



Regional Value Chains in CAREC

The Case of Kyrgyzstan Garment Industry

November 2019

The working paper explores the role of Regional Value Chains (RVC) in promoting regional integration which is understood as a strategy that promotes the benefits of collective and collaborative activities among member countries through economies of scale, more vigorous intra-regional trade, expansion of markets, shared information platforms for exchange, and harmonized frameworks for social and economic interaction.

This study also looks into the Kyrgyzstan garment industry as an example of a relatively successful regional value chain with the potential to upgrade and engage in the global value chain for garments.

The RVCs are significant in the light of the unique context of CAREC. Despite its historical significance as the site of the ancient trade route - the Silk Road - the CAREC region has not been able to form a part of global production hubs and value chains. According to the CAREC Regional Integration Index (CRII), designed by the CAREC Institute based on the Huh and Park Asia–Pacific Regional Cooperation and Integration Index (RCI) to measure the depth and breadth of regional economic cooperation among the 11 member countries, CAREC region is the least integrated across all dimensions with the regional value chain score of 0.176.

Asia has benefitted from the rise of GVCs, providing income and employment by building on the region’s reputation as the “world’s workshop” (ADB Outlook 2014: 37). GVC trade, however, has mostly been concentrated in East and Southeast Asia with the People’s Republic of China as the core, altogether providing 12.1% of total global manufacturing output in 2008. Together with the seven Southeast Asia economies, both subregions account for all Asian GVC trade. In contrast, Central Asia, South Asia, and the Pacific are largely excluded from the GVC trade, owing to poor connectivity to GVC hubs, and capturing only a low share of value-added processes in their economies (Ibid.: 57, 61).

Considering the above, CAREC member countries can and should exploit the potential within the Asia-wide region to integrate into global value chains through enhanced regional cooperation and integration. Further research into the factors that impede and hinder integration into GVCs can help determine why some economies are less able to capture a share of value-added processes.

Dr. Teresita Cruz-del Rosario, Research Consultant of the Asian Development Bank, in cooperation with the CAREC Institute, tried to identify those factors, and formulate policy lessons which should help address the bottlenecks and boost participation in regional and global value chains in the CAREC region.

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Abbreviations

| | |
|-------|---|
| ADB | Asian Development Bank |
| BPO | Business Process Outsourcing |
| CAREC | Central Asia Regional Economic Cooperation |
| CIS | Commonwealth of Independent States |
| CMT | Cut Make Trim |
| CRII | CAREC Regional Integration Index |
| EAEU | Eurasia Economic Union |
| EEU | Eurasian Economic Union |
| EFTA | European Free Trade Agreement |
| EU | European Union |
| FDI | Foreign Direct Investment |
| FEZ | Free Enterprise Zones |
| GDP | Gross Domestic Product |
| GDP | Gross Domestic Product |
| GIZ | Deutsche Gesellschaft für Internationale Zusammenarbeit |
| GVC | Global Value Chain |
| MNC | Multinational Corporations |
| OECD | Organization of Economic Cooperation and Development |
| PRC | People's Republic of China |
| RCI | Regional Cooperation and Integration |
| RVC | Regional Value Chain |
| SDG | Sustainable Development Goal |
| SECO | State Secretariat for Economic Affairs |
| SME | Small and Medium Enterprise |
| UNDP | United Nations Development Programme |
| USAID | United States Agency for International Development |
| VAT | Value-Added Tax |
| WTO | World Trade Organization |

1. Executive Summary

The Regional Value Chains (RVCs) in the CAREC region are at a low level of development. Being a dimension in the CAREC Regional Integration Index (CRII), the RVC score stands at 0.176 (2016), which is one of the lowest in the Asia-wide region and is much lower than the similar score in East and Southeast Asia.

The logic for this study, therefore, is to investigate the factors that contribute to the low level of RVC development and to propose policy measures that will correct this deficiency. This study also looks at the Kyrgyzstan garment industry as an example of a relatively successful regional value chain with the potential to upgrade and engage in the global value chain for garments.

Though not optimal, the situation of RVC formation in the CAREC region is not altogether negative. Through the lens of the Kyrgyzstan case study on garments, the RVC study yields strategic policy lessons by examining the prospects, problems, and potentials for further deepening and advancing along the garment value chain. Ultimately, the goal of strengthening RVCs is to link with global value chains, thereby allowing the latter to engage in global trade and become more integrated into the global market system.

Presently, the Kyrgyz garment industry enjoys favorable market linkages with Kazakhstan and Russia, with ample government and donor support to provide financing for SMEs and inter-industry support through business associations. Further, Kyrgyzstan's membership in the WTO and the Eurasian Economic Union (EAEU) has benefitted the garment industry in terms of favorable export terms.

Of crucial importance to the understanding of the RVCs in the CAREC region is the role of small and medium enterprises (SMEs). Data reveals predominance of SMEs in the region. They contribute substantially to business activity in all CAREC countries. This predominance, however, is not unique to the region. The SME predominance is a feature in advanced economies as well, namely, the European Union (EU). What is markedly different among these two regions, however, is the ability of EU enterprises to succeed in regional and global trade by taking advantage of regional geographies, skills development, and knowledge of market linkages. The RVCs in the CAREC region can certainly benefit from the comparative lessons of advanced economies and within the Asian region itself, namely East and Southeast Asia.

The study reveals the policy lessons which are similar to those that promote intra-regional trade. The link between intra-regional trade and RVCs is rather obvious: RVCs are the motors of intra-regional trade through the activities of firms and enterprises that operate across borders and can thus link economies to one another. Without solid knowledge and expertise in cross-border operations, and without strong businesses that can operate with regional markets, RVCs cannot flourish.

