

**KYRGYZSTAN'S ENTRY INTO THE CUSTOMS UNION:
AN EXIT FROM THE RE-EXPORTING PATH?**

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Abstract

Kyrgyzstan's potential entry into the customs union of Belarus, Kazakhstan and Russia is by far the hottest debate in the country these days. Special place in these heated discussions is devoted to the future of Kyrgyzstan's re-exporting activity, since the country has been the regional centre of re-exports of Chinese goods for many years. The purpose of the present study is to evaluate whether Kyrgyzstan's entry into the customs union will be an exit from its re-exporting path. The methodology applied in the current work is the comparative analysis of tariff rates in Kyrgyzstan and the customs union of Belarus, Kazakhstan and Russia with emphasis put on the tariff rates for re-exported goods. The detailed examination of Kyrgyzstan's trade relations with Belarus, Kazakhstan and Russia on the one side and with China on the other provides a basis for this analysis. The major finding of the study is that the new tariff structure of the customs union is not expected to have a significant effect on Kyrgyz re-exports. Thus, Kyrgyzstan's entry into the customs union will not be an exit from its re-exporting path.

Key words: Customs union, re-exports, Kyrgyzstan, Belarus, Kazakhstan, Russia

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INTRODUCTION

Kyrgyzstan's expected entry into the customs union of Belarus, Kazakhstan and Russia is by far the hottest debate in the country these days. Numerous headlines ranging from neutral to optimistic on the one side ("Debate in Kyrgyzstan: to join or not to join a common customs border?"¹) and negative to pessimistic on the other ("Kyrgyzstan faces bleak prospects in the customs union"²) have flooded the media, and they reveal a big controversy and disagreement around this issue. Economists, politicians and the general public are all attempting to speculate about the potential effects of the customs union on the Kyrgyz economy in the case the country commits to joining it.

The special place in the customs union debate is devoted to the discussion of the future of Kyrgyzstan's re-export activity, since the country is the regional centre of re-exports from China to Russia and to Central Asian countries. Under the current regime the country has very low tariff rates, which makes it profitable to re-export Chinese goods to other countries through the territory of the Kyrgyz Republic. If the country joins the customs union new common external tariff (CET) with respect to third countries will replace the existing rates. The fear of many economists and people involved in re-exporting activity is that introducing new tariff rates with respect to third countries would put an end to the re-exporting future of Kyrgyzstan. This fear results in a large number of people being strongly against the country's entry into the customs union and putting pressure on the government not to accept the offer from Belarus, Kazakhstan and Russia.

In spite of its significant practical importance for policy-makers and wide coverage in mass media, the topic has been poorly studied in academic literature due to its recent appearance.

¹ Solidarity Center

² Central Asia – Caucasus Institute

Moreover, a limited number of works that do analyze possible positive and negative effects of Kyrgyzstan's entry into the customs union, focus on the expected effects on the economy as a whole. In other words, they do not explicitly focus on the impact of future membership of Kyrgyzstan in the customs union on its re-exporting activity. Thus, the present research is conducted to partially fill this gap. The major research question posed in the present study is whether Kyrgyzstan's entry into the customs union will be an exit from its re-exporting path. The main finding of the current work is that the tariff structure of the customs union, which will replace the current tariff rates of the Kyrgyz Republic, is not expected to have a significant effect on the country's re-exports. Therefore, Kyrgyzstan's entry into the customs union of Belarus, Kazakhstan and Russia is not going to put an end to the re-exporting activity of the country.

Before going on with the examination of existing literature on customs unions and quantitative analysis it is worth summarizing why re-exports are so important for the economy of the Kyrgyz Republic. First, as was mentioned before, Kyrgyzstan became the regional centre of re-exports of Chinese goods to Russia and Central Asia. It is estimated that 75% of imports from China to Kyrgyzstan are subsequently re-exported to other countries (Shinn et al. 2010: 9). Moreover, Kyrgyz garment producers use cheap textile products from China to produce clothing, which is subsequently exported to Russia and Central Asian economies. Because of the low tariff rates and thus low costs on inputs of production Kyrgyz light industry has been very competitive in other countries and is the top-priority industry in the Kyrgyz Republic. Introducing changes in tariff rates will thus inevitably have huge effects on the apparel industry of the country.

Second, as there are enormous volumes of goods passing through Kyrgyzstan, which require handling and administration on its territory, there is therefore a significant number of people employed in this activity. Namely, according to the World Bank estimates, around 70, 000 people are directly involved in re-exports and about 350, 000 people are indirectly connected

with this activity in the country³ (qtd. in Shinn et al. 2010: 10). Labor costs, which are central for poverty reduction, constitute around 30% of overall expenses in Kyrgyzstan (Ibid). Thus, major changes in re-exports will affect a large number of people and their welfare.

Third, re-exporting activity provides a source of revenue for the government as well in the form of collected customs duties on imported goods. Thus, according to data from the National Bank of the Kyrgyz Republic, tax revenues from customs duties amounted to 7, 146.8 million Kyrgyz soms or 154.9 million USD in 2011, which is equivalent to 13.5% of all tax revenues in that year (*www.NBKR.kg*).

Because of the academic nature of this study and at the same time its focus on policy considerations there are different types of literature used as a basis of the research. Specifically, scholarly articles of Cadot et al. (1999), Chang and Winters (2002), Saggi (2006), Venables (2003) and other authors examining the theoretical side of the debate are used in this study along with policy papers analyzing specific customs unions and focusing on the practical side of the issue (Beshimov et al. (2010), Feenstra and Hanson (2004), Golub (2010), Kaminski and Raballand (2009), Laird (1997), etc.). Moreover, working papers of policy institutes and development banks add a new perspective on the debate (the Eurasian Development Bank, the World Trade Organization, the World Bank, Kazakh Institute of Strategic Research, etc.).

The methodology used in this research is to analyze data on current tariff rates that exist between Kyrgyzstan and its trade partners and future tariff rates under the customs union's regulation. The emphasis will be put on evaluation of tariff rates for re-exported goods. The results of this analysis will be further applied to speculate about the future of the re-exporting activity of the Kyrgyz Republic.

³ Kyrgyzstan's overall population is estimated at 5, 448, 000 people for 2010 (*www.WorldBank.org*)

The structure of the paper is organized as follows. Chapter 1 is devoted to the discussion of existing literature on customs unions and re-exports including the analysis of particular customs unions throughout the world (MERCOSUR). Chapter 2 provides a detailed analysis of the customs union of Belarus, Kazakhstan and Russia with sections devoted to the study of trade profile of the Kyrgyz Republic and tariff schedules before and after joining the customs union. This examination is followed by chapter 3 where the major question asked in the present research is answered and policy recommendations are made. Final section with summary of the results concludes the paper.

CHAPTER 1. Customs Unions: Theoretical Framework

There is extensive academic literature as well as policy papers analyzing various aspects of the subject at hand. Some of them focus on the theoretical side of the problem by examining price effects, tariff formation, changes in volume of imports, etc. as a result of the creation of a typical customs union. Others, instead, study a particular customs union and evaluate its economic effects on member and non-member countries, the union's objectives and achievements, prospects for future development, etc. This chapter is the review of the literature used in the present study, which will shed light on the operation of customs unions and the nature of re-exports and help address the research question, whether Kyrgyzstan's entry into the customs union will be an exit from the re-exporting path. The first section of this chapter starts with a discussion of what customs unions are and how they are differentiated from other forms of regional trade agreements and then provides an analysis of tariff formation in customs unions.

1.1 Customs Unions: Characteristics, Objectives and Implications

The fact that Belarus, Kazakhstan and Russia decided to form a customs union and not another type of preferential trade agreement means that a customs union offers benefits, which these countries are seeking. What are customs unions and how are they differentiated from other types of trading arrangements? What key characteristics do they have and what kind of objectives are placed when forming a customs union? What are the implications for member and non-member countries under the customs union? This section provides answers to these important questions.

Customs unions, their major features, similarities and differences in relation to other types of trade agreements are analyzed in detail in an article by Anne O. Krueger "Free trade agreements versus customs unions" (1997). In her work she provides important definitions of

five types of trading arrangements: *preferential trading arrangement*, *free trade agreement*, *customs union*, *common market* and *single market*. Summary of definitions is provided in Table 1.

Table 1. Types of preferential arrangements (from less to more integrated)

Type	Definition
Preferential trading arrangement	any trading arrangement which permits the importation of goods from countries signatory to the preference at lower rates of duty than are imposed on imports from third countries.
Free trade agreement	preferential arrangement in which tariff rates among members are zero, although external tariffs may be at different rates for different members of the arrangement.
Customs union	arrangement in which there is zero duty between members on imports of goods and services, and a common external tariff.
Common market	arrangement in which not only movement of goods and services, but also of factors of production, is relatively free among member countries.
Single market	arrangement in which all producers and consumers within the arrangement are governed by the same rules, in the sense that participants in one geographic part of the market may not be prevented from operating in another part of the market.

Source: Anne O. Krueger “Free Trade Agreements versus Customs Unions.” Journal of Development Economics 54 (1997)

As can be seen from Table 1, customs unions are situated in the middle on the scale of integration of preferential arrangements. What is distinct about a customs union in relation to other types of arrangements is that it provides free movement of goods and services inside the union while simultaneously erecting a sort of “fence” with respect to third countries. This “fence” is uniform across members and is represented by a common external tariff (CET) that is used by all member countries with respect to non-members. Moreover, partner countries inside the union should have not only identical tariff rates in relation to third countries but also the same non-tariff measures against non-members. This is the crucial difference between customs unions and, for example, free trade agreements where members can set different tariff rates in relation to non-members.

Removing trade barriers inside the customs union provides many advantages to its members: facilitating trade through significant reduction of transaction costs, encouraging industrial and agricultural production, easier access of domestic companies to external markets, rise in product quality in response to heightened competition, etc (Muzaparova et al. 2009: 27). In addition, conducting a common external policy in relation to third countries makes defending and advocating the positions of member countries more effective in the international arena (Ibid). Moreover, increased economic integration is expected to reinforce economic as well as political ties inside the union, which may have substantial positive effects on the countries.

While it is known that the features of customs unions provide numerous advantages to member countries stated above, what kind of implications do these features have for re-exports? As Muzaparova et al. explicitly state in their work, “introduction of common external tariff with respect to third countries will provide a firm protection from foreign competition and set reliable barriers against smuggling and re-exports...” (2009: 135). Other scholars also indirectly point to this feature of customs unions to protect them from re-exports. For example, Cadot et al. (1999) and Krueger (1997) discuss the “rules of origin” (ROO) frequently adopted in regional integration agreements. These authors argue that in free trade agreements where members do not have to impose common tariffs with respect to third countries, rules of origin are applied “to prevent the transshipment of goods between members with different external tariffs” (Cadot et al. 1999: 640). From these it can be concluded that protection from re-exports is one of the unique characteristics that customs unions can provide unlike other types of trading arrangements. Thus, by joining the customs union of Belarus, Kazakhstan and Russia Kyrgyzstan may face a tradeoff between numerous advantages of membership and the potential loss in its re-exporting activity.

1.2 Re-exports: Definitions, Rationale and Channels

Having analyzed the peculiarities of customs unions and their implications for member and non-member countries it is useful to turn to the second part of the issue raised in the present study: namely, re-exporting activity. After all, the main research question of this work as reflected in the title is whether Kyrgyzstan's entry into the customs union will be an exit from its re-exporting path. The present section is devoted to the analysis of the literature on re-exports, major definitions, rationale and channels of work.

The first important question is “What are re-exports?” In its simplest form, re-exports are defined as “goods that have been imported into a country and are then exported” (*Financial Times Glossary*). In other words, it is a situation when country *A* imports goods from country *B* and then exports these imported goods to country *C*. There is also a term “transit”, which in its nature is very similar to re-exports. Golub (2010) in his article “The Role of Transit and Re-export Trade in Togo's Economy” devotes time to analyzing similarities and differences between these two terms. As the author claims, transit and re-exports represent the main types of transshipment of goods and “the classification of goods into these two categories is complex with rather minor differences” (Golub 2010: 8). He gives the following definitions of re-exports and transit used in Togo:

Re-exports are primarily defined as goods initially entering Togo under a customs regime such as bonded warehouse or temporary admission and subsequently designated as re-exports to be shipped to another country. Goods transshipped by boat or air are also classified as re-exports (Ibid).

As for “transit”, the author claims that

in Togo international transit is defined as any goods brought into the country and then designated as in transit to a neighboring country. Transit differs from re-exports insofar as goods in transit are not initially placed under a temporary domestic customs regime and are shipped by road (Ibid).

As can be seen from the definitions, there is no fundamental or conceptual difference between these two terms. Differences capture mostly minor and administrative features such as mode of transportation and the regime under which the goods arrived into the country. Thus, these differences do not change the essence of the activity. Consequently, for the purposes of the present work by re-exports we will mean both re-exports and transit as defined in Golub's article.

