

## **FDI and Its Significance on Economic Development In Developing Countries: A Case Of Kyrgyzstan With Issues And Suggestions**

Choong Y. Lee

*Kelce College of Business, Pittsburg State University, Pittsburg, KS 66762  
U.S.A.*

*Tel: 620-235-4587, Fax: 620-235-4513*

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**ABSTRACT:** The purpose of this research is to evaluate the economic situation of Kyrgyzstan and its attraction of foreign direct investment (FDI), to provide a clear view of Kyrgyz economy's potential and the prospective of further development of the Kyrgyz economy with FDI. Although the Kyrgyz Republic is one of the least developed economies among those former Soviet republics in transition, with more FDI this country can develop its economy easily due to its potential and geopolitical advantages. Since Kyrgyzstan has not enough domestic financial resource, FDI should become the main driver of the economic development in Kyrgyzstan. Recently, Kyrgyzstan has implemented some reformative initiatives and measures, however, the overall environment regarding FDI is not significantly improved yet in this country. Also, the current policy for FDI is not strong enough to attract more FDI for developing higher-value added industries in Kyrgyzstan other than the mining industry. In addition, the hostile atmosphere and wrong perception about FDI among Kyrgyz people must be eased or alleviated in order to get more FDI in Kyrgyzstan for its economic development.

**Keywords:** Foreign Direct Investment (FDI), Economic Development, SWOT Analysis, Transition Economy, Kyrgyzstan

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### **I. Introduction**

Kyrgyzstan is a landlocked country in Central Asia, bordering Kazakhstan, China, Tajikistan and Uzbekistan with the population of about 5 million. It is farther from the sea than any other individual country in Central Asia, and more than 80% of the land are mountainous, with the remainder made up of valleys and basins.

Kyrgyzstan has significant deposits of minerals and metals including gold and rare earth metals. Due to the country's predominantly mountainous terrain, less than 8% of the land is cultivated, and this is concentrated in the northern lowlands and the fringes of the Fergana Valley. The principal river is the Kara Darya, which flows west through the Fergana Valley into Uzbekistan. Across the border in Uzbekistan it meets another major Kyrgyz river, the Naryn. The confluence forms the Syr Darya, which originally flowed into the Aral Sea. As of 2010, it no longer reaches the sea, as its water is withdrawn upstream to irrigate cotton fields in Tajikistan, Uzbekistan, and southern Kazakhstan. The Chu River also briefly flows through Kyrgyzstan before entering Kazakhstan.

All throughout the Soviet times, Kyrgyzstan was as agrarian supplier for the USSR, and after its independence in 1991, considerable changes had to be made to transform its country from a command planning economy into a free market system. Such reforms were de-monopolization, privatization, debt and tax restructuring, and price liberalization. This country had also reformed its banking system, changed investment laws dramatically, loosened up the trade barriers and established its own currency. All those reforms and changes put Kyrgyzstan in the number one position in Central Asia in terms of the economic freedom according to the UN report. In the process of those changes the country had to face numerous challenges in economic, social and environmental levels. Kyrgyzstan had to undergo many ambitious programs of reforms, and most of those programs are still under implementation for continuous development of its economy as well as socio-political stability.

The Kyrgyz government believes that through FDI continued growth, diversification of the economy and development of the country will be ensured. For that, however, this country will have to provide stable economic conditions and create favorable environments for attracting more FDI continuously.

## **II. Kyrgyz Economy and Its Outlook**

The Kyrgyz economy was severely damaged by the collapse of the Soviet Union and the resulting loss of its largest market. In 1990 just before its independence, almost 98% of Kyrgyz exports went to other parts of the Soviet Union then. Due to such a high level of economic independence, until the late 1990s the Kyrgyz economy was worse than any other former Soviet republic except war-torn Armenia, Azerbaijan and Tajikistan, as most of factories and state farms collapsed with the disappearance of their traditional markets in the former Soviet Union. While economic performance has improved considerably in the last decade, and particularly since the early 2000s, difficulties remain in securing adequate fiscal revenues and providing an adequate social safety net. Remittance from about 800,000 Kyrgyz migrants working in other countries, including Russia, Kazakhstan and other western countries, represent about almost 40% of Kyrgyzstan's GDP in 2014 (CIA, 2014).

Agriculture is still an important sector of the economy in Kyrgyzstan. By the early 1990s, the private agricultural sector provided between one-third and one-half of harvests. In 2010, agriculture accounted for 35.6% of GDP and about half of employment. Kyrgyzstan's terrain is mountainous, which accommodates livestock raising, the largest agricultural activity, so wool, meat and dairy products from livestock are major commodities. Main crops include wheat, sugar beets, potatoes, cotton, tobacco, vegetables, and fruit. As the prices of imported agrichemicals, fertilizers and petroleum are so high, most of farming is being done by hand and by horse, as it is the tradition. Agricultural processing is a key component of the industrial economy as well as one of the most attractive sectors for foreign investment.