The Kyrgyz garment industry illustrates these linkages and policy lessons. The most significant of these policy lessons to support the advancement of RVCs are the following:

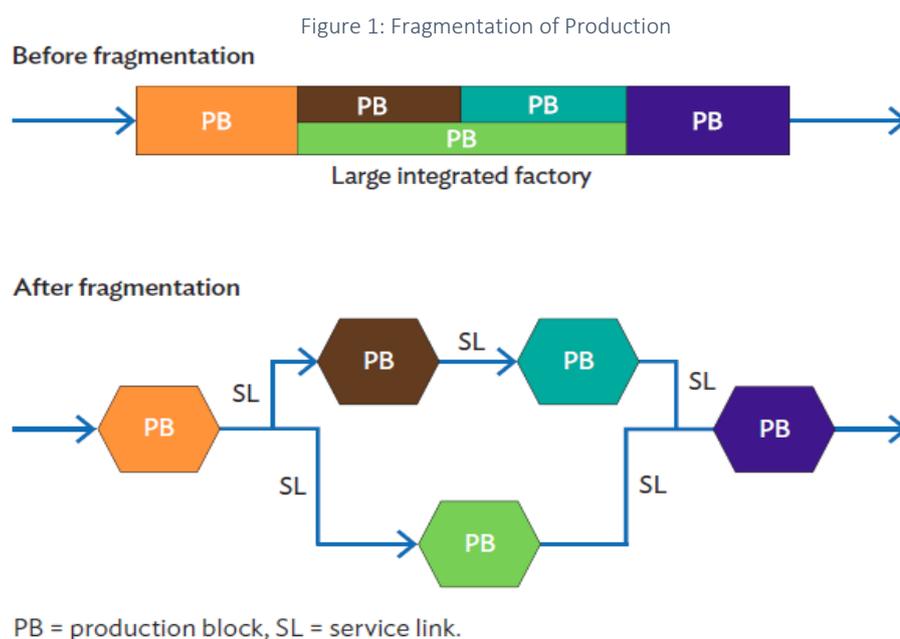
- 1) Upgrading of firms to advance along the value chain requires policy support in terms of helping these businesses expand. Micro enterprises, i.e. those who employ five people and less, are not able to capture the benefits of regional transactions. Mostly, they dissipate given the competition from relatively bigger SMEs. Similarly, smaller enterprises, i.e. those with 5-10 employees, need to expand their operations beyond Cut-Make-Trim (CMT) contracts. These business activities are largely unsustainable. Labor moves rapidly within the industry in situations where contracts are not renewed.

Also, with the proliferation of CMT contracts across a large number of SMEs, these enterprises cannot establish their niches in the garment industry region wide.

- 2) RVCs operate within a macroeconomic environment which provides the conditions under which RVCs can function efficiently. The Kyrgyzstan case study illustrates how policy reforms should be targeted towards improving the country's macroeconomic situation to support RVCs who wish to engage in intra-regional and global trade. Kyrgyzstan's heavy debt burden, for example, restrict the abilities of enterprises to operate efficiently and competitively even as they are needed to support revenue generation.
- 3) Access to financing for SMEs and RVC activities is imperative for regional integration. Financial institutions within CAREC member countries must undertake the needed reforms to steer these entities towards supporting SMEs that depend on financial assistance for upgrading activities to advance along the value chain. Also, financial support is necessary to establish linkages to overseas markets and assist in expanding beyond the region.
- 4) Capacity building for firms and enterprises are necessary to capture the benefits of regional value chains. Among the required activities are skills training and development, particularly in the technical skills of marketing management, regional value chain management, accounting and bookkeeping, retail distribution, establishing networks, and information exchange. Toward this end, capacity building also requires a technology-based knowledge platform for businesses that can provide the latter with their information and communication needs regarding issues such as pricing, market behavior, and global trends and patterns in the industry. The Kyrgyz garment industry would benefit from technical training in garment software for patterns, designs, and the like.
- 5) Associations and collective bodies and allied networks constitute the "soft" infrastructure for RVCs. These networks perform valuable tasks in terms of knowledge sharing about market outlets, customer preferences, industry regulations and procedures, and updated industry technologies. Further, these bodies provide complimentary activities, as in the case of Kyrgyz garment and textile associations that sponsor exhibitions to showcase finished products and provide members with market outlets outside the region. Further, these associations establish representative offices in overseas markets that facilitate trade exchanges and expand business contacts.
- 6) Finally, RVCs are dependent on cross-border trade facilitation measures that include infrastructure development to ease transport challenges, especially in difficult terrains. Alongside investments in hard infrastructure are policy measures to ease regulatory burdens in border areas. These measures include regulations and procedures that hasten cross-border transactions, simplified and harmonious procedures on both sides of the border.

2. RVCs and GVCs in CAREC: Background and Conceptual Framework

A value chain is defined by the ADB (2014: 38) as the “full range of a firm’s activities, from product conception to production and finally after-sales service.” Value chains arise when different activities within the production process are “sliced up” and distributed across different geographical locations rather than concentrating the production in a single factory. The company, usually a multinational corporation (MNC) establishes a network of suppliers and affiliates, each overseeing a specific production block (see Figure 1 below). Each of the members within the network is geographically dispersed to benefit from locational advantages such as low-cost labor, technical and managerial know-how, lower transport and coordination costs, and manageable trade barriers (Ibid.) Other networks may be involved in the assembly of the final product (e.g. end stitching of a garment).



Source: ADB Outlook 2014, p. 38

Fragmentation of the production process across borders is a salient feature of globalization today, a phenomenon generally referred to as global value chains (GVCs). The MNCs have moved away from local production towards coordinating the various stages of the production process in different countries and among different suppliers, in a bid to lower costs. The dispersion of production centers across different parts of the globe lies at the core of outsourcing and offshoring of business activities. These networks, according to Kajuna (2016: 1) “provide transition economies and developing countries an opportunity to integrate into the global economy,” provided that these networks operate efficiently.

The proliferation of GVCs occurred in the late 1980s and is referred to as the “second great unbundling”¹ due to the lowering of costs with the advent of technology and rapid transmission capability. Coordination via fast communication brought down costs, so firms began to outsource spatially. Some firms organized as Business Process Outsourcing (BPO) are only involved in product inventories, monitoring of product flows, and after-sales services. Fragmentation thus occurred both

¹ The “first great unbundling” was a term coined by Baldwin (2006) which largely referred to the spatial separation between production and consumption because of steam power. Despite this separation, however, the production process was still concentrated in factories and industrial districts. See ADB Outlook 2014, p. 38.

functionally and geographically. It is worth noting that value chains differ from the traditional network of trading partners in that the former requires a degree of vertical integration especially in cases of specialization involving numerous parts and components for a single product. For example, the production of car parts with highly specialized components requires intense coordination among different production sites to ensure the efficient assembly of all parts before releasing into the market.

One of the most interesting findings is that the strongest links to GVCs are regions, specifically in Europe, North America, and Asia. Within these regional value chains, participation is uneven. Firms in higher-income countries within the region participate in marketing, design, and distribution, while middle- and low-income countries within the same region contribute low-skilled tasks (Pomfret and Sourdin 2018: 31). One of the direct implications for this uneven participation in RVCs is the need for greater regional integration to spread the benefits of value-adding activities.