The rationale behind re-exporting activity and its emergence is discussed in several economic theories of intermediation. According to Feenstra and Hanson (2004), there are three major theories that explain why a country becomes involved in re-exporting activity: theories of *information costs; transport hubs; taxes, tariffs, and quotas*. Information costs theory states that asymmetry of information between suppliers and buyers creates incentives to trade through middlemen. For example, buyers may not be informed about the quality of suppliers' products, while suppliers may have trouble identifying tastes of buyers. This situation gives rise to the appearance of middlemen who gather information both about suppliers and buyers and match them in the market. Another possibility for the emergence of middlemen who import goods and then subsequently re-export them is that these intermediaries help suppliers find markets for their goods abroad.

According to the second theory of intermediation, firms may ship exports from their country through the territory of another country to use the advantages of "hubbing". As Feenstra and Hanson argue,

Similar to passenger air travel, it may be efficient for exporting firms in a particular country to ship goods in bulk to an international hub, where they are unloaded, are combined with other goods going to the same destination market, and then are loaded onto a new ship for the final leg of travel (2004: 9).

The third theory of intermediation discussed in the paper of these scholars has to do with taxes, tariffs and quotas. Namely, the authors argue that according to this theory, re-exports

occur to avoid taxes and trade barriers (Ibid). Thus, for example if country *B* wants to export its goods to country *C*, it may find out that to export directly to the destination country it has to pay very high tariffs or, equivalently there are strict quota regulations between these countries. However, country *B* can also export its goods to country *C* through the territory of country *A* with which it has low tariff rates. Moreover, the intermediary country *A* has favorable tariff and non-tariff regulation with country *C*. In this situation country *B* may decide to export its goods through country *A* due to cost considerations.

How does the reality with re-exporting activity in Kyrgyzstan fit into theory? Shinn et al. (2010) and Kaminski and Raballand (2009) in their works discuss in detail how and why Kyrgyzstan has become the regional centre of re-exports. First, as the scholars point out it is “favorable geographic location for trade intermediation between China and the Central Asian states to its west” (Kaminski and Raballand 2009: 589). Second and most importantly, Kyrgyzstan has adopted a system of simplified customs clearance with China where “consumer goods entering Kyrgyzstan are subject to low flat tariff duties at the border depending on the *volume* of goods and not their value” (585). This procedure makes customs processing significantly easier and moreover, profitable for suppliers because if they had paid the duties dependent on the value of imported goods but not their weight, they would have ended up paying much more in tariff-related fees (Ibid). Third, the Kyrgyz Republic has a free trade agreement with Russia, Kazakhstan and other countries of the Eurasian Economic Community (EurAsEc), which makes it profitable for Chinese goods to access those countries through Kyrgyzstan and in this way enjoy the benefits of the FTA.

From this analysis it could be seen that the third theory of intermediation, which claims that re-exports emerge mostly because of the desire of traders to avoid taxes and trade barriers is most applicable to the case of Kyrgyzstan. The other two theories of intermediation, which have

to do with information costs and transport hubs may also play the role but it appears to be rather minor.

So far, we analyzed what re-exporting is and major rationales for re-exports. At this point it is useful to turn to the discussion of channels through which re-exporting works in the Kyrgyz Republic. The way re-exporting is carried out on the territory of Kyrgyzstan is rather unique and has very special features. The most important role in re-exports is played by “*bazaars*”, or wholesale markets. The mechanism of re-exporting activity in Kyrgyzstan through bazaars is described in detail in the study of Kaminski and Raballand (2009). As they rightly explain, traders from Kyrgyzstan travel to China to buy goods in cash. They usually purchase products in cities such as Urumqi and Kashgar due to their geographic proximity to the border. Traders then arrange transportation of these goods to the bazaar, namely the one called Dordoi, which is one of the biggest public wholesale markets in Eurasia. Subsequently,

at Dordoi, goods are purchased by traders from elsewhere in the Central Asian region and the former USSR (Uzbek, Kazakh, Tajik, or even Russian) or Afghanistan (again in cash in most cases), loaded in buses, and transported to smaller bazaars such as those in Kazakhstan, Russia’s Urals and West Siberia regions, and southern Kyrgyzstan (e.g., Karasuu, Osh, or Batken) (Kaminski and Raballand 2009: 584).

Afterwards, final users purchase goods in these smaller bazaars in the respective countries. Thus, this is the way re-exporting is carried out in the Kyrgyz Republic.

Now, what major conclusions about re-exports can be drawn from the analysis in this section of literature review? To summarize, re-exports represent goods that have been imported into a country and then exported to another country. There is a term “transit”, which is sometimes used in the literature to describe goods transshipped through a country. The analysis of the literature in this respect revealed that there are no fundamental or key differences in the concepts of transit and re-exports and thus for the purposes of the present research will be used as one term “re-exports”. There are several theories in economic literature providing explanations for why re-exports emerge in one or the other country: theories of information

costs, transport hubs, and last, the theory of taxes, tariffs and quotas. The situation with the re-exporting activity in Kyrgyzstan appears to be explained most by the last theory of intermediation. Due to low tariff rates and simplified customs clearance on the border of the Kyrgyz Republic and China as well as free trade agreement between Kyrgyzstan and countries of the EurAsEc it has become profitable to export goods from China to other Central Asian economies and to Russia through the territory of Kyrgyzstan. The major channel through which re-exporting activity is carried out in the country is through “bazaars”.

1.3 Estimated Effects of Tariff Changes on Trade Flows of CU Entrants

To this point, literature review has focused on what customs unions are, their objectives and implications. In addition, we studied in detail the rationale behind re-exporting activity and the way it is carried out in the Kyrgyz Republic. As was mentioned in the introduction to the present work, if Kyrgyzstan joins the customs union of Belarus, Kazakhstan and Russia it will have to adopt common external tariffs with respect to third countries. This means that the country will have to give up its current tariff schedule and replace it with a new one. These changes in tariff rates will inevitably lead to changes in prices and consequently, trade flows and trade patterns of new entrants with member and non-member countries. This, in its turn, will shape the re-exporting future of Kyrgyzstan. What does the economic literature say about the effects of tariff changes on trade flows of customs unions' entrants?

Before getting to the analysis of that question it is useful to first differentiate between various types of literature used in the present research, as to analyze different approaches taken by scholars, their methodologies, objectives and the frameworks within which they studied the question at hand. This examination will help build expectations about the results of the present study and at the same time avoid the limitations and drawbacks found in the works of others.

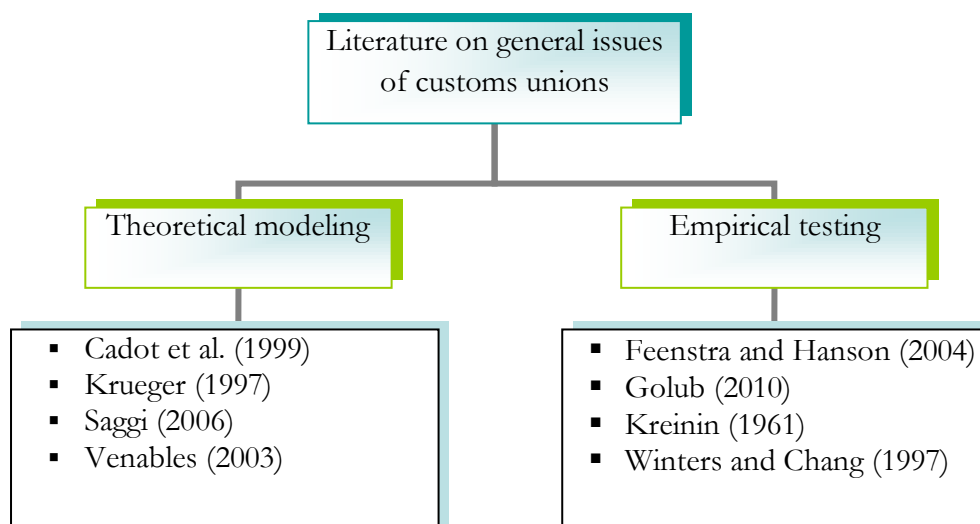


Figure 1. Classification of Literature on General Issues of Customs Unions by Type (author's elaboration)

The literature used in the current study is represented by two major types: literature that focuses on general issues that a typical customs union faces and the other type that is based on case studies (particular cases of customs unions). The first type of literature can be subsequently divided into two groups: literature that focuses on theoretical modeling and the one that conducts empirical testing (see Figure 1). Saggi (2006) who worked on the theoretical side of the problem, argues that tariff rates on non-member countries are higher under the customs union than the rates on non-members under the free trade agreement (35). Cadot et al. add to this by concluding that increasingly deep integration can lead to rising protection against nonmember imports (651). This suggests that after joining the customs union of Belarus, Kazakhstan and Russia Kyrgyzstan may expect that the common external tariff (CET) will be higher than the existing rates. This proposition will be tested later in the empirical part of the present study.

Other lessons drawn from theoretical analysis of remaining authors in this group concern identifying winners and losers from regional trade agreements. A very important conclusion is reached by Venables, who argues that

Integration between low income countries tends to lead to divergence of member country incomes, while agreements between high income countries cause convergence. Results suggest that developing countries are likely to be better served by “north – south” than by “south – south” agreements (2003: 747).

If correct, this conclusion has far-reaching implications for our study. Countries, which are already members of the customs union at hand (Belarus, Kazakhstan and Russia) are upper middle income economies according to the World Bank definition (GNI per capita of these countries are 5,950 USD; 7,580 USD and 9,900 USD respectively for 2010), while the Kyrgyz Republic is a low income country (GNI per capita is 830 USD for 2010). In this respect, joining the customs union of Belarus, Kazakhstan and Russia may overall be beneficial for Kyrgyzstan.

The empirical evidence on the influence of changes in tariff rates on countries’ trade flows is presented in the works of Kreinin (1961) and Winters and Chang (1997), who try to explore these effects using empirical data and different methodologies (econometric estimation; simple comparison of trade flows and tariff rates “before and after”, etc.). Kreinin (1961), who studies the effect of the United States tariff reduction program of 1955 and 1956 on the prices and volume of imports subject to tariff concessions, reveals that

tariff concessions and subsequent fall in prices were accompanied by a 59 per cent increase in the import volume of the reduced group, compared to a 17 per cent rise in that of the non-reduced category – a differential of 42 percentage points (Kreinin 1961: 315).

As for Winters and Chang (1997), they show that lowering of preferential tariffs had a favorable effect on Spanish terms of trade, while it also had an unfavorable impact on non-member countries. While these results do not suggest that Kyrgyzstan can expect a comparable rise in imports from member countries or a comparable fall in imports from non-member countries (China), they suggest that the effect from Kyrgyzstan’s entry into the customs union and the subsequent change in its customs rates may be huge.

So far, we have analyzed the literature that focused on general issues faced by a typical customs union. Now we can turn to the evaluation of literature based on case studies of selected customs unions. Figure 2 demonstrates this type of literature employed in the present research.

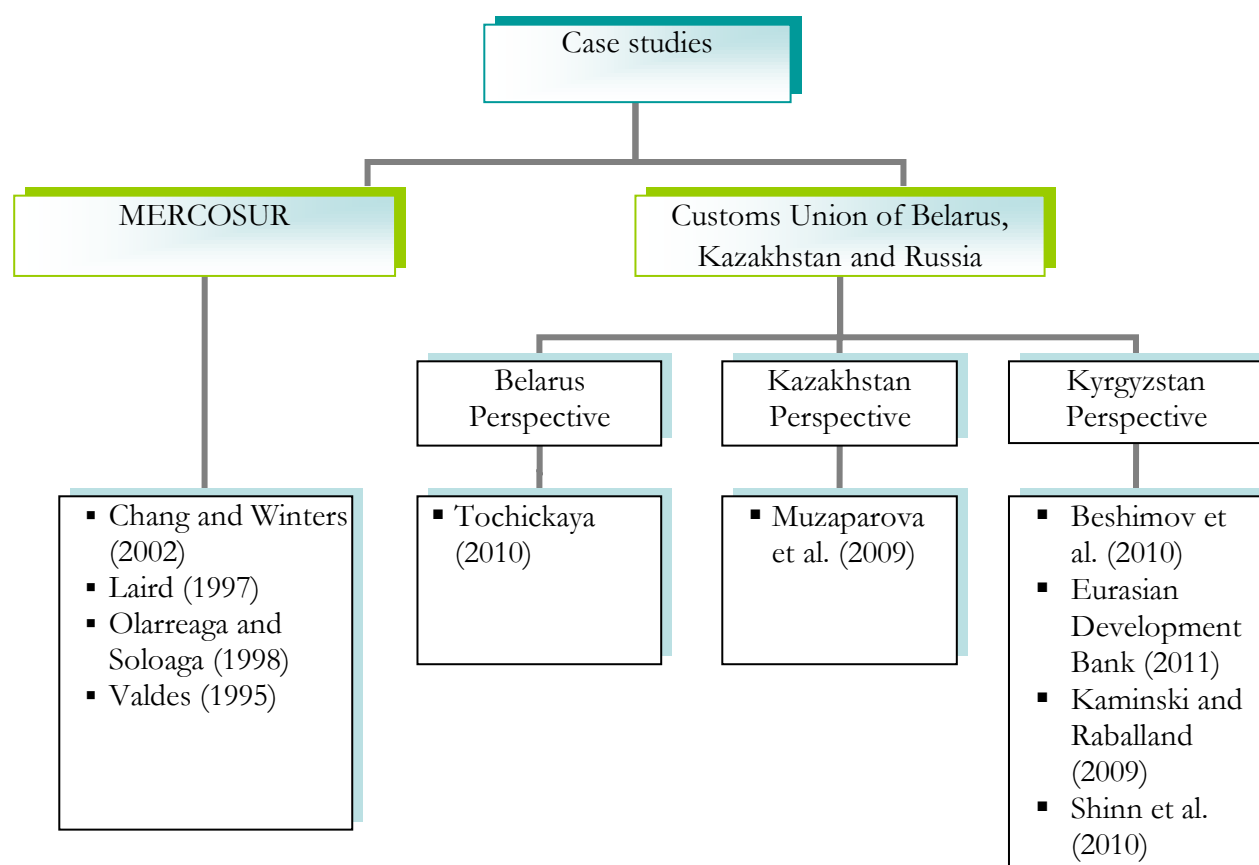


Figure 2. Classification of Literature Based on Case Studies (author's elaboration)