Kyrgyzstan is rich in mineral resources but has negligible oil and natural gas reserves; it imports oil and gas. Among its mineral reserves are substantial deposits of coal, gold, uranium, antimony, and other valuable metals. Metallurgy is an important industry, and the government hopes to attract more FDI in this field. The government has aggressively encouraged foreign involvement in the mining industry for extracting and processing those minerals and rare earth elements deposited in Kyrgyzstan for its economic development. The country's plentiful water resources and mountainous terrain enable it to produce and export large quantities of hydroelectric energy.

On a local level, the economy is primarily kiosk in nature. A large amount of local commerce occurs at bazaars and small village kiosks in most of country regions. A significant amount of trade is unregulated. There is also a scarcity of common everyday consumer items in remote villages. Thus a large number of homes are quite self-sufficient with respect to food production. There is a distinct differentiation between urban and rural economies in Kyrgyzstan.

The principal exports are nonferrous metals and minerals, woolen goods and other agricultural products, electric energy and certain engineering goods. Imports include oil and natural gas, ferrous metals, chemicals, most machinery, wood and paper products, some foods and some construction materials. Its leading trade partners include Russia, China, Kazakhstan, Germany, and Uzbekistan.

For the last four years, Kyrgyzstan's Gross Domestic Product (GDP) grew by around 5% annually, or about 3.5% excluding gold business. Industry expanded by more than 15%, reflecting strong mining and goods processing. Agriculture grew by 2.4%, while trade expanded by 5.8%. Growth in construction halved to 11.2% from 22.0% in 2014, reflecting more moderate expansion in capital investment, which also halved, to 6.8% from 13.5% in 2014 (ADB, 2015).

Inflation becomes a serious concern now and will be a real challenge to the Kyrgyz economy. Inflation spiked in 2014, reaching about 8.5 percent (year-on-year), due to the depreciation of the *som* earlier in the year. Pressures on the exchange rate re-surfaced at the beginning of 2015, and despite interventions by the central bank (NBRK), the *som* depreciated further this year. Despite slower domestic demand, increases in administered energy prices, further depreciation, and a poor harvest could increase inflation above the projection of around 10 percent in 2015. Also, inflation may accelerate, following the opening of the borders within the EEU as a consequence of external shocks from the depreciation of the Kazakh tenge and the Russian ruble. Inflation is expected to be higher than anticipated before for a while because of transitional price adjustments within the EEU and continued depreciation of the Kyrgyz *som*.

Also, another area with a bad signal to the economy is a chronic problem of trade deficit as well as government spending deficit as remittances from Kyrgyz migrants working abroad have been less and less, reflecting continued recession in Russia and Kazakhstan with the ruble depreciation. The growth slowdown is likely to reduce imports and, together with robust gold exports, should narrow the external imbalance (World Bank Report, 2014).

Hikes in tax rates and increased tax enforcement measures helped to off-set the impact on the budget of slower growth this year, with the medium-term plan projecting a significant investment-led fiscal expansion. With the latest Budget supplement, the budget deficit in 2015 is projected to increase to around 6.0 percent of GDP, on account of faster implementation of foreign financed projects. A further increase in the deficit is envisaged in 2015. Keeping fiscal risks manageable may require an adjustment in policies and public expenditure reform.

The Kyrgyz Republic's accession to the Eurasian Economic Union (EEU) in May 2015 and the physical opening of the EEU borders effective in August 2015 add uncertainty to the country's growth prospects since two leading countries of the EEU, Russia and Kazakhstan, are in a difficult situation and their current economic situation would not be improved significantly in a short time period considering the global political economy. Declining economic growth across the world and among its leading partners, including Russia, Kazakhstan and China, will hurt the Kyrgyz economy further. A decline in Kyrgyzstan's economic situation is surely expected with falling remittances and slowing Russian and Kazakh economies as key factors.

### **III. Current Situation and Challenges in Kyrgyzstan**

#### **3.1 Economic Situation**

Despite the backing of major Western lenders, including IMF, World Bank and ADB, Kyrgyzstan has had economic difficulties constantly for the last two decades. Initially, these were a result of the breakup of the Soviet trading bloc and resulting loss of markets, which impeded the country's transition to a free market economy. Also, political instability with widespread corruption hurts its chance of developing a sustainable economy. However, accession of the EEU could not guarantee much expected benefits quickly although Kyrgyzstan really wants immediately.

The slowdown in Russia and increased tensions in trade relations with neighbors are affecting remittances and non-gold exports. Economic activity has been further affected by the poor agriculture harvest. In addition, difficulties expected in ensuring stable energy supply in the winter may add a further drag on activity throughout the rest of the year (ADB, 2015).

While growth between 2000 and 2014 was positive for the poor, the link between growth and poverty reduction has weakened in recent years. According to the CIA World Factbook in 2014 (CIA, 2014), a third of the country's population lived below the poverty line. There is still a certain percentage of inequalities among the population. The poverty rate is still high and some of the social indicators are the lowest even in Central Asia. Robust reduction in poverty in the Kyrgyz Republic has happened mostly in years with growth rates in excess of 5 percent. Such growth has been accompanied by a major contribution from domestic demand and non-commodity exports.