The fragmentation of production is potentially beneficial to firms in countries and regions that wish to enhance performance and benefit from intra-regional and cross-border trade in the first instance. Strong regional development promotes the integration of markets and subsequently triggers upgrading processes that create opportunities to link with global exchanges. By complying with international standards of quality and productivity, regional firms become competitive to attract multinational investment that will usher the entrance of RVCs into GVCs (Kahuna Ibid.). The key, therefore, to integration in global value chains is stronger regional integration. Numerous scholars have argued that the actual geographic scope of GVCs is regional; thus, even while final goods and products are sold in the global market, the intermediate production activities, especially in the manufacturing sector, are mostly carried out in countries within the same region.

The perspective of economic geography is significant for firms who decide to disperse their production processes along adjoining borders. The benefits of geographic proximity are evident in labor supply, spillovers of business knowledge, the formation of business alliances, and development of distinct business cultures. Further, economies of scale can be achieved with shared infrastructure, intra-regional outsourcing, and industrial linkages across adjoining countries². Finally, there is evidence on the increase in demand for intermediate and final goods from adjacent countries, thus spurring intra-regional trade and the development of regional value chains (Suder et al. 2015: 406).

All said, fragmentation of production, while dispersed, follows the logic of geographical proximity to obtain maximum benefits from spillover effects, and to manage risks, what De Backer, et al. (2018: 4) refers to as “co-location of different functions.”

3. The Role of Small and Medium Enterprises

The SMEs are the backbone of many economies, especially in less developed economies. But even in developed countries, the small business sector occupies a major portion of the economy. In the 27 countries that comprise the European Union, SMEs contribute substantially to GDP through exports of goods and services: Germany - 52%; Sweden - 49%; Lithuania – 84%; Estonia – 92%. The formula for the success of these SMEs is an “internationalization” strategy that has been proven to succeed even while remaining relatively small by taking advantage of geographical proximity to important markets.

² Agis Allianz Dresdner Informationssysteme Gmbh Annual, https://www.allianz.com/content/dam/onemarketing/azcom/Allianz_com/investor-rela (accessed April 26, 2019)

Lithuania, for example, being “sandwiched” between the European Union (EU) and the Commonwealth of Independent States (CIS), leveraged its position to trade between these two regions. For the period of January-June 2013, Lithuania’s trade with the EU, European Free Trade Association (EFTA), and the CIS states accounted for 90% (Brazinskas and Beinoravicius 2014: 1034) of total trade. The lesson here is straightforward: not only MNCs can conduct business abroad; SMEs can likewise form part of RVCs and GVCs provided they overcome the obstacles that prevent them from joining value chains by employing the correct strategies.

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The obstacles that SMEs face can be classified into four categories (Carter and Jones-Evans 2006):

- a) internal-domestic (limitations within the firm, home country environment)
- b) internal-foreign (limited marketing ability, lack of knowledge of overseas markets)
- c) external-domestic (absence of government support to overcome barriers)
- d) external-foreign (foreign government restrictions, lack of contacts, cultural differences)

The SMEs can utilize this categorization of obstacles as a simple diagnostic tool to identify the nature and intensity of obstacles and subsequently develop a strategy to overcome them.

SMEs in the CAREC region are numerous and comprise a significant number within the member countries. In Kyrgyzstan, SMEs account for about 13.8% of total employment and 42.8% of GDP. In Tajikistan, SMEs accounted for 43% of GDP in 2008, with an average growth rate of 2% since 2001, whereas in Afghanistan, SMEs constitute 85% of all businesses (Neufeld and Earl 2014: 8).

These enterprises create wealth, generate employment, act as change agents, and enroll marginalized citizens into the economy, particularly women (Kapalova 2014). They constitute the building blocks for a robust export-oriented economy while simultaneously providing for welfare needs of citizens.

However, the sector faces massive challenges both in the macro- and micro-economic environments. While not insurmountable, these challenges must be overcome so that the sector can participate in regional value chains, promote intra-regional trade, and eventually, participate in global trade.

The most important of these challenges is to upgrade the competencies of SMEs to convert these enterprises into export firms. In turn, upgrading processes are dependent on policy support from governments that need to reform the enabling policy environment for SMEs. Based on research data, upgrading also requires expanding the size of SMEs that micro-enterprises are not able to access finance nor information on global markets. Typically, the smallest enterprises are the most vulnerable to changes in the overall environment; however, their size allows them adaptability and resilience (Ibid.: 12).

A further challenge facing SMEs is informality. In **Afghanistan**, an estimated 70-80% of SMEs are informal and unregistered (Ibid: 13). Due to a regulatory environment that increases the cost of doing business along with heavy tax burdens, entrepreneurs prefer to remain in the informal sector; others split their businesses to lower costs and remain relatively hidden from the bureaucracy to avoid further regulations (Ibid.). Informality creates a vicious cycle in which an unstable labor force

and limited capabilities to compete in the marketplace prevents upgrading, keeping the enterprise in a state of smallness, unable to strategize for future expansion and hence are kept locked out of the export sector.

Access to finance is an acute problem of SMEs in the CAREC region. In turn, weak financial institutions as in the case of **Tajikistan** hamper lending to enterprises due to the lack of a creditor information system. In **Afghanistan**, women-led enterprises are disadvantaged from securing credit and loans because of property and land registration systems that favor men. **The reform of financial systems is a policy priority for countries that aim to support the SME sector to become more globally competitive** (Ibid.: 16).

Trade facilitation across borders will also boost SME activity and deepen RVC formation. **The simplification of procedures and clarity of regulations are necessary steps to ensure that the exchange of goods and products is a smooth and unimpeded process.** SMEs in the CAREC region are still hampered by several restrictions, among them, border bureaucracies that remain un-harmonized and cumbersome. In Tajikistan and Afghanistan, technological assistance is lacking at the border areas that would otherwise facilitate the flow of goods (Ibid. 17-18). These are a few measures that can create the enabling environment for SMEs to participate in RVCs.

4. The CAREC Regional Integration Index

In 2017, the CAREC Institute designed the CAREC Regional Integration Index (CRII) based on the Huh and Park Asia-Pacific Regional Cooperation and Integration Index (RCI) to measure the depth and breadth of regional economic cooperation among the 11 member countries. It compares the intra-CAREC state of integration vis-a-vis regional and global integration index rankings.