As we can see, there are case studies of two existing customs unions used for the purposes of this study: MERCOSUR and the customs union of Belarus, Kazakhstan and Russia. Muzaparova et al. (2009) with reference to information from the World Trade Organization state that there are 14 customs unions in the world these days. The most notable are MERCOSUR, West African Economic and Monetary Union (WAEMU), Gulf Cooperation Council and the customs union of Belarus, Kazakhstan and Russia. Criticism may arise why the European Union (EU) as an example of the single market and thus a customs union is not analyzed for the purposes of this research. This is one of the most studied and well researched unions, so it may

have yielded valuable insights into the operation of these arrangements. The major reason why literature on the EU is not analyzed in this paper is because the European Union represents the type of integration, which goes far beyond a simple customs union. As a result, it is very difficult to identify what effects are solely due to its features of a customs union. In addition, the EU has been continuously expanding including more and more members, so the qualitative assessments are difficult to be done. Instead, here we focus on MERCOSUR (which includes Argentina, Brazil, Paraguay and Uruguay), since it is relatively well researched and certain conclusions can be drawn from its operations. And, of course we focus on the customs union of Belarus, Kazakhstan and Russia.

Chang and Winters (2002) measure the effects of MERCOSUR on the pricing of non-member exports to Brazil. They reveal that because of the creation of the customs union the prices of non-member exports declined significantly and thus non-member countries experienced significant losses in export revenues. Whether the operation of the customs union of Belarus, Kazakhstan and Russia resulted in losses in export revenues of the Kyrgyz Republic, will be evaluated in the empirical part of this work.

As for other scholars in this group, a very interesting and relevant to the goals of the present work is the study by Valdes (1995), who assesses the potential prospects for Chile to access North American Free Trade Agreement (NAFTA) or MERCOSUR. The situation is quite similar to the one experienced by the Kyrgyz Republic these days because the country is already a member of the free trade agreement with Belarus, Kazakhstan and Russia and is thinking whether to go deeper in its integration with these countries through a customs union. Valdes argues that it is more favorable for Chile to access NAFTA than MERCOSUR because “joining NAFTA does not rule out the possibility of an association with MERCOSUR, not as a member – and thus not subject to the common external tariff rules” (1296). By making this statement, the author refers to what has been discussed in the first section of the present chapter: namely, the

difference between free trade agreements, which are more flexible and less integrated than customs unions. In addition, the author indirectly points to the potential losses from joining a customs union, namely having to adhere to common external tariff (CET).

The last type of literature that has not been examined in the present literature review concerns the customs union of Belarus, Kazakhstan and Russia. This customs union is the subject of the present research and thus it requires a more detailed analysis and discussion. For this purpose, we leave this part to the next chapter of this work, which is entirely devoted to the analysis of the customs union of Belarus, Kazakhstan and Russia and prospects for Kyrgyzstan and its re-exporting activity.

The major lessons obtained in this section of literature review that examined the effects of tariff changes on trade flows of CU entrants are that tariff rates under the customs unions will be higher with respect to non-member countries under the customs union than under the free trade agreement. In terms of welfare effects, theoretical predictions are that new entrants are expected to benefit from “north-south” type of agreements than from “south-south”. Empirical evidence suggests that changes in trade flows are potentially huge in response to changes in tariff rates.

CHAPTER 2. Customs Union of Belarus, Kazakhstan and Russia:

Prospects for Kyrgyzstan

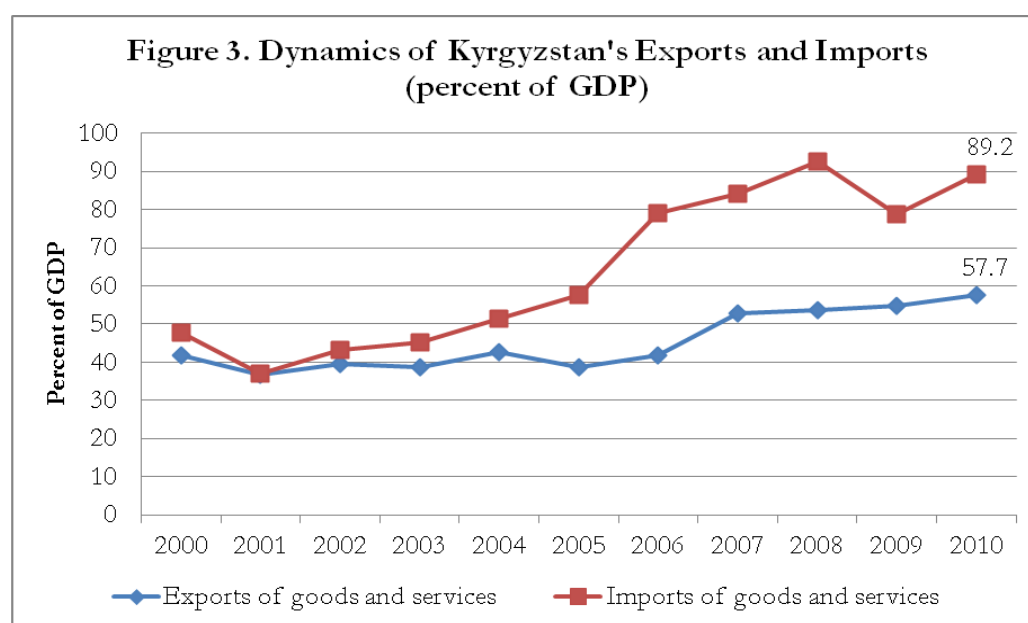
The idea of forming a customs union in the post-Soviet space has been there for a long time. However, this idea was realized only on January 1, 2010 when the customs union of Belarus, Kazakhstan and Russia officially came into existence and the common external tariff (CET) with respect to third countries took effect. In July 2010 the Customs Code came into force and the customs control on the border of Russia and Belarus was abolished. However, the Code took the full effect and all the members of the union including Kazakhstan removed all customs borders and respective customs duties and fees between each other by July 2011.

From the very early stages of its creation the customs union of Belarus, Kazakhstan and Russia has attracted a lot of attention of mass media, both local and international; policy institutions; trade experts and the international community as a whole. It has even been claimed by some that this economic union has more political motives when “the main successor of the USSR does not want to give up its old paternal habits and is strengthening its influence to be a serious competitor of China and the West” (qtd. in *“Vecherniy Bishkek”*). This research is an academic study, which focuses on the economic side of the union, thus the potential political motives behind the creation of the customs union will not be analyzed in the present work. Nevertheless, the issue is very important from economic point of view as well since it is speculated that the customs union can further be expanded to include more members and transformed into an economic and even the monetary union (Muzaparova et al. 2009: 93). In addition, even ignoring the potential political side of the issue in forming such types of arrangements it is usually predicted by theory that they will serve economic interests of bigger members (Cadot et al. (1999), Muzaparova et al. (2009)). In this context it is important to conduct the analysis of the prospects for Kyrgyzstan and its re-exporting activity in the customs union of Belarus, Kazakhstan and Russia given the title and the goal of the present work. This

chapter is devoted to the detailed analysis of the customs union at hand and deriving conclusions with respect to re-exporting future of the Kyrgyz Republic.

2.1 Overall Trade Structure of the Kyrgyz Republic

Kyrgyzstan has been a very open economy from the early stages of its development, since 1991 when the country became independent of the Soviet Union. The country has been the first among the CIS (Commonwealth of Independent States)⁴ countries to enter the World Trade Organization on December 20, 1998 and since then had the most liberal trade regime of all countries of EurAsEc (Eurasian Economic Community)⁵ (Tochickaya 2010: 4). Figure 3 shows the dynamics of Kyrgyzstan's exports and imports in relation to GDP from 2000.



Source of data: the World Bank, World Development Indicators

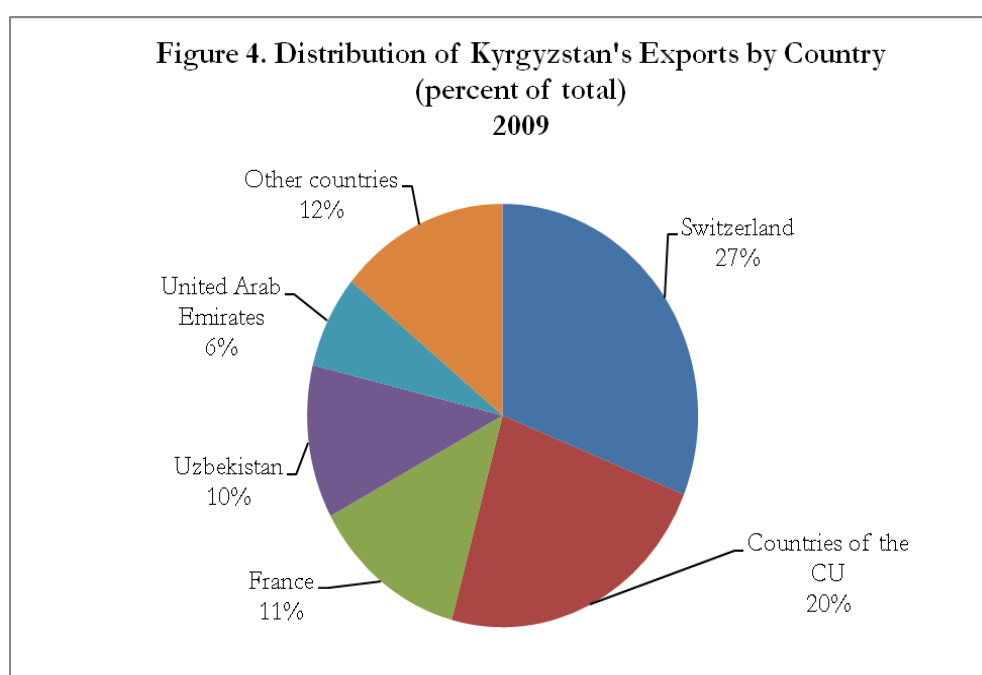
As can be seen from the Figure, Kyrgyzstan's trade has been characterized by trade deficit throughout the whole period except 2001 when exports and imports were almost equal.

⁴ Members of CIS are Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan and Uzbekistan. Ukraine is commonly included in the list, but it is not an official member of CIS

⁵ Members of EurAsEc are Belarus, Kazakhstan, Kyrgyzstan, Russia, Tajikistan and Uzbekistan

Referring to the openness of the economy, it has been steadily growing throughout these years. In 2010, imports alone reached 89.2% of GDP, while the overall trade to GDP ratio has been 146.9%, which demonstrates a very high degree of openness. This, in its turn, implies that the Kyrgyz economy is very much dependent on trade and any changes that influence its trade patterns will subsequently have big influence on the economy as a whole.

