration**

- Food exports should be focused on high-value processed food. It is important to set up an institutional mechanism for international food safety standards through assistance from international development agencies or vertically integrated foreign investors.
- The government could explore ways to globalize its market for garments. To enable this, the government should (i) remove administrative and fiscal restrictions that hinder firm growth, (ii) promote FDI, and (iii) introduce an import duty drawback scheme for exporters. The country could be an attractive location for Turkish garment producers, which have already started relocating production in the face of increasing domestic wages in Turkey.
- The government should undertake financial sector reforms for directing migrant workers’ remittances to socially and economically desirable investments through financial intermediation.

2. **Agriculture**

- Dry beans are the Kyrgyz Republic's top export crop product, but reliance on the Turkish market (and to some extent, the Russian market) leaves the product vulnerable to external conditions. There is thus a need to diversify export destinations beyond neighboring countries, which can be done by joining global value chains. Given its small size, Kyrgyz agriculture must rely on external technological knowledge and inputs to increase its productivity.
- To grow the dairy industry in the northern zone, trade disputes need to be addressed, including reducing transaction costs associated with customs and facilitating the overall business environment.
- The central zone is dependent on livestock and is thus vulnerable to animal health risks especially due to limited knowledge of farmers about disease prevention and control. To address this, the government needs to strengthen vaccination programs.
- The opening of trade between the Kyrgyz Republic and Uzbekistan in 2017 is expected to increase agricultural trade. Agriculture in the Fergana Valley zone can benefit significantly from this. Farmers, processing firms, and traders need to take advantage of the new trading environment, and support from the government in developing incentives to nurture the agricultural value chain.

3. **Services and tourism**

- For the services sector, ensuring a robust private sector is the key to promoting strong growth and creating more jobs. Facilitating this requires a strong policy focus on upgrading public infrastructure, promoting human capital development, and improving the overall business environment. Moreover, the country also needs to develop financial services to help entrepreneurs innovate by making credit more accessible and affordable, and reduce the cost of capital by attracting greater private investment.
- To promote the country’s transport and logistics services, simpler and more transparent border control processes are needed to avoid delays and reduce transactions cost.
Tourism is a promising source of employment growth given its strong backward and forward linkages. Effective branding strategies are needed to position tourism products in overseas markets. The Issyk-Kul Lake Tourism Corridor provides plenty of growth areas and has untapped potential for niche tourism. It is important to develop more attractions and tourism activities to entice more visitors, especially during winter when demand is low. This will require investing in infrastructure of tourist destinations.

4. Information and communication technology

- Despite a lack of direct access to the sea, the Kyrgyz Republic’s location between the PRC and Europe offers the potential for the country to become a digital hub along the Silk Road. Recognizing these opportunities, the government has launched the National Digital Transformation Program that aims to create conditions for the emergence of the digital economy by mainstreaming digital technologies in the public administration and services, creating competence centers and innovative clusters that will provide new opportunities and economic breakthrough using digital innovations. However, success of the initiative depends on how effectively the country can harness human and financial resources.
- The institutional arrangement for the new program will need to have sufficient capacity, authority, or scope to supervise such a high-level, economy-wide strategic initiative and to monitor and coordinate across different levels of government.
- For the successful execution of the new program, it is critical to formulate an implementation strategy providing a sequence of actions. At some stage, the country will need to move to common protocol and systems for its e-government architecture. The move will entail significant effort to convert existing systems and hence needs to be sequenced.
- Cost estimates for the entire initiative or identification of individual projects needs to be explicit so that private sector and other development partners can identify projects or areas where development investments or support are most needed.

5. Energy

- The government’s policy of selling electricity at prices that are far below cost has led to the sector’s poor financial performance. To secure long-term financial sustainability, there is a need to implement and strictly adhere to a new medium-term tariff plan as part of a comprehensive reform package.
- To ensure that customers realize real benefits for the higher tariffs they will pay, the sector needs to invest in service quality improvement.
- Low-income households need to be protected, not by shielding them from tariff increases but by substantially increasing the resources available for social assistance and for services used heavily by the poor.

6. Transport and logistics

- Improvements in transport and logistics will support increased trade and inclusiveness. The government needs to address road maintenance and safety on existing roads, in addition to constructing new roads.
- Transport asset management should be implemented properly to sustain assets at the minimum practicable cost and to streamline investments for new road connections.
- Necessary steps should be taken to lift the European Union’s restrictions on Kyrgyz airlines due to safety concerns. This problem could be resolved partly by attracting FDI to the sector, which could improve safety of local carriers.
- Costs of international trade could be reduced through improved border management, which includes improving soft infrastructure (e.g., ICT) associated with transport and logistics.

7. Human resources development

- To encourage small and medium-sized enterprises to move from the informal to the formal sector, the government could equalize taxation for small and large companies, reduce the taxation on wages, and reduce regulatory pressure on large firms.
- To improve the outcomes in education, more resources need to be allocated for teacher training and monitoring to increase the quality of teaching and to include life skills (e.g., communication, presentation, time management) and ICT skills (e.g., programming) in the curriculum so students are better prepared to meet the demands of the labor market.
- To improve the skills of workers, more public funds should be allocated for retraining and vocational education. Also, supporting sector-specific qualifications standards will benefit those who did not complete formal training but learned well on the job, to certify their skills and gain access to higher level jobs.
- Last, equipping potential migrants with the skills and information needed to secure legal employment will help them get better jobs with larger welfare effects at both the household and macroeconomic levels.