Following the lead of RCI, the CRII includes 26 indicators that measure various aspects of regional integration along six dimensions: (i) trade and investment integration, (ii) money and finance integration, (iii) regional value chains, (iv) infrastructure and connectivity, (v) free movement of people, and (vi) institutional and social integration. The 26 indicators are normalized and aggregated using principal component analysis to yield an index ranging from 0 to 1, with higher values representing higher levels of integration.

In the context of the CAREC region, the low score of the regional value chain dimension (0.176) is related to the low score on trade and investment dimension (0.137). Limited intra-regional trade and cross-border investment among CAREC countries signals very limited activity among RVCs. In turn, the participation of the CAREC members in GVCs tends to be also low. Weak regional integration translates into weak integration in the global economy.

The factors that account for weaknesses in RVCs can be distilled from a rather substantial literature that examined the state of intra-regional trade and investment since efforts began to integrate the region through policy and program interventions.

The factors that relate to weak cross-border trade and investment are the same ones that affect poor RVC formation. These include less open trade regimes; restrictive and burdensome regulatory frameworks; tax burdens; labor rigidities; poor infrastructure; weak (technological) connectivity; distance to major markets; weak or no access to finance for capitalization of businesses; weak incentives for investments; and lack of market information (Vandenberg and Kikkawa 2015).

The Kyrgyzstan case study illustrates the possibility for investing in small and medium enterprises that can later be upgraded to penetrate the GVCs through an enabling policy environment for RVC

formation. What follows is an extensive discussion of the garment industry and policy lessons for future similar endeavors.

5. Kyrgyzstan's Garment Industry: Background

Kyrgyzstan is a small, low-income country surrounded by bigger and wealthier neighbors, notably the PRC, Kazakhstan, and Uzbekistan. It is a landlocked country with a land area that is 199,951 square kilometers, about the same size as its closest neighbor Tajikistan. Its longest borders are with Uzbekistan (1,314 km), Kazakhstan (1,212 km), and the PRC (1,063 km). Its population is 5.9 million, with a GDP per capita of US\$1,103 in 2016. Improvements have been achieved with poverty reduction rates, dropping to 25.4% in 2016 from a high of 40.7% in 2006. However, it is still at par with its CAREC neighbors: Tajikistan (31.3%) and Pakistan (25.4%). In contrast, Kazakhstan's poverty rate in 2015 was 2.7%, followed by Azerbaijan at 6% (World Bank 2016).

The country possesses abundant natural resources, among them, gold, mercury, and uranium. Gold is the largest export, and the Kumtor gold mine is the second largest in the world (Birkman 2012: 12). The volatility of world prices in gold is always a source of vulnerability to Kyrgyzstan's trade and foreign exchange earnings. Hydropower resources are likewise abundant and provide the potential for hydroelectric development. Agriculture employs half of the population. Agricultural products are largely for domestic consumption, although tobacco and cotton are significant exports (Ibid.: 13).

Despite a rather turbulent history in the past two decades that saw frequent changes in political leadership, Kyrgyzstan has remained resilient and continued to deliver relatively sound economic performance. However, Kyrgyzstan's growth rates are volatile. For the period 2013-2017, growth rates averaged 5.5%. The GDP growth rate was very erratic, owing largely to the country's reliance on the gold sector which suffers from periodic fluctuations.

More worrisome is the dependence of the Kyrgyz economy on remittances. In 2010, remittances contributed almost 30% to GDP. Comparatively, its neighbor Tajikistan contributed 37% to the country's GDP for the same period. Remittances from the Kyrgyz labor migrants in 2018 amounted to US\$2.24 billion, an increase of US\$160.2 million more from the previous year. The 90% of remittances come from Russia, according to reports from the National Bank of Kyrgyzstan³. In 2013, remittances from Tajikistan migrants amounted to some US\$4.13 billion⁴. According to the World Bank, both countries comprise the top remittance-receiving countries as a percentage of GDP in 2014. See Figure 2 below.

A high literacy rate of 99% and high youth unemployment are critical factors that contribute to out-migration. The destination of migrants is primarily Russia whose shrinking population and massive mineral resources combined produced a demand for outside labor (Agadjanian and Gorina 2018: 2). Of the 750,000 migrants from Kyrgyzstan, 80% are in Russia, and 20% are in Kazakhstan. Unofficial data estimates that there are about one million Kyrgyz labor migrants. Comparatively, there are also an estimated one million labor migrants from Tajikistan in Russia. For long-term sustainable growth, Kyrgyzstan, or any country for that matter, cannot rely on remittances as a strategy.

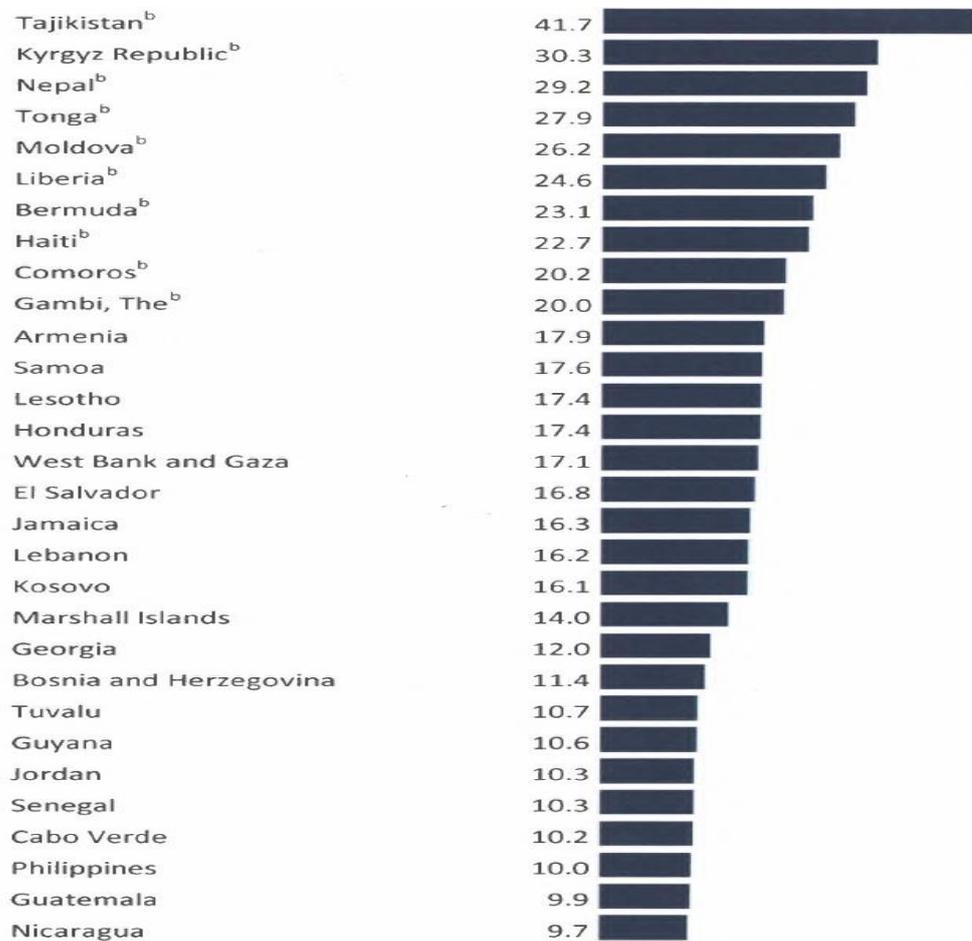
Kyrgyzstan's macroeconomic profile is generally positive. Forecasted growth in 2019 is 3.5%, which falls below the long-term average of 4.3%. Kyrgyzstan remains an open economy as compared with its neighbors. Its trade/GDP ratio in 2017 was 102.2 compared with Tajikistan (56.6), Afghanistan