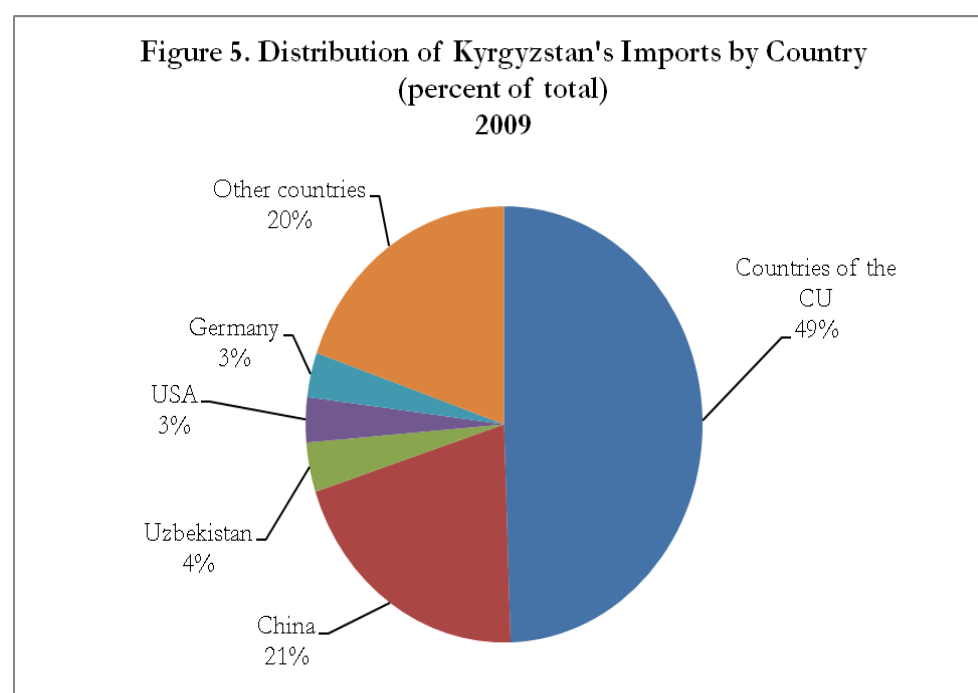
Kyrgyzstan's major trading partners with respect to exports and imports for 2009 are presented in Figures 4 and 5. The reason why the analysis is conducted for 2009 and not 2010 is



Source of data: the National Statistics Committee of Kyrgyzstan, www.stat.kg

that Kyrgyzstan experienced significant political changes in 2010, namely the Revolution of April when the President of the country was overthrown. Such major events certainly had a great impact on the economy of the country and trade in particular. In fact, during the political unrest in Kyrgyzstan some of the neighboring countries temporarily closed their borders. Thus, analyzing trade data for 2010 would be inappropriate and would yield results that significantly deviate from the “normal” state.

Coming back to the discussion of major trading partners, Figure 4 demonstrates that Kyrgyzstan exports most to Switzerland (27% of total share), followed by countries of the newly formed customs union (Belarus, Kazakhstan and Russia, which constitute 20% of total share), France (11%) and Uzbekistan (10%). It may seem unusual why Switzerland's share in Kyrgyzstan's exports is so big. These huge values of exports to this country are explained by the fact that the Swiss company has a license and special rights to operate in the largest gold mine of the country "Kumtor". Therefore, exports from Kyrgyzstan to Switzerland are not dependent on external economic conditions and will not be influenced by the entry or non-entry of the country to the customs union. Thus, if we disregard Switzerland, countries of the customs union are the economies to which Kyrgyzstan exports most. This evidence suggests that Belarus, Kazakhstan and Russia play a big role in Kyrgyz exports and thus liberalizing trade further with these countries by entering the customs union may have potentially significant benefits to the country.



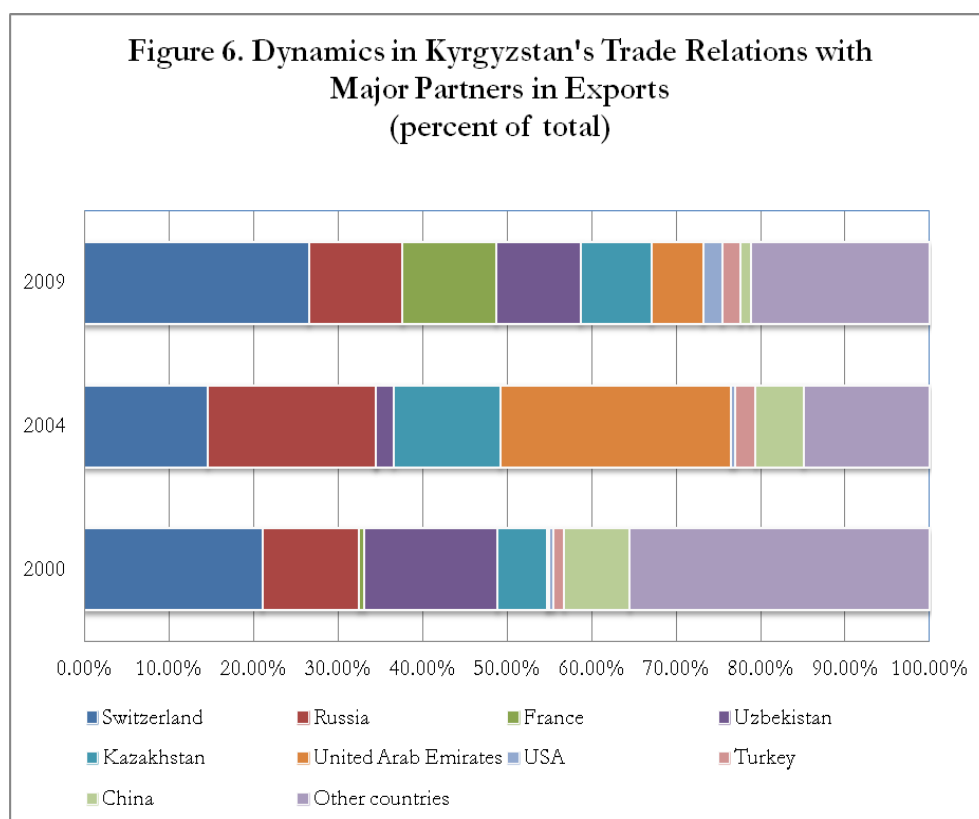
Source of data: the National Statistics Committee of Kyrgyzstan, www.stat.kg

Figure 5 depicts major trading partners of Kyrgyzstan in terms of imports (for 2009). Here, the overwhelming majority of imported goods is represented by countries of the customs

union (Belarus, Kazakhstan and Russia), which constitute 49% of the total share. According to data from the National Statistics Committee of the Kyrgyz Republic, China with its 21% of the total share comes second. However, it is important to note that as Shinn et al. (2010), Kaminski and Raballand (2009) and the report by the Eurasian Development Bank (2011) argue, the data of the Statistics Committee of Kyrgyzstan differ considerably from the data reported in the IMF Direction of Trade Statistics database and the data from the UN Comtrade using “mirror statistics”. They further argue that the value of imports, specifically imports from China are heavily understated in the statistics of Kyrgyz agency. This issue will be addressed in more detail later, in the analysis of Kyrgyzstan-China trade relations. For now, we assume that even if data for imports, especially imports from China are heavily understated, the magnitude is not so large as to exceed the share of Belarus, Kazakhstan and Russia taken together (according to the National Statistics Committee, their share is more than twice as big as the share of China). Thus, the overall picture does not change. Nevertheless, the conclusion from the analysis of major trading partners of Kyrgyzstan in terms of imports is that both the countries of the customs union and China play a great role in Kyrgyz imports.

So far, the analysis of the geographic distribution of exports and imports of the Kyrgyz Republic focused on one year, 2009. How did the distribution change over time? Figure 6 shows how the share in total exports of main trading partners of Kyrgyzstan changed over time. Analysis of the dynamics in Kyrgyzstan’s trading partners through time is a valuable tool to derive conclusions as to the trends and directions that the country is following. This gives insight into which countries are gaining importance in Kyrgyzstan trade relations, while which other countries are losing it. Data are presented for 2000, 2004 and 2009. As we see from the graph, there are no clearly observable trends in trade relations of Kyrgyzstan with countries in terms of exports. The share of Kyrgyz exports to Russia grew from 11.5% in 2000 to 19.9% in 2004, and

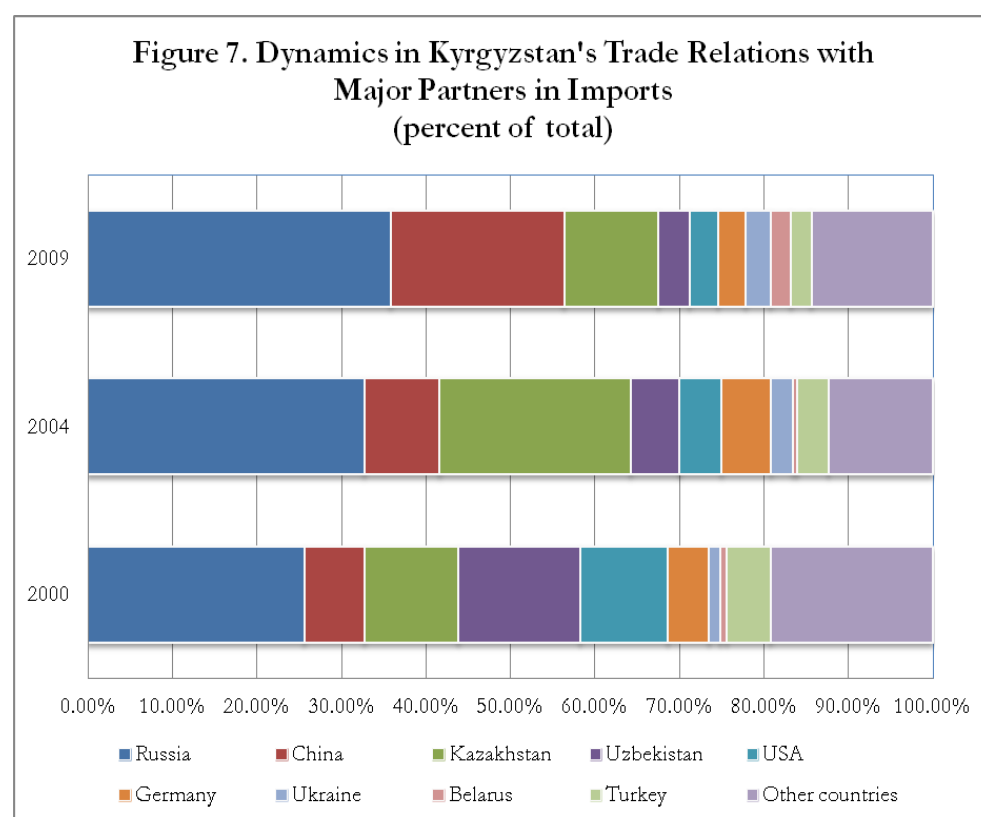
fell again to 11.1% in 2009. The same direction of change is true for Kazakhstan. As for Belarus, its share in both Kyrgyz exports and imports has been negligible.



Source of data: the National Statistics Committee of Kyrgyzstan, www.stat.kg

Figure 7 is similar to Figure 6 but it depicts the situation with major trading partners of Kyrgyzstan in terms of imports. Unlike with exports, there are several clear trends in the dynamics of Kyrgyzstan's trade relations with respect to imports. First, the graph clearly indicates the growing importance of Russia as a source for imports, whose share rose from 25.6% in 2000 to 32.7% in 2004 and further to 35.9% in 2009. Interestingly, the importance of China as a source of imports has been steadily growing as well. The respective shares in Kyrgyzstan's imports from China are 7.1% (2000), 8.9% (2004) and 20.5% (2009). The fact that both Russia's and China's share has been increasingly growing over time suggests that both countries are gaining more importance in the Kyrgyz market. However, in spite of smaller absolute values for

China, the rate of growth of China's share has been significantly higher than for Russia, which suggests that China is gaining importance very quickly.



Source of data: the National Statistics Committee of Kyrgyzstan, www.stat.kg

As for other countries, there are no observable tendencies for Kazakhstan, whose share in Kyrgyz imports grew in 2004 in relation to 2000 and then it fell again in 2009. The reverse is true for Belarus. Its share first decreased in 2004 compared to 2000 and then increased again in 2009.

The discussion of the country's trade profile must include the analysis of major goods traded with other countries. In addition, this analysis will further help answer the major research question of the present study, what is the expected impact of Kyrgyzstan's entry into the customs union on its re-exporting activity. Table 2 shows the distribution of exports and imports by product category for 2009.

Table 2. Distribution of Kyrgyzstan's Exports and Imports by Product Category in 2009

Product category	Exports (million USD)	Imports (million USD)
Live animals and animal products	43.5	96.7
Vegetable products	104.1	121.6
Animal or vegetable fats and oils	1.1	59.7
Prepared foodstuffs; beverages, spirits and vinegar; tobacco	45.2	267.3
Mineral products	125.9	876
Products of the chemicals or allied industries	166.9	300.8
Plastics and articles thereof; rubber and articles thereof	9.3	121.3
Raw hides and skins, leather, furskins and articles thereof	6.7	6
Wood and articles of wood	0.1	64.6
Pulp of wood or of other fibrous cellulosic material	6.2	53
Textile and textile articles	161.8	209
Footwear, headgear and umbrellas	2.4	42.6
Articles of stone, plaster, cement, asbestos	10.3	56.4
Pearls, precious and semi-precious stone	671.7	2.8
Base metals	36.9	183.1
Machinery and mechanical appliances, electrical equipment	49.8	408.5
Vehicles, aircrafts, vessels	36.7	279.7
Optical instruments and apparatus	1.3	36.5
Miscellaneous manufactured articles	276	37.4
Total	1,755.9	3,223

Source: the National Statistics Committee of Kyrgyzstan, www.stat.kg

Product categories are from the FEACN (Foreign Economic Activity Commodity Nomenclature) used in Kyrgyzstan and many other post-Soviet countries. It is no surprise that pearls, precious and semi-precious stone is the number one exported product from Kyrgyzstan because of the massive amounts of gold exported to Switzerland from the Kyrgyz gold mine “Kumtor” (38.3% of the total share). Chemicals and allied industries (9.5%), textiles (9.2%), mineral products (7.2%) and vegetable products (5.9%) come next. In terms of imports, mineral products are the most imported good to Kyrgyzstan with its share in total imports of 27.2%. Machinery and electrical products are on the second place (12.7%), followed by chemicals and

allied industries (9.3%), transportation (8.7%), foodstuffs (8.3%) and textiles (6.5%). This information is essential for our further analysis and the products with the biggest shares should be given most attention when analyzing the current and future tariff rates structure of the Kyrgyz Republic.