³ *Central Asia: Who Benefits from Labor Migration?* The Times of Central Asia. 16 December 2018. <https://www.timesca.com/index.php/news/26-opinion-head/20615-central-asia-who-benefits-from-labor-migration> (accessed 15 April 2019)

⁴ *Ibid.* (accessed 15 April 2019)

(55.9) and Pakistan (25.8). It relies much more on trade compared with its neighbors. Its major trading partners are Switzerland, the PRC, Russia, and Kazakhstan⁵. It ranked 97th in the Global Competitiveness Index⁶ in 2018-2019, up by five places in 2017-2018, and consistently improving over the past few years. Economic freedom in Kyrgyzstan has improved considerably over the past two decades. Its economic freedom score is 62.8, ranked 78th, and is now considered as a “moderately free” economy⁷. These results bode well for the country in terms of intra-regional trade.

Figure 2: Top Remittance Receiving Countries as a Percentage of GDP, 2014



Source: Migration and Remittances Factbook 2016 Edition. The World Bank, p.30

However, there are some worrying features of Kyrgyzstan’s economy. The projected decline in remittances will affect growth rates, as Russia’s economy slowed down, and its currency sharply

⁵ Trade-to-GDP ratio measures the importance of international transactions relative to domestic transactions. This indicator is a calculation based on the simple average (i.e., mean) of total trade (i.e., the sum of exports and imports of goods and services) relative to GDP. In “Charting Kyrgyzstan 1H” <https://search-proquest-com.libproxy1.nus.edu.sg/docview/2166664829?pq-origsite=summon> (accessed 15 April 2019)

⁶ Competitiveness is defined as the set of institutions, policies, and factors that determine the level of productivity of a country.

⁷ The Index of Economic Freedom is a composite measure of four major categories: i) Rule of Law; ii) Government Size; iii) Regulatory Efficiency; and iv) Market Openness. The index is published yearly by the Heritage Foundation. In “Charting Kyrgyzstan 1H” <https://search-proquest-com.libproxy1.nus.edu.sg/docview/2166664829?pq-origsite=summon> (accessed 15 April 2019)

depreciated in 2014. There is also a trend of decreasing Foreign Direct Investment (FDI) inflows in 2016-2017. Falling gold prices, debt unsustainability, and relatively poor performance of the Free Economic Zones (FEZs) altogether contribute to a not-so-encouraging portrayal of Kyrgyzstan's economy (ADB Report 2018: 4). The GNI per capita, though increasing over several years, remains the lowest throughout the region. Poverty remains a problem for the overall economy (see Figures 3 and 4 below). More needs to be done in terms of policy interventions for the country to close the enormous economic disparities if Kyrgyzstan is to catch up with its neighbors.

Despite these conditions, there are bright spots. Kyrgyzstan's tax regime is one of the most liberal, involving only eight taxes. The corporate tax of 10% are one of the lowest in the world, and the Value-Added Tax (VAT) of 12% is the lowest in the region. Despite the high cost of capital, funding sources have been made available for SMEs through credit lines opened by local commercial banks. Further, the Kyrgyz-Russian Development Fund is intended for SMEs, and a low-interest credit line for agricultural producers is available through funding from the Ministry of Finance to local commercial banks (Ibid.5). Inflation is kept in check and stays below 5%, thus allowing banks to lower interest rates to boost growth. Kyrgyzstan's international reserves have increased to cover its external debt and import needs.⁸

Figure 3: Per Capita GNI for selected countries

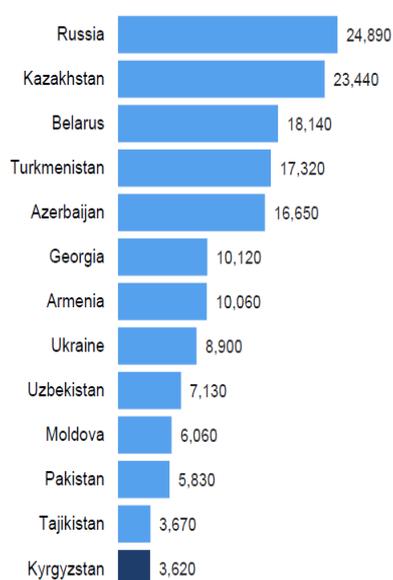
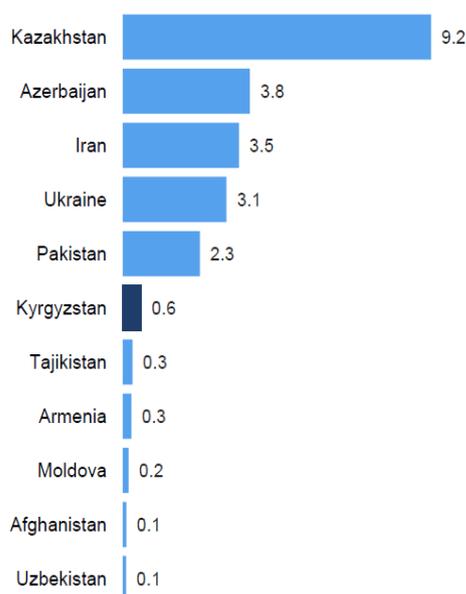


Figure 4: Average FDI, 2015-2017



Source: World Bank, "Charting Kyrgyzstan 1H" (accessed 16 April 2019)

Further, human development indicators are good. Kyrgyzstan is classified as a medium human development country, faring better than Tajikistan. According to the UNDP National Human Development Report 2016, Kyrgyzstan posted the best improvement in the index for the period 2010-2014 compared with its neighbors. Its index value rose by an average of 0.8% year on year.

Kyrgyzstan's accession to the World Trade Organization (WTO) in 1998 and the Eurasia Economic Union (EAEU) in 2015 signals positive benefits due to their membership in global and regional bodies. For one, expansion in trade cooperation becomes a more realistic expectation. As a member of EAEU, there are positive consequences for the Kyrgyz labor migrants, namely restrictions were

⁸ "Charting Kyrgyzstan 1H" <https://search-proquest-com.libproxy1.nus.edu.sg/docview/2166664829?pq-origsite=summon> (accessed 15 April 2019)

canceled, such as patents and work permits; examinations in law, culture, history, and language; and verification of educational documents. Further, migrants were entitled to equal social security and medical services. With increased participation in the Eurasian labor market, Kyrgyz migrant workers fill the niches in the professional industries rather than being confined to the construction sector. Professional migrant workers are prevalent in the service industries, for example, in the educational and medical professions (UNDP Human Development Report 2016: 48-50).

Further, through EAEU membership, Kyrgyzstan harmonized its laws and procedures to conform to regional standards. In partnership with other donors, particularly the USAID, the garment manufacturers undertook social and labor audits and certification to attract markets beyond their traditional Russian and Kazakh clients.⁹

The UNDP Report 2016 goes further to state the relationship between trade and human development, emphasizing the benefits of trade to the creation of increased incomes, new working places, entrepreneurship and innovation, and providing options for vulnerable population. In line with Kyrgyzstan's commitment to the Sustainable Development Goals (SDGs), international trade development has been incorporated into the strategic agenda. The SDG 17 categorically states that global trade partnerships will create fair, multisided trade systems and stimulate exports among countries (Ibid.: 38). The role of SMEs in this respect cannot be overstated; neither is the necessity for Kyrgyzstan to continue participating in cross-border trade to meet not only its economic aspiration but also its commitments to human development and to their professed SDGs. The garment industry in Kyrgyzstan is an illustrative case in which the economic and social development goals happily coincide.

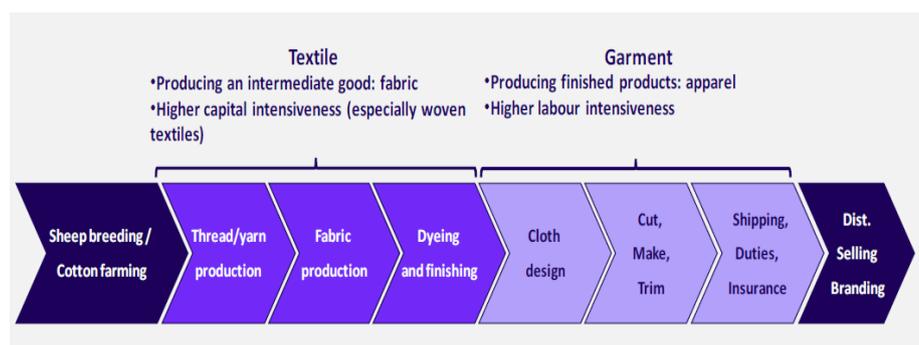
6. Kyrgyzstan's Garment Industry as a Regional Value Chain

Kyrgyzstan exemplifies the value of RVCs with the potential of transforming the industry into a global value chain. The value chain for Kyrgyz apparel industry dates to the Soviet era, during which time, the Kyrgyz industry was vertically integrated from sheep breeding to production of fabric to finished clothing. Textile production during the Soviet era was undertaken by large state enterprises and was heavily subsidized. In the post-independence period, Kyrgyzstan's textile industry shut down due to lack of funds and the disintegration of supply and distribution networks. However, with the opening of the border with the PRC that facilitated the flow of fabrics and technical equipment, alongside a liberal tax regime and low labor costs, the light industry in garment production quickly filled the vacuum (Alff 2016:447).

Producing garments requires several steps, from fabric production to clothing design and production, shipping, and distribution. Each of these steps adds value to the final product. For the clothing industry, the design and branding activities are the most value-adding in the chain. To obtain the maximum value, garment manufacturers will have to invest in the design, branding, and distribution activities (OECD 2014:22). Advancing in the chain will have implications for investments in human resources and skills training, as well as access to finance, expansion of markets, and upgrading of the operational capacities of firms. Figure 5 below is a graphic representation of the different links in the value chain for garments.

⁹ <https://www.export.gov/article?id=Kyrgyz-Republic-Garment-Manufacturing> (accessed on 11 June 2019)

Figure 5: The Textile and Garment Value Chain



Source: OECD Report 2014, p. 21

7. SME as the Bedrock of the Kyrgyzstan Garment Industry

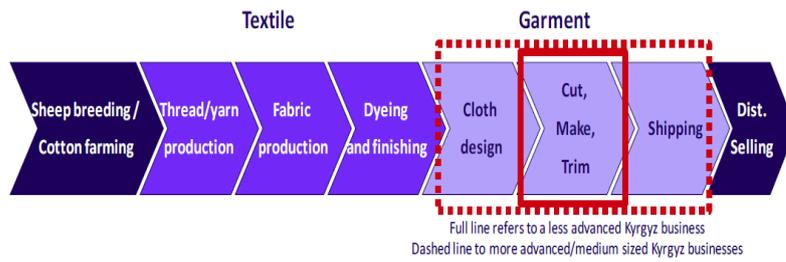
The garment industry is dominated by small and medium enterprises. According to the following categorization, small enterprises own 5-15 sewing machines and are considered as mini workshops. Medium enterprises (typically registered) own 20-70 sewing machines, have a steady supply of workers and customers and have been in operation for at least five years. Large enterprises own more than 70 sewing machines. Both medium and large enterprises typically own space in the Dordoi Bazaar and have regular outlets in Russia and Kazakhstan. In terms of employment, 76% of these enterprises employ 15 employees and less; 20% have 16-50 employees, and only 4% have more than 50 employees. The medium-sized firms can retain their workers through a combination of benefits and better working conditions, i.e. larger space, ventilation, and the like (OECD Report 2014: 26).