What are the major conclusions of the analysis of trade profile of the Kyrgyz Republic? First, Kyrgyzstan is a very open economy and its degree of openness is steadily growing through time. This suggests that the country is very much dependent on trade and any major changes in its trade activity will inevitably have huge effects on the economy and the population's welfare. Second, Kyrgyzstan's major trading partners in terms of exports are represented by Switzerland (27% of the total share), countries of the customs union (Belarus, Kazakhstan and Russia) with 20%, France (11%) and Uzbekistan (10%). The geographical structure of imports is following: countries of the customs union (Belarus, Kazakhstan and Russia) have an overwhelming majority (almost 50% of total share), followed by China (21%), Uzbekistan (3.7%) and other countries. The analysis of the dynamics in trade relations of Kyrgyzstan with its partners in terms of exports showed no observable trends. However, for imports it is revealed that both China's and Russia's importance is growing in the region. In terms of product categories, pearls, precious and semi-precious stone is the number one exported good (38.3%) followed by chemicals and allied industries (9.5%), textiles (9.2%), mineral products (7.2%) and vegetable products (5.9%). For imports, mineral products are on the first place (27.2%) followed by machinery and electrical goods (12.7%), chemicals and allied industries (9.3%), transportation (8.7%), foodstuffs (8.3%) and textiles (6.5%).

2.2 Trade Relations with Belarus, Kazakhstan and Russia

The analysis of the overall trade profile of the Kyrgyz Republic revealed that countries of the customs union of Belarus, Kazakhstan and Russia play a great role in trade relations of the country. Mostly, this is because of high volumes of trade with the Russian Federation and Kazakhstan. As the analysis showed, Belarus' role in Kyrgyz trade is negligible. This is mostly due to the small size of Belorussian economy and the big geographical distance to Kyrgyzstan. Table 3 demonstrates trade flows between Kyrgyzstan and the countries of the customs union.

Table 3. Kyrgyzstan's Trade with Countries of the Customs Union (million USD)

	2008	2009	2010
Total Trade with CU	2,410.9	1,834.2	1,968.8
Exports			
Belarus	5.3	3.5	6.4
Kazakhstan	184.1	140.6	181.7
Russia	310.2	185.8	257.8
Total for CU	499.6	329.9	445.9
	26.9%*	19.7%	25.4%
Imports			
Belarus	42.5	74	53.4
Kazakhstan	376.6	339.9	385.6
Russia	1492.2	1090.4	1083.9
Total for CU	1911.3	1504.3	1522.9
	46.9%**	49.5%	47.3%

Table 3 includes information on exports and imports of Kyrgyzstan with each of the member countries of the customs union. Statistics for absolute values of trade flows (in millions of USD) are complemented with data on the share of the customs union in total exports/imports of the Kyrgyz Republic. As can be seen, the total share of members of the customs union in exports of Kyrgyzstan has been

Source of data: the National Statistics Committee of Kyrgyzstan, www.stat.kg

*share of the customs union in total exports

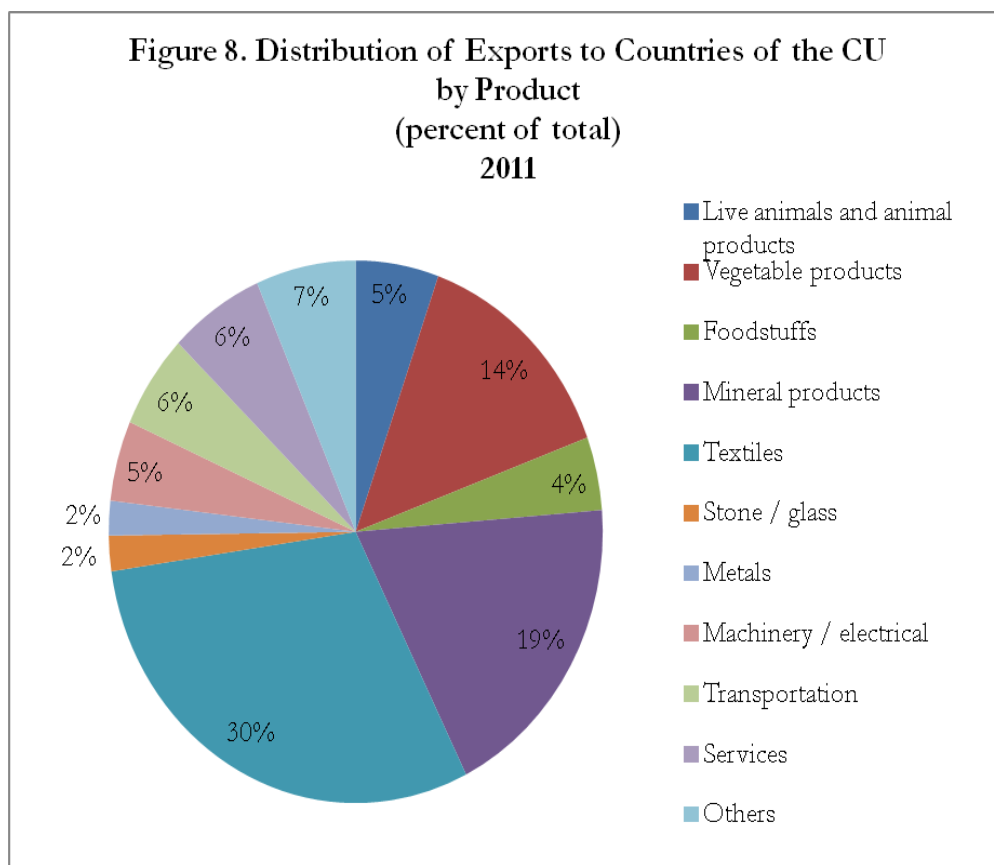
**share of the customs union in total imports

consistently high throughout these years, comprising around 25% of total exports. It is interesting to note that in 2009 both the share and the value of each member country's trade

flows fell in relation to 2008. Another interesting observation is that in 2010, in spite of the large-scale political changes and the Revolution in Kyrgyzstan exports from Kyrgyzstan to Belarus, Kazakhstan and Russia increased considerably compared to 2009. The rise was not only in absolute values but also in the share of these countries in exports from Kyrgyzstan. In addition, what is important is that the customs union started operating and the common external tariff (CET) with respect to non-members took effect from January 2010. As can be seen from the Table, it did not have any negative effect on Kyrgyz exports.

The analysis of the import side reveals that the share of Belarus, Kazakhstan and Russia together is very big reaching almost half of Kyrgyzstan's imports. This is mainly due to very high import volumes from the Russian Federation and moderately high flows from Kazakhstan. Belarus' role, as was mentioned before, is rather small. If we look at the dynamics, the situation is very different for each of the countries. If imports from Belarus increased in 2009 and then decreased again in 2010, the situation is the opposite for Kazakhstan, whose imports fell in 2009 from 376.6 million USD to 339.9 million USD and then rose again to 385.6 million USD in 2010. It was mentioned in the previous section of this chapter that Russia's role in imports of Kyrgyzstan is growing in relation to 2000 and 2004. However, both the trade volumes as well as the share of Russia has been decreasing in recent years. At the same time one must keep in mind that the differences are not drastic, so they cannot be a basis for building strong arguments.

In order to evaluate the impact of potential entry of Kyrgyzstan into the customs union it is crucial to analyze the distribution of exports to and imports from Belarus, Kazakhstan and Russia by product category. Data for this analysis are taken from the United Nations Comtrade database for 2011, with Kyrgyzstan being set as a reporting country. As the graph shows, mineral products and textiles make up 49% of total exports from Kyrgyzstan to countries of the customs union (Belarus, Kazakhstan and Russia). Their respective shares are 30% and 19%.

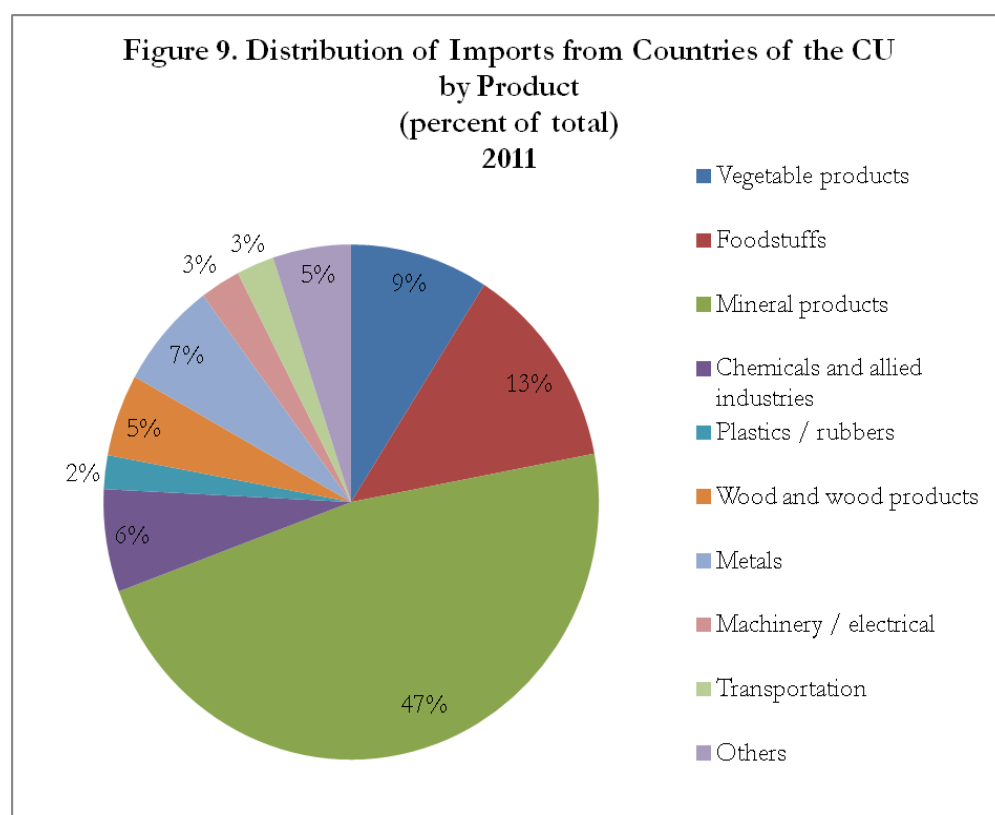


Source of data: the UN Comtrade database (Reporter: Kyrgyzstan)

These results are consistent with the discussion in the first chapter of the present research that Kyrgyzstan exports large amounts of apparel (which is included in textiles category) to Russia and other Central Asian countries. Part of these exports may also represent re-exports from China of textile products. As for other categories of goods, vegetable products are the third most exported good from the Kyrgyz Republic to Belarus, Kazakhstan and Russia, followed by others.

Figure 9 shows the distribution of imports to Kyrgyzstan from Belarus, Kazakhstan and Russia taken together by product category. The allocation of goods in this case is less diversified than it was the case with exports. Almost half (47%) of imported goods is represented by mineral products. This is no surprise as Kyrgyzstan imports large amounts of oil and oil-related products from Russia. Foodstuffs are the second most imported product from countries of the

customs union (13%), followed by vegetable products (9%). Other categories of goods receive comparably similar weights in the distribution of imports to Kyrgyzstan from these countries.



Source of data: the UN Comtrade database (Reporter: Kyrgyzstan)

In this section, we have analyzed trade relations of the Kyrgyz Republic with the member countries of the customs union, namely Belarus, Kazakhstan and Russia. Export and import flows to and from these countries for the last three years were thoroughly evaluated and conclusions drawn from this examination. The remainder of this part of the research focused on the study of main product categories that are traded with Belarus, Kazakhstan and Russia. It was found that in exports mineral products and textiles make up 49% of total exports from Kyrgyzstan to these countries. Imports from countries of the customs union are dominated by imports of mineral products, which are mostly due to oil-related goods from Russia and Kazakhstan.

The last point to be added to this analysis concerns trade agreements that exist between Kyrgyzstan and the countries of the CU. As Shinn et al. and the report of the World Bank point out, at the moment Kyrgyzstan has a special free trade agreement with Belarus, Kazakhstan and Russia (within the framework of CIS and EurAsEc), which allow customs free (exempt from duties) trade between these countries (2010: 13). However, as scholars argue, the situation might change and the members of the customs union may decide to revoke this free trade agreement. Therefore, Kyrgyzstan cannot rely on this trade agreement for a long time.