Outputs of garment sewing vary. Some enterprises produce parts of clothing like pockets and sleeves; others perform final stitching processes to complete the final ready-to-wear garment. Women's apparel and hosiery constitute about 70% of the product mix. The share of men's apparel has declined over the past several years. Typical garment products consist of women's blouses, trousers, jackets, skirts, and woolen coats and sweaters (Birkman, et al. 2012: 23).

Most SMEs in the garment industry operate the Cut-Make-Trim (CMT) contracts. A few medium-sized firms are involved in design, shipping, distribution, and some retail. There is more than enough potential for these enterprises to advance in the value chain through policy interventions that will be discussed in a later section. See Figure 7 below.

Kyrgyzstan's apparel industry has attracted attention in the academic and development communities, largely due to its economic successes, among them, the contribution of the industry to overall GDP amount to some 15%; employment generation; success of SMEs to penetrate the export market; demonstration of the positive effects of the cross-border trade and thus the industry's overall contribution to regional integration.

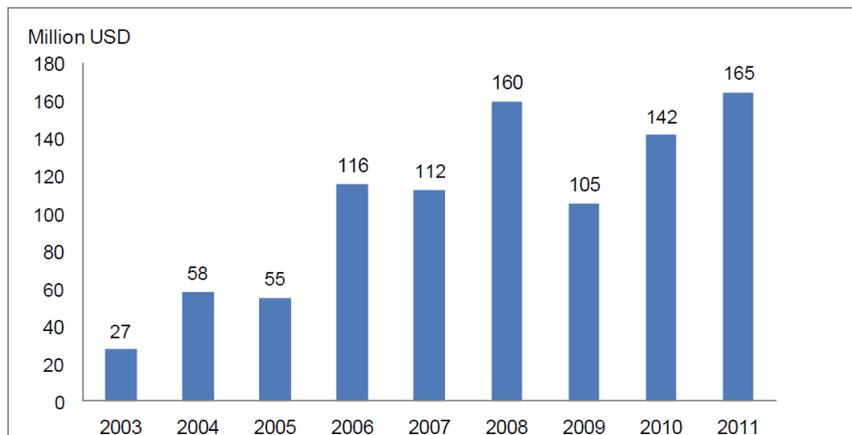
Figure 6: Kyrgyz Companies in the Value Chain



Source: OECD Report 2014, p. 27

Garment production has been steadily increasing over the past decade. Figure 7 below illustrates the compound growth rate of 18% in the garment production sector in Kyrgyzstan for the period of 2003-2011. Starting at US\$27 million in 2003, the garment industry exploded to US\$165 million in 2013. These official estimates, according to the OECD Report (2014), are under-reported, since most businesses operate fully or partially in the informal economy. Thus, figures could go as high as US\$800 million, while the United States Agency for International Development (USAID) estimates stand at US\$375 million.

Figure 7: Garment Production in Kyrgyzstan



Source: OCED 2014

The industry employs approximately 100,000 people. Other estimates go up to 300,000 employees, representing between 4-13% of the total labor force. Production sites are located within the Bishkek area and the surrounding Chiu region, which accounts for about 54% of registered garment companies (OECD Report 2014: 28). Majority of workers are female. Working hours tend to be long, stretching up to 15 hours a day, especially during peak seasons. Seasonal work also means that workers, especially those employed in the mini workshops, have little to no benefits, and are a mobile workforce that can shift from firm to firm. Materials, especially sewing machines, are imported from the PRC. A few are sourced from Italy, and usually by the larger enterprises with bigger inventory and customer orders.

Sales outlets are normally found in the Dordoi Bazaar, one of the biggest wholesale markets in Asia. Export markets in Russia and Kazakhstan are mainly facilitated through the large Kyrgyz diasporas in the two countries. The Kyrgyz business owners in the retail trade in Central Asia and Russia give Kyrgyzstan a competitive advantage. Target customers are usually middle-class consumers in Russia and Kazakhstan. Presumably, both share the same style in clothing (Jenish Ibid.: 12). Knowledge of

consumer tastes due to past historical familiarity among Kyrgyz suppliers and their Russian and Kazakh customers has given Kyrgyz producers an added advantage (OECD 2014: 28).

Garment exports, primarily to Russia and Kazakhstan steadily increased in value from US\$15 million in 2003 to US\$155 million in 2012 (Jenish 2014: 4). Imported fabric from the PRC enjoy low tariffs, and exports to Russia and Kazakhstan benefit from free-trade agreements. Also, tariffs are easy to calculate as they are based on weight (OECD 2014: 32). Altogether, the Kyrgyz garment industry has enjoyed a favorable trade situation that has been one of the important drivers for the industry's significant growth in the past decade.

The policy changes in import tariffs directly affected the industry. Tariff increases from US\$0.20 to US\$0.35 per kilogram of imported fabric for on-land transportation from the PRC increased the costs of production and value of the final product. This resulted in a decrease in demand for imported Chinese fabric. For the period of January-October 2012, the total value of imported Chinese fabric was US\$102.39 million. In January-October 2013, the value dropped significantly to approximately US\$67 million (Jenish: *ibid.*). It should be noted, however, that the industry remains resilient as these firms are small and medium-sized enterprises that can make quick adjustments in their business models with changing tariff situations. Alff (2016: 452) also notes that pragmatism and adaptability from both the Chinese exporters and Kyrgyz entrepreneurs allow long-standing business relationships to continue even considering new trade agreements.

Technological tools in the form of software for apparel design has lately become popular among firms. However, there are training and cost implications. Licensed versions could cost up to EUR10,000, whereas the non-licensed versions could cost only US\$500. The policy implications for skills upgrading and technological assistance will be discussed in a later section of the paper.

8. The Policy Environment for Garment Production SME

The accession of Kyrgyzstan to the WTO and the Eurasian Economic Union (EEU) has had a positive effect on the garment industry. While tariffs on Chinese fabrics increased by some 3.7%, Kyrgyz exports were protected from competition from exports originating from outside the EEU. Harmonization of procedures across borders has facilitated the flow of goods for EEU members. The Kyrgyz garment producers and exporters have benefitted from these new trade arrangements.

The patent system served as a policy driver for the formalization of the SMEs. The patent is an administrative tool that simplifies the tax system for SMEs that have less than 20 workers. In this system, the corporate income tax is replaced by a fixed contribution per "post," in this case, per machine. Social contributions to workers' welfare are likewise replaced by a fixed amount per post (OECD 2014: 36).

The rationale for the patent system is to provide an incentive to SMEs to register and enter the formal trading system rather than remain in the informal sector. The taxes and social contributions for SMEs are simplified and lower than the normal tax system. Compliance is high since there is no requirement for bookkeeping. The 40% of surveyed companies (undertaken by the OECD) reported compliance and satisfaction with the patent system.

The government of Kyrgyzstan issued strategic documents in support of the garment industry, namely:

- i. The Program for the Textile and Clothing Industry 2013-2015 which provides details for the government's multi-year planning exercise and 36 activities that include, among others, the

establishment of a “Technopolis” in Bishkek to organize study tours and marketing courses in the region, in support of the industry.

- ii. The National Export Strategy that includes a diagnostic of strengths and weaknesses of the export sector. For the clothing industry, a detailed program includes diversification of supplier inputs, strengthening industry capabilities, and promoting the sector (OECD 2014: 37).

Business associations, namely the Association of Light Industry (Legprom) and the Union of Textile (Souzhtextil) are filling the demand for training, management, supply chain management, accounting, and marketing (Birkman et al., 2012: 33). These private sector associations work hand-in-hand with the Kyrgyz government to fulfill the objectives set out in the National Export Strategy and meet the demand for additional trained workers that will expand the garment industry further. These partnerships aim to promote the “Made in Kyrgyzstan” brand through bi-annual fashion shows and textile and apparel industry exhibitions. The 600-strong membership of the Association of Light Industry composed mostly of apparel businesses arranges trade shows yearly since 2006. Entitled “Fashion Industry: Fashion and Equipment,” the show attracts foreign and local buyers aimed primarily at the export market. The association has over two dozen representative offices in Russia and Kazakhstan to promote the activities of their members. The Souzhtextil association, on the other hand, has 32 entities that are focused on promoting local conditions for businesses to thrive (Birkman, et al. 2012: 33-35).

International partners are at the forefront of supporting the burgeoning apparel industry for the past several years, among them, the Asian Development Bank, the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), the State Secretariat for Economic Affairs (SECO in Switzerland), and the USAID are among the few with strategic initiatives to support the industry. These organizations have focused on skills training, trade promotion, capacity development, and overall reform to enhance Kyrgyzstan’s global competitiveness (OECD 2014: 35).

9. Policy Lessons and Challenges of the Garment Industry

Despite considerable achievements over several decades, the apparel industry in Kyrgyzstan faces considerable challenges that must be addressed and resolved to maintain and expand the industry’s competitiveness in the CAREC region. The first and foremost challenge is the overall macroeconomic environment in which the industry operates. Kyrgyzstan’s massive debt is a challenge to macroeconomic stability and makes the country vulnerable to external shocks. The ratio of public and publicly guaranteed external debt to GDP in 2017 stood at 56%. Its external debt service (as a percentage of exported goods and services) was 36.6% for the same year (ADB 2018). This overall macroeconomic situation raises doubts on about the viability of the export sector to contribute substantially to Kyrgyzstan’s debt challenge.

Further, a narrow export base dominated by the gold production further contributes to vulnerability, due to the volatility of the gold sector. Foreign direct investment remains low, and the inflow of remittances has been able to contain the current account deficits to 10-15% of GDP (ADB 2018). Overall, Kyrgyzstan remains dependent on remittance and does not bode well for a sustainable growth strategy. Regional economic cooperation remains a viable strategy and an imperative for Kyrgyzstan’s future development. As a small landlocked country with relatively fewer resources, the necessity for regional integration for Kyrgyzstan proves more prominent. SMEs, as a vital component of the Kyrgyz economy, will play a very important role in economic diversification.

To integrate the garment industry further into regional value chains, and eventually into the global value chains, the garment industry needs to operate at a level of efficiency to make it more competitive. Upgrading measures are considered immediate to take advantage of Kyrgyzstan's positive position in the value chain. **However, garment enterprises will need to consider expanding their activities beyond CMT contracts and advance into branding and marketing activities to add value.** Remaining in their current position will result in stagnation and hamper the ability of garment enterprises to integrate into global markets.

Required upgrading measures include:

- a) **Skills development:** training and capacity building for sewers, cutters, and assemblers are necessary skills for garment workers. However, other skills are required to advance in the value chain. These include marketing management, branding and design skills, and export market knowledge.
- b) **Access to financing:** banks and lending institutions need to support SMEs with easier terms for loans and credit. In turn, banks and the overall financial institution will need support to reform their operations that will benefit SMEs. The role of donor organizations and the private sector financing cannot be overstated.
- c) **Expansion of markets:** SMEs need assistance in linking to bigger markets. As the Kyrgyz garment industry case illustrates, limited markets impede integration to global outlets. Thus far, the Kazakh and Russian markets have been reliable outlets. However, to scale up operations into global value chains, Kyrgyz SMEs will need to set their sights within and beyond the CAREC region. Policy support for export-oriented activities will be required.
- d) **Inter-industry coordination.** Membership in associations is a positive benefit to garment businesses, and support for these associations strengthens the bargaining abilities of members to achieve better gains for the industry. Support for government initiatives to expand the network of stakeholders in the industry is a role for donor organizations.
- e) For cross-border transactions, **trade facilitation measures need strengthening.** Better information exchange among countries will deepen RVC formation, and consequently, intra-regional trade. Harmonization and simplification of procedures are desired outcomes of policy initiatives. The overall goal for trade facilitation is, as the term suggests, to ease the exchange of goods, materials, and people, thereby deepening overall intra-regional trade and strengthening regional integration further.

10. Conclusion

As a small landlocked country, Kyrgyzstan stands to benefit from regional integration efforts by stimulating and diversifying the country's economy to mitigate its dependence on the gold sector, which suffers from period fluctuations in global prices, as well as expand markets for its garment industry. The latter has demonstrated a relatively positive record in terms of economic performance and has been able to establish regional markets, particularly with Kazakhstan. There is a potential for scaling up the enterprises involved in the garment industry, and in so doing, advance along the regional value chain to penetrate global markets. To achieve this, **policy support is needed in the following areas: i) better access for firms to sources of credit and finance; ii) capacity building in technology transfer/upgrading, market expansion, branding and distribution, and linkage to business associations; and iii) cross-border facilitation measures that will harmonize procedures to facilitate intra-regional trade and expansion of RVCs.**

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