2.3 Trade Linkages with China and Re-export Activity

In the introduction to the present work, it was argued that Kyrgyzstan has become the regional centre of re-exports from China to Russia and to Central Asian countries (Kazakhstan, Uzbekistan, Tajikistan and Turkmenistan). In order to evaluate how Kyrgyzstan's entry into the customs union will affect its re-exporting activity it is essential to examine what is the magnitude of these re-exports, what type of products are re-exported and what are the tariff rates for these goods under the current regime in order to compare it with future rates. This part of the study is devoted to the analysis of these questions.

Table 4. Kyrgyzstan's Trade with China (million USD)

	2008	2009	2010
Total trade			
National Statistics Committee of the KR	772.6	643	694.6
UN Comtrade (mirror statistics)	9,333.3	5,276.0	4,199.6
Exports			
National Statistics Committee of the KR	44.4	19.4	28.3
UN Comtrade (mirror statistics)	121.3	48.5	72.1
Imports			
National Statistics Committee of the KR	782.2	623.6	666.3
UN Comtrade (mirror statistics)	9,212.0	5,227.5	4,127.5

Source of data: the National Statistics Committee of the Kyrgyz Republic, the UN Comtrade database

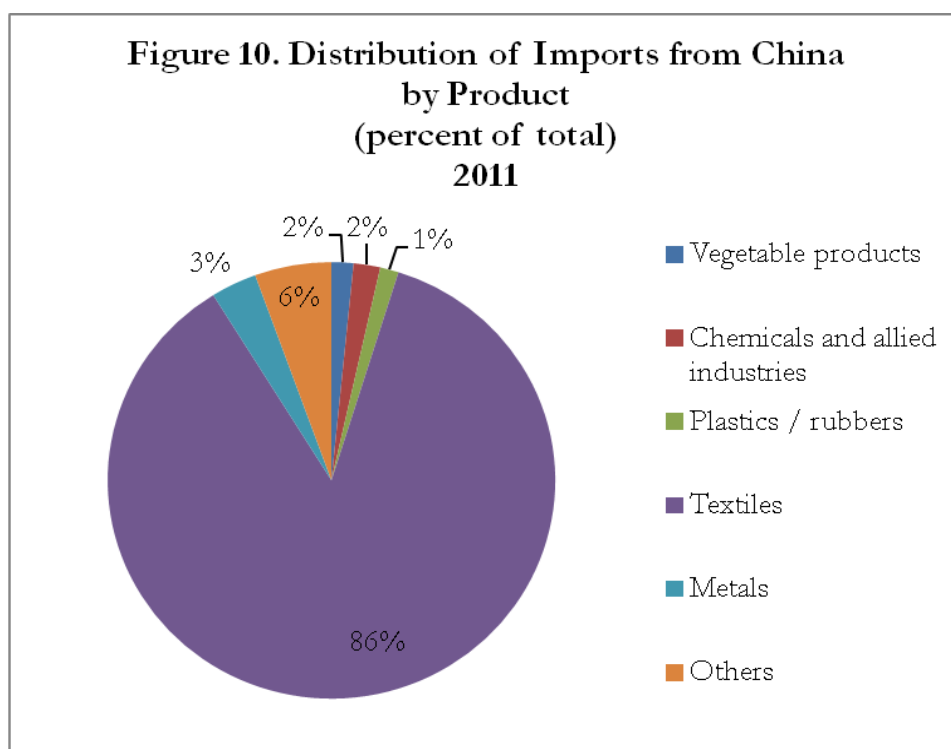
Table 4 shows trade flows between Kyrgyzstan and China for the past three years. Earlier it was mentioned that according to many researchers, data of the National Statistics Committee of the Kyrgyz Republic differ considerably from the data from other sources (IMF's Directions of Trade Statistics database, UN Comtrade database, etc.), especially for imports from China to Kyrgyzstan. For this reason, we provide data from both the Statistics Committee of Kyrgyzstan and the UN Comtrade database. In the United Nations Comtrade database it is possible to set the reporter country and thus, get data both from the "point of view" of Kyrgyzstan or China. In Table 4 statistics from the UN Comtrade are calculated using "mirror" statistics (setting China as a reporting country). Setting Kyrgyzstan as a reporting country in the UN Comtrade database yields the same results as of the National Statistics Committee, since this agency reports its data for Kyrgyzstan.

As we can see, the difference in data is huge. Specifically, data values from the UN Comtrade statistics are 2.5 – 2.7 times higher than the respective data from the National Statistics Committee for exports and 6.2 – 11.8 times bigger for imports. Literature suggests several reasons for such a big difference in data. As Shinn et al. argue, this difference is mainly due to a simplified customs clearance procedure used in Kyrgyzstan for "bazaar" goods coming from China. As was discussed in detail in the first chapter of the present study, the Kyrgyz Republic sets customs duties according to the volume and weight of consumer goods entering the country but not the value. Thus, customs officials have no incentive to accurately classify and define the value of imported goods (Shinn et al. 2010: 9). One more explanation frequently cited in the literature is that the use of "mirror statistics" method is not necessarily correct as countries reporting trade data to the UN Comtrade database have different methodologies in assessing the value of goods imported and exported to a country. As a result, these data compiled using different methodologies cannot be compared according to this view (Shinn et al. 2010: 9; European Development Bank 2011: 9). In spite of their validity, the two reasons described above

may account for only a small part of the big disparity in data. The most important reason for this discrepancy may actually be the huge re-exports of Chinese goods through Kyrgyzstan. As Kaminski and Raballand (2009) argue, “mirror import statistics provide clues as to the size of the re-exports... Thus, some portion of the unreported imports only touch down in Kyrgyzstan on their way to other countries” (583). Hence, this big disparity in official and mirror statistics is an additional piece of evidence that Kyrgyzstan re-exports large amounts of Chinese goods to other countries.

In spite of the differences in data, they show the same picture in terms of exports dynamics from Kyrgyzstan to China. Namely, exports to China experienced a big fall in 2009 compared to 2008 and then rose again in 2010. The rise, though, was not enough as to reach the levels of 2008. As for imports, according to the official Kyrgyz statistics they fell from 782.2 million USD in 2008 to 623.6 million USD in 2009 but then rose again reaching 666.3 million USD in 2010. However, in relative values official statistics show that the share of imports from China in total imports has been steadily growing in the past three years. According to the United Nations Comtrade database, the value of imports from China has been falling in the recent years.

Because this research focuses on the analysis of re-exports and the effect of Kyrgyzstan’s potential entry into the customs union on its re-exporting activity, it is crucial to analyze the import structure of Chinese goods. The detailed analysis of exports from Kyrgyzstan to China is not required, since the expected entry of the Kyrgyz Republic into the customs union of Belarus, Kazakhstan and Russia should not have a significant effect on its exports to China. There are no export duties levied by Kyrgyzstan and the tariff rates of China for imported goods should not change considerably. Figure 10 depicts the distribution of Chinese imports by product.



Source of data: the UN Comtrade database (Reporter: Kyrgyzstan)

As can be seen, textiles constitute the overwhelming majority (86%) of imported goods from China. This result is consistent with our earlier discussions that Kyrgyzstan imports large amounts of cheap fabric and textile-related goods and uses them in the production of clothing, which is subsequently exported to Russia, Kazakhstan and other countries. Because of the low tariff rates for this category of goods as well as cheap labor in Kyrgyzstan, garment production industry has been very competitive and one of the top-priority industries in the country. Thus, special attention should be given to textiles when assessing the impact of Kyrgyzstan's possible entry into the customs union on its tariff rates. The next most imported category from China to Kyrgyzstan is metals, followed by vegetable products and chemicals. However, their share is in no way comparable to the substantial share of textiles in total imports.

When we were analyzing the channels through which re-exporting is conducted in Kyrgyzstan, we stated that the major channel is Kyrgyz bazaars, or wholesale markets. What are the products that are re-exported from China through Kyrgyzstan to Russia and to Central Asian

countries? Kaminski and Raballand (2009) discuss this issue in detail in their study explicitly focused on the nature of re-exports through Kyrgyz bazaars. They identify two criteria that should be satisfied for goods, which are both bazaar goods and are the likely candidates for re-exports:

First, the volume of their imports into Kyrgyzstan is anomalously high... Second, these products are characterized by positive trade gaps – i.e., the values of mirror imports exceed those of officially reported imports (Kaminski and Raballand 2009: 584).

Applying these two criteria, authors conclude that apparel and textile-related goods; footwear, and miscellaneous manufactured articles are the products re-exported through Kyrgyzstan from China. These results are consistent with the analysis of import structure carried out in the present study. Specifically, we noted that the share of textiles is overwhelmingly big in total imports from China. Identifying what type of goods is re-exported through Kyrgyzstan is very important for the goals of this research, and special attention will be given to these product categories when analyzing the present tariff rates and the rates that are applied in the customs union of Belarus, Kazakhstan and Russia.

We have analyzed the dynamics of trade flows between Kyrgyzstan and China for the past three years, compared the data from the National Statistics Committee of the Kyrgyz Republic and the United Nations Comtrade database, examined the import structure of Chinese goods by product category and identified what are the goods re-exported through Kyrgyzstan. The last question remains in the analysis of Kyrgyz-Chinese trade relations as to what is the magnitude of re-exports through Kyrgyzstan and especially what is the value of re-exports from China destined to Russia and Kazakhstan. As noted before, the huge disparity in official and mirror import statistics provides clues as to the size of re-exports. However, they do not give specific numbers for re-exports. Because of the complexity of the issue of re-exports and the unique channels of re-exporting in Kyrgyzstan (e.g. bazaar's role in re-exporting; paying for

goods in cash, etc.) it is very difficult to estimate the value of re-exports. However, there are estimates of re-exports done by the World Bank, which are presented in Table 5.

Table 5. Estimates of re-exports from China through Kyrgyzstan (million USD)

	2008	2009	2010
Estimated re-exports of “bazaar” goods*	8,127	4,189	3,091
Estimated re-exports destined to Kazakhstan and Russia	7,221	3,873	2,958

Source: the World Bank report “Customs Union between Belarus, Kazakhstan and Russia: Potential Impact on Kyrgyzstan and Tajikistan

*including mainly clothing, footwear, fabrics, construction materials

As can be seen from the Table, the value of re-exports through Kyrgyzstan is huge. Thus, in 2010 it reached 3.1 billion USD! As the figures suggest, the majority of re-exports from China is destined to Kazakhstan and Russia. It is interesting to note the decreasing trend in re-exports in the past three years. While the fall of re-exports in 2009 is explained by the increasing severity of the financial crisis, the fall in 2010 is due to the temporary closure of Kyrgyz-Kazakh border because of the Revolution in Kyrgyzstan.

Having completed the analysis of this section, what major conclusions can be drawn? The analysis of the trade profile of the Kyrgyz Republic produced important results that are crucial for the subsequent study of the main research question of the present work, whether Kyrgyzstan’s entry into the customs union of Belarus, Kazakhstan and Russia will be an exit from its re-exporting path. Specifically, we have looked at the overall trade structure of the Kyrgyz economy and revealed that members of the customs union (Belarus, Kazakhstan and Russia) are in the top major trading partners list both by exports (20% of the total share) and imports (49% of the total share). China is the second most important partner of Kyrgyzstan in terms of imports taking 21% of total imports. The analysis of the main trading partners of the Kyrgyz Republic through time revealed that both China and Russia are gaining more and more

importance in the region, with their shares in total trade increasing over time. The detailed study of Kyrgyzstan's trade relations with Belarus, Kazakhstan and Russia showed that textiles and mineral products are the most exported product categories from Kyrgyzstan, while mineral products are also the most imported good to the Kyrgyz Republic. The detailed study of Kyrgyzstan's trade relations with China confirmed that Kyrgyzstan re-exports large amounts of goods from China to Kazakhstan and Russia, and the overwhelming dominance of textiles in imports from China suggest that textiles and textile-related goods are the goods re-exported most. In addition, footwear, and miscellaneous manufactured articles are in the list of goods re-exported by Kyrgyzstan from China.

2.4 Tariff Structure of Kyrgyzstan and the Customs Union: Comparative Analysis

Having obtained these important results, we can now turn to the examination of tariff rates that are in place in the Kyrgyz Republic now and compare them with the tariff rates of the customs union of Belarus, Kazakhstan and Russia. In doing so, special attention will be given to the product categories that are re-exported most through the territory of Kyrgyzstan. This section of the present work is devoted to studying these questions.

We start the comparative analysis of tariff rates in Kyrgyzstan and the customs union of Belarus, Kazakhstan and Russia with the study of average rates across main categories of goods. Summary of the tariff rates is presented in Table 6. Product categories are from the FEACN (Foreign Economic Activity Commodity Nomenclature) used both in the Kyrgyz Republic and countries of the customs union for goods' classification purposes. This classification system is based on the Harmonized system of classification. Tariff data used in the present research are taken from the law of the Kyrgyz Republic "On customs tariff of the Kyrgyz Republic" and from the official website of the customs union of Belarus, Kazakhstan and Russia (www.tsouz.ru). All calculations of average tariff rates are done by the author.

Table 6. Average tariff rates across product categories: Kyrgyzstan and the customs union

Product category	Tariff rates, Kyrgyzstan	Tariff rates, Customs Union	Difference
Live animals and animal products	7.5	15.9	8.4
Vegetable products	6.7	8.2	1.5
Animal or vegetable fats and oils	9.5	5.9	-3.6
Prepared foodstuffs; beverages, spirits and vinegar; tobacco	7.4	11.3	3.9
Mineral products	4.1	4.6	0.5
Products of the chemicals or allied industries	1.1	8.3	7.2
Plastics and articles thereof; rubber and articles thereof	2.1	8.8	6.7
Raw hides and skins, leather, furskins and articles thereof	3.4	9.6	6.2
Wood and articles of wood	0	11.7	11.7
Pulp of wood or of other fibrous cellulosic material	0	9.1	9.1
Textile and textile articles	7.4	10.4	3
Footwear, headgear and umbrellas	9.8	11	1.2
Articles of stone, plaster, cement, asbestos	8.1	15.1	7
Pearls, precious and semi-precious stone	9.8	18.2	8.4
Base metals	2	9.1	7.1
Machinery and mechanical appliances, electrical equipment	2.7	5.9	3.2
Vehicles, aircrafts, vessels	3.8	10	6.2
Optical instruments and apparatus	5.6	9.8	4.2
Miscellaneous manufactured articles	5.8	13.4	7.6
Works of art, collectibles and antiques	5.8	13.5	7.7
Total average	5.1	10.5	5.4

Source: author's calculations

From Table 6 we can derive several preliminary conclusions. First, the average tariff rate that is in place in the Kyrgyz Republic now is 5.1% and the average tariff rate for the customs union of Belarus, Kazakhstan and Russia is 10.5%. Thus, the average tariff rate of the customs union is more than twice as big as the respective rate in Kyrgyzstan. This suggests that overall the customs union of Belarus, Kazakhstan and Russia has more protection against nonmember imports than the Kyrgyz Republic. This result is consistent with the findings of the literature review conducted in the present work where it was claimed that increasingly deep integration can

lead to rising protection against nonmember imports. In addition to this, higher average tariff rate of the customs union suggests that if Kyrgyzstan decides to become a member of the union, it will also have higher rates for imports from China, which will subsequently have adverse effects on its re-exporting activity. However, these are preliminary results based on average rates and a more detailed analysis with respect to re-exported goods will follow.

Second, in all of the product categories except “animal or vegetable fats and oils” the average tariff rates are higher in the customs union than in the Kyrgyz Republic. So, if the country becomes a member of the union, rising protection against nonmember imports is expected to be across-the-board. In the only case with “animal or vegetable fats and oils” the situation is the opposite when the average tariff rate of the customs union (5.9%) is lower than the respective rate in Kyrgyzstan (9.5%).

Next, if we look at the magnitude of differences between average rates across major product categories, the biggest disparity is in the “wood and articles of wood” category (11.7 percentage point difference), followed by “pulp of wood or of other fibrous cellulosic material” (9.1 percentage point difference), “pearls, precious and semi-precious stone” and “live animals and animal products” (difference in both of 8.4 percentage points). From this, we see that none of the product categories that constitute re-exported goods from China is in the list of most affected. The smallest difference in average rates is observed in “mineral products” category (0.5 percentage point difference), followed by “footwear, headgear and umbrellas” (1.2 percentage point) and “vegetable products” (1.5 percentage point). It is interesting to note that “footwear, headgear and umbrellas”, which was identified as the product category re-exported through the territory of Kyrgyzstan is in the list of the least affected product categories. This suggests that re-exports of this category of goods is not likely to be affected much.

Having provided the overall picture of the differences in average tariff rates between the Kyrgyz Republic and the customs union of Belarus, Kazakhstan and Russia it is time to turn to the detailed analysis of product categories that we earlier identified as re-exported goods from China. This detailed examination will identify the expected effect of changes in tariff rates on re-exports from China and consequently, provide answers to the main research question of the present study, whether Kyrgyzstan's entry into the customs union will be an exit from its re-exporting path. Product categories re-exported most through the territory of the Kyrgyz Republic are apparel and textile-related goods, which capture the overwhelming majority of re-exported products; footwear, headgear and umbrellas, and miscellaneous manufactured articles.

Table 7. Average tariff rates in “textiles and textile articles” group: Kyrgyzstan and the customs union

Product sub-category	Tariff rates, Kyrgyzstan	Tariff rates, Customs Union	Difference
Silk	5	4.8	-0.2
Wool, fine or coarse animal hair, horse hair yarn and woven fabric	6.5	5	-0.8
Cotton	6.1	11	4.9
Other vegetable textile fibers; paper yarn	4.9	7.8	2.9
Man-made filaments	4.4	9.1	4.7
Man-made staple fibers	5.4	8	2.6
Wadding, felt and nonwovens	3.7	8.4	4.7
Carpets and other textile floor coverings	10	20	10
Special woven fabrics; tufted textile fabrics; lace	9.6	15	5.4
Impregnated, coated, covered or laminated textile fabrics	4.7	6.2	1.5
Knitted or crocheted fabrics	10	10	0
Articles of apparel and clothing accessories, knitted or crocheted	10.8	10.8	0
Articles of apparel and clothing accessories, not knitted or crocheted	12	10	-2
Other made up textile articles; sets; worn clothing	10.8	18.9	8.1
Total average	7.4	10.4	3

Source: author's calculations

Table 7 presents the detailed comparison of tariff rates in “textiles and textile articles” across its sub-categories. As can be seen from the Table above, the average tariff rate in “textiles and textile articles” group is 7.4% in the Kyrgyz Republic, while in the customs union of Belarus, Kazakhstan and Russia it is 10.4%. Thus, the overall difference in rates is 3 percentage points, which is not very big. Therefore, the preliminary results suggest that the average rate levied on imported goods from China including the goods, which are subsequently re-exported, is going to rise if Kyrgyzstan joins the customs union. This, in its turn, will make imported goods more expensive and thus negatively affect their trade flows and consequently, re-exports. However, the difference is not going to be big, so the effect of the change in tariffs on re-exporting activity should be limited. Based on this information, our preliminary conclusion is that Kyrgyzstan’s entry into the customs union of Belarus, Kazakhstan and Russia is not going to be a complete exit from the re-exporting path. It will, most likely, adversely affect the re-exporting activity, but not to the extent as to shut down re-exports completely.

The analysis across sub-categories of “textiles and textile articles” reveals that the biggest disparity in rates not in favor of Kyrgyzstan’s re-exports from China is in “carpets and other textile floor coverings” sub-category (10 percentage point difference) and “other made up textile articles; sets; worn clothing” (8.1 percentage point difference). Thus, re-exports of these goods are likely to be affected most in the negative terms by the introduction of the common external tariff (CET). It is interesting to note that across several categories tariff rates in the customs union of Belarus, Kazakhstan and Russia with respect to non-member countries are even lower than the respective rates in Kyrgyzstan. These are “articles of apparel and clothing accessories, not knitted or crocheted” (negative 2 percentage point difference), “wool, fine or coarse animal hair, horse hair yarn and woven fabric” (negative 0.8 percentage point) and “silk” (negative 0.2 percentage point). This suggests that in these sub-categories of goods Kyrgyzstan may not fear the possible decline in imports from China and thus, re-exports. It appears that in these

categories of goods re-exports from China are expected to have even more favorable terms. Continuing our analysis, in two of the sub-categories there is no difference in rates between Kyrgyzstan and the customs union (“knitted or crocheted fabrics” and “articles of apparel and clothing accessories, knitted or crocheted”). So for traders dealing with these items there is going to be no difference between entry or non-entry of Kyrgyzstan into the customs union of Belarus, Kazakhstan and Russia. The remaining sub-categories of “textiles and textile articles” show the disparity in rates ranging from 1.5 percentage points to 5.4 percentage points. Thus, for these categories of goods re-exporting will likely be negatively affected. However, its extent is expected to be not significant.

The next point of our analysis in tariff rates under the customs union and the Kyrgyz Republic is the discussion of “footwear, headgear and umbrellas” category, which was earlier identified as one of the re-exported goods from China. Summary of average rates across sub-categories is presented in Table 8.

Table 8. Average tariff rates in “footwear, headgear and umbrellas” group: Kyrgyzstan and the customs union

Product sub-category	Tariff rates, Kyrgyzstan	Tariff rates, Customs Union	Difference
Footwear, gaiters and the like	9.1	9.1	0
Headgear and parts thereof	10	10	0
Umbrellas, sun umbrellas, walking sticks	10	15	5
Prepared feathers and down; artificial flowers	10	10	0
Total average	9.8	11	1.2

Source: author’s calculations

As we can see, the difference in tariff rates across sub-categories of “footwear, headgear and umbrellas” is minor. Namely, in all of the groups with the exception of “umbrellas, sun umbrellas and walking sticks” the tariff rates, which are in place in the Kyrgyz Republic and the

customs union of Belarus, Kazakhstan and Russia are exactly the same. Therefore, for these items it does not matter whether Kyrgyzstan eventually joins the customs union or not. This, in its turn, should have no effect on re-exports of respective goods from China through the territory of Kyrgyzstan. As for “umbrellas, sun umbrellas and walking sticks”, the tariff rate in the customs union is 15%, while in the Kyrgyz Republic it is 10%, which makes a 5 percentage point difference. Only the imports and subsequent re-exports of this sub-category of goods in “footwear, headgear and umbrellas” are likely to suffer in the case Kyrgyzstan joins the customs union.

The last category that requires detailed analysis is “miscellaneous manufactured articles”, which were identified in the list of re-exported goods from China through Kyrgyzstan to Russia and Central Asian countries. The comparison of average tariff rates across sub-categories is presented in the following Table.

Table 9. Average tariff rates in “miscellaneous manufactured articles” group: Kyrgyzstan and the customs union

Product sub-category	Tariff rates, Kyrgyzstan	Tariff rates, Customs Union	Difference
Furniture; bedding; mattresses; lamps and lighting fittings	2.5	13.2	10.7
Toys, games and sports requisites	5.1	12.9	7.8
Miscellaneous manufactured articles	9.7	14.2	4.5
Total average	5.8	13.4	7.7

Source: author’s calculations

From Table 6 we can see that in contrast to other categories of goods, which are re-exported through the territory of Kyrgyzstan from China, the difference in tariff rates between Kyrgyzstan and the customs union for “miscellaneous manufactured articles” is significant. While the average tariff rate for this category is 5.8% in the Kyrgyz Republic, it is more than twice as big in the customs union of Belarus, Kazakhstan and Russia comprising 13.4%. Therefore, we can

expect that imports of these goods from China for the re-exporting purpose are likely to decrease substantially. Analyzing sub-categories of this group, we can see that the biggest discrepancy is observed across “furniture; bedding; mattresses; lamps and lighting fittings” (10.7 percentage point difference). Thus, re-exports of these items are likely to suffer most if Kyrgyzstan becomes member of the customs union. For other sub-categories of goods, the difference in tariff rates is quite big as well, with 7.8 percentage point difference for “toys, games and sports requisites” and 4.5 percentage point difference for “miscellaneous manufactured articles”.

In this section of the work we analyzed the present tariff structure of Kyrgyzstan and compared it with tariff rates of the customs union of Belarus, Kazakhstan and Russia. Special emphasis in this analysis was put on the examination of tariff rates of goods that are re-exported from China through the territory of the Kyrgyz Republic. While several preliminary conclusions were made in this section, the overall interpretation of results and their implications for the future of Kyrgyz re-exports is made in Chapter 3. In that chapter we also provide answers to the main research question of the present study, whether Kyrgyzstan’s entry into the customs union of Belarus, Kazakhstan and Russia will be an exit from the re-exporting path.

CHAPTER 3. Kyrgyzstan's Entry into the Customs Union: an Exit from the Re-exporting Path?

Kyrgyzstan's potential entry into the customs union of Belarus, Kazakhstan and Russia has produced heated discussions among policy-makers, economists and the general public. One of the key aspects of these debates has been the discussion of the fate of the re-exporting activity in case the country commits to joining the union. Because the Kyrgyz Republic has become the regional centre of re-exports of Chinese goods to other Central Asian countries and the Russian Federation, the fear of many economists has been that the introduction of common external tariff (CET) may become an obstacle for re-exports. The present research has addressed this issue in detail and set its goal to investigate the potential effects of Kyrgyzstan's entry into the customs union on its re-exporting activity.

So far, we have analyzed both academic literature and policy papers; examined the trade profile of the Kyrgyz Republic with separate analysis of trade relations with members of the customs union (Belarus, Kazakhstan and Russia) on the one side and China on the other. In addition, we have made a comparative analysis of tariff rates, which are in place in Kyrgyzstan now and the rates, which will replace the existing ones if Kyrgyzstan joins the customs union. Detailed examination of tariff rates across categories of goods, which are re-exported from China through the territory of the Kyrgyz Republic, has been conducted with some preliminary results with respect to the future of re-exports. This chapter is devoted to analyzing implications of new tariff rates for the re-exporting activity of the country and providing policy recommendations in this respect.

3.1 Implications of New Tariff Structure for Kyrgyz Re-exports

What implications does the tariff structure of the customs union of Belarus, Kazakhstan and Russia have for the future of Kyrgyz re-exports given that Kyrgyzstan will have to adopt it if

it decides to become a member of the customs union? The comparative analysis of tariff rates revealed that the average rate across major product categories for Kyrgyzstan is 5.1%, while the respective rate in the customs union is more than twice as big, namely 10.5%. Thus, if the Kyrgyz Republic joins the customs union it will have to impose roughly two times higher protection from foreign imports in average terms. However, because in this study we are interested in the effects of common external tariff (CET) on re-exports we focus on the results of detailed analyses of product categories actually subject to re-exports. It was identified that goods re-exported from China through the territory of Kyrgyzstan are represented by “textiles and textile articles”; “footwear, headgear and umbrellas”; and “miscellaneous manufactured articles”. Discussion of each of these categories and implications of their tariff structures is provided below.

“Textiles and textile articles” constitute the overwhelming majority of imported goods from China (86% of total imports from China in 2011). In addition, they also represent the majority of all re-exported goods as well. Consequently, the results of the comparative analysis of tariff rates and its implications for re-exports of these goods will be the most important and largely determining the overall results for re-exports. The examination of tariff rates for textiles and textile articles revealed that the average tariff rate is 7.4% in Kyrgyzstan and 10.4% in the customs union of Belarus, Kazakhstan and Russia, producing a 3-percentage point difference between these rates. Although the average rate is going to be higher if Kyrgyzstan becomes a member of the customs union, the difference in relation to the existing rate is going to be not significant. This means that although prices of textiles and related goods entering Kyrgyzstan from China are going to be higher and thus give incentive for traders to re-export less of these goods, the increase in prices should not be as big as to cause major changes in re-exports of these goods. Most likely, the amounts of re-exports will decrease but it is definitely not going to end the re-exporting activity altogether. The analysis of sub-categories of textiles and textile

articles revealed that there are several sub-categories of goods, which will actually experience the fall in tariff rates if Kyrgyzstan becomes a member of the customs union. These are “articles of apparel and clothing accessories, not knitted or crocheted”, “wool, fine or coarse animal hair, horse hair yarn and woven fabric” and “silk”. Moreover, there are sub-categories of goods, which will face the exact same tariff rates under the customs union, such as “knitted or crocheted fabrics” and “articles of apparel and clothing accessories, knitted or crocheted”. These findings add to the argument that re-exports of textile products are not going to be significantly affected by new tariff regime. Of course, there are also sub-categories of goods that will experience a tangible rise in tariff rates, which will subsequently provide disincentives to import them from China for further re-exporting. These are “carpets and other textile floor coverings”, which will experience the rise from existing 10% tariff rate to 20%, and “other made up textile articles; sets; worn clothing”, whose tariff rates are expected to rise by 8.1 percentage points. However, the nature of these goods as well as the small share of these sub-categories of goods in total imports from China suggest that the decline in their re-exports will not have a significant effect on total re-exports of textile articles. As for remaining sub-categories of goods, the range of their tariff difference is from 1.5 percentage points to 5.4 percentage points. We believe that this magnitude of change is not that big as to significantly alter the behavior of economic agents, and their disincentive effect for re-exports is rather small. This is not to say that re-exports of these goods will not be affected, just that the effect will be limited and will not cause major changes in the re-exporting activity of Kyrgyzstan.

The argument that Kyrgyzstan’s re-exporting activity will not be drastically affected by the entry of the country into the customs union of Belarus, Kazakhstan and Russia is also supported by evidence from the analysis of “footwear, headgear and umbrellas” category. These items are also re-exported from China to Kazakhstan, Russia and other countries through the territory of the Kyrgyz Republic, although the size of their re-exports is in no way comparable to

huge flows of textiles and textile products. Nevertheless, the comparative analysis of tariff rates for this category of goods in the customs union and in Kyrgyzstan demonstrated that the average rate in Kyrgyzstan is 9.8%, while the respective rate in the union is 11.0%. Thus, the difference is very small suggesting that the effect of the change in tariff regime will have very small, if any effects on re-exports of these goods. The difference in average rates for “footwear, headgear and umbrellas” category between the Kyrgyz Republic and the customs union of Belarus, Kazakhstan and Russia is entirely driven by the disparity in rates across “umbrellas, sun umbrellas and walking sticks” sub-category where the rise in tariff rate is expected to be from 10% to 15%. Thus, this is the only sub-category of goods, whose re-export volumes might be affected by the entry of Kyrgyzstan into the customs union. Even so, the overall re-exporting activity will not be influenced by this change.

The comparative analysis of tariff rates for “miscellaneous manufactured articles” yielded results that are different from the overall results for other two categories of goods re-exported from China through Kyrgyzstan. Specifically, the average tariff rate, which is in place in Kyrgyzstan now for this category is 5.8%, while the respective rate is more than twice as big in the customs union of Belarus, Kazakhstan and Russia (13.4%) making up a differential of 7.6 percentage points. In spite of this big difference, the new unfavorable rates for these products will have only a limited negative effect on overall re-exporting activity of Kyrgyzstan. While the re-exports of these particular items are likely to fall, their share in total imports from China is negligible, which suggests that their share in re-exports is very small as well.

In light of these findings of the comparative analysis of tariff rates, our overall conclusion is that the adoption of common external tariff (CET) by Kyrgyzstan will not have a significant effect on its re-exporting activity. Re-exports of some of the sub-categories of goods might be negatively affected by new tariff rates but the magnitude of change is expected to be small. This is due to the small share of these goods in total imports from China as well as a

rather small change in rates. Therefore, coming back to the main research question of the present study, we can conclude that Kyrgyzstan's entry into the customs union will not be a complete exit from its re-exporting path. This result is also supported by evidence from Uzbekistan, which imposed a very unfavorable regime with respect to imports of goods from neighboring countries. As the report of the World Bank suggests, these measures decreased imports from these countries but it did not completely eliminate it (2011: 7).

Because the entry of Kyrgyzstan into the customs union of Belarus, Kazakhstan and Russia implies that the country will move up in its integration with these countries from currently existing free trade agreement to the customs union, it means that the Kyrgyz Republic will need to adopt the common external tariff (CET) of the customs union and also common non-tariff policies with respect to non-members. Thus, the potential concern may be that while this increased integration will lead to more simplified customs procedures inside the union removing the internal barriers between member countries, it might also lead to increased non-tariff regulations with respect to non-members. In other words, it is likely that a simplified customs procedure on the border of Kyrgyzstan and China with respect to "bazaar goods" may be eliminated. This may have a potential disincentive effect on re-exports of Chinese goods. However, at this point it is difficult to assess the potential effect of expected non-tariff regulations on the re-exporting activity.

Another potential concern of Kyrgyzstan's entry into the customs union of Belarus, Kazakhstan and Russia may be that because all members of the union will have the exact same external tariff rates as well as the same non-tariff regulations there may no more incentive to import goods from China to Kazakhstan and Russia through the territory of Kyrgyzstan. Kazakhstan shares a border with China, so Chinese goods may enter Kazakhstan directly and even go to Russia through Kazakhstan. However, we expect that due to the already established tradition and stable long-term relationships of traders with buyers and suppliers and because

origin and destination markets are set up and respective routes are already formed, there will be no incentive for traders to change them. They will not want to incur additional fixed costs, search and transaction costs. Moreover, the geographical proximity of cities (such as Kashgar) specialized in bazaar goods to Kyrgyzstan will give incentive to import goods through its territory because of the low transport costs. In view of these arguments, we expect that re-exporting activity of the Kyrgyz Republic is not likely to be significantly affected by this.

3.2 Policy Recommendations

In the present study we identified that Kyrgyzstan's potential entry into the customs union of Belarus, Kazakhstan and Russia will not be an exit from its re-exporting path. We argued that the change in tariff as well as non-tariff regulations that will underlie the entry of the country into the customs union will not have a significant effect on Kyrgyz re-exports. At the same time, we concluded that re-exports of some of the categories of goods might suffer in response to the unfavorable change in rates in their product categories. How can the potential negative effect of Kyrgyzstan's membership in the customs union be mitigated in relation to re-exports of these goods?

We provide several policy recommendations in this respect. First, when the customs union of Belarus, Kazakhstan and Russia was being formed and the formation of common external tariff (CET) was under way, Kazakhstan was able to negotiate favorable tariff rates for some of the sensitive categories of goods. Thus, the present situation with tariff rates in the customs union is not necessarily the most rigid. Theoretically, with the entrance of new members into the customs union tariff rates for some of the categories of goods with respect to third countries may be renegotiated across members. Therefore, one of the recommendations that we provide in the present study is for Kyrgyzstan to try to renegotiate lower rates for categories of goods that are re-exported through its territory. This concerns mostly textiles, as they not only

constitute the overwhelming majority of imported goods from China but they are also used in the production of garments, which is one of the priority industries in Kyrgyzstan. At the same time the bargaining power of Kyrgyzstan may be very limited once it enters the customs union. Mostly due to the small economic size of the country and thus its little economic weight in the customs union, we may expect that the Kyrgyz Republic will not be able to negotiate favorable terms in selected categories.

One more policy recommendation that concerns the change in tariffs due to the introduction of the common external tariff (CET) comes from the article of Muzaparova et al. (2009). Specifically, they suggest that the customs union of Belarus, Kazakhstan and Russia adopt some sort of “compensation mechanism”, which would allocate compensations to countries, whose customs related revenues were significantly reduced due to the unfavorable change in tariff rates (Muzaparova et al. 2009: 60). As the authors argue, such kind of mechanism was introduced in the European Union when the common external tariff (CET) was formed and proved successful in adapting member countries’ economies to the operation of the union (Muzaparova et al. 2009: 57). Such kind of mechanism would be very beneficial for the Kyrgyz Republic as well, since because of the unfavorable change in tariff rates in some of the categories of goods imports of those goods may fall. Compensations would provide a sort of insurance against possible shocks in customs related revenues.

CONCLUSION

Kyrgyzstan's potential membership in the customs union of Belarus, Kazakhstan and Russia is the most debated policy issue in the country nowadays. Special attention in these heated discussions is placed on speculating about the future of Kyrgyzstan's re-exporting activity if the country commits to joining the union. Kyrgyzstan has been the regional centre of re-exports of Chinese goods to Russia, Kazakhstan and other Central Asian countries providing a source of revenue for more than 400, 000 people directly or indirectly involved in re-exports. As a result, the fear of policy-makers has been that new tariff regime will have adverse effects on the re-exporting activity of the country and thus the welfare of many people. In light of these events, the present study has been devoted to identifying the potential effects of Kyrgyzstan's membership in the customs union of Belarus, Kazakhstan and Russia on its re-exporting activity. The main research question of the current study is whether Kyrgyzstan's entry into the customs union will be an exit from its re-exporting path.

The major conclusion derived from this study is that Kyrgyzstan's entry into the customs union of Belarus, Kazakhstan and Russia is not going to be an exit from its re-exporting activity. It was found that the changes in tariff rates of re-exported goods under the new regime are not large enough as to shut down re-exports completely. In addition, unfavorable changes in tariff rates are observed only in selected categories of goods, while in some other categories the change is actually towards more favorable terms, or there is no change at all.

The methodology applied in the present work to identify the potential effects of Kyrgyzstan's entry into the customs union on its re-exporting activity is first conducting the detailed analysis of trade profile of the Kyrgyz Republic with emphasis placed on trade relations with Belarus, Kazakhstan and Russia on the one side and China on the other. The results of this examination were subsequently applied to compare the tariff structure of Kyrgyzstan with the

respective system of the customs union. Based on this comparative analysis of tariff rates across major categories of re-exported goods, we obtained answers to the main research question of this study.

The findings of the present work have important implications for the debates around Kyrgyzstan's entry into the customs union of Belarus, Kazakhstan and Russia. They suggest that because the re-exporting activity of Kyrgyzstan is not expected to be largely influenced by the introduction of common external tariff (CET) as it is usually assumed in mass media, policy makers do not have to fear major changes in this respect. Thus, in deciding whether or not for Kyrgyzstan to enter the customs union of Belarus, Kazakhstan and Russia the argument with re-exports cannot be used against the country's membership in the union. As a result, it may be overall beneficial for the country to become a member of the customs union. However, this statement needs further testing and detailed examination, so this may be an opportunity for further research.

The current study concludes with policy recommendations that serve to smooth down the potential entry of Kyrgyzstan into the customs union. Specifically, if the Kyrgyz Republic joins the customs union of Belarus, Kazakhstan and Russia it may try to renegotiate common external tariffs with other members in "sensitive" product categories that are re-exported through its territory. However, due to the small economy of the country and thus its insignificant weight the Kyrgyz Republic may not succeed in this role. The second policy proposal is for the customs union of Belarus, Kazakhstan and Russia to establish some sort of "compensation mechanism" for the unfavorable changes in tariff rates and the respective revenues. As evidence from the European Union suggests, this practice may be quite successful in adapting member countries to the operation of the customs union.

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