The medium-term growth outlook has become more challenging. The impact of the lower economic growth in Russia would continue to have an adverse impact on domestic consumption and export performance. Furthermore, the current slowdown in re-exporting activities, which are highly labor-intensive, may continue and result in job losses in the future. Enhanced government spending on infrastructure and investments in energy, transport and mining would help generate positive growth rates, but the economy is currently projected to grow slowly, actually lower than the original forecast of about 4 percent a year, over the next three years.

#### **3.2 Financial Situation**

For years, remittances have kept the Kyrgyz economies afloat. Billions of dollars cross borders every year and mean they help hundreds of thousands of families in Kyrgyzstan escape from poverty and maintain a modest standard of living for them. Official estimates from the Kyrgyz State Committee for Migration and Employment put the number of Kyrgyz migrant workers between half a million and 800,000. Remittances from those migrant workers are very important for Kyrgyzstan since total remittances may be as much as 15 percent

of GDP in Kyrgyzstan. Also, foreign remittance is a major source of hard cash Kyrgyzstan desperately needs for any chance of developing a sustainable economy. This definitely has a social effect because it helps the families of those migrants to cope with poverty and lack of jobs at home (Levina, 2015).

However, as the current crisis from cheap oil and gas prices takes its toll on labor markets across the former Soviet Union, the resulting financial catastrophe is threatening Kyrgyzstan. Kyrgyz migrant workers in Russia and Kazakhstan are having increasing trouble with those countries' troubled economy now, and are thus unable to send cash back to their families in Kyrgyzstan. Less money being sent back home means more tension in this poor country and more strain on the governments.

Labor migration has been able to solve the twin evils of poverty and unemployment in Kyrgyzstan for the last two decades. Now, the Kyrgyz government must find an alternative to tackle all those social and economic challenges faced with the current hardship especially from its leading partners, such as Russia, Kazakhstan and China. The Kyrgyz government expects to come under severe pressure to develop programs that alleviate mounting social woes. The challenges will be all the more formidable because as a result of the current economic decline, the Kyrgyz government will experience a significant drop in revenue.

### **3.3 Challenges Faced by Kyrgyzstan**

Even though the recent data shows a visible improvement in the Kyrgyz economy, there are still a few challenges that remain unsolved, including political instability with ethnic violence, corruption with ineffective public sectors and scarcity of adequate human resource with poor infrastructure. Here are the most critical issues that must be addressed. First, it is the issues regarding the mining industry, especially with the Kumtor mine. The Kumtor case must be resolved reasonably and its gold mining business must be managed wisely, in order to not jeopardize the overall environment for FDI and to not give a wrong signal to potential investors from all over the world. Second, business environment should be continuously improved to attract more FDI, and the economy must be well diversified to keep doing business well. Third, developing human resource is crucial for the sustainable development of economy, and there is an acute skill shortage in Kyrgyzstan. Therefore there is an urgent need of nation-wide human resource development to provide a better investment condition to foreign investors with steady supply of high quality labor. Fourth, there is a need for very well prepared foreign investment policies, which will define the degree of state regulation and involvement, ownership of land and other property, legal protection and other critical issues of tax, etc. Finally, the key infrastructures must be improved to create a better business environment to attract investors (Levina, 2015).

There is a potential economic crisis currently happening in the Kyrgyz economy. As discussed earlier, first of all, financial crisis in Russia will cause the financial sector of the Kyrgyzstan to lose its liquidity due to the effect that the sector heavily depends on foreign credit. If the credit is not affordable the foreign investment will not be flowing into Kyrgyzstan which would lead to lots of problems in various sectors of the Kyrgyz economy. Then, huge devaluation of the Kazakh tenge will increase volatility of the Kyrgyz currency, som, and therefore, it troubles the repayment of foreign debt and makes it more unpredictable. Hence, such macroeconomic shocks will make financial lending businesses and banks of Kyrgyzstan more sensitive to economic downfall and recession in international markets (Lee and Tugut, 2008).

Although, through reprioritizing the economic growth plans, together with timetables, strategies and processes for future development, and rethinking short and long term perspectives socio-economic impacts on national wealth and population distribution, and overall economic development will create a more favorable investment climate and attract more capital flow (Lee and Tugut, 2008).

## **IV. Importance of FDI for Kyrgyzstan**

Many studies in the past show that FDI has played an important role for economic development especially in developing countries (Nunnenkamp and Spatz, 2004). FDI has contributed towards promoting economic growth and sustainable development, and reducing social and income disparities in those countries.

In order for Kyrgyzstan to develop its economy, FDI looks more important and critical since there are no major domestic sources of finance for developing its economy. The economic outlook of Kyrgyzstan has become more challenging, as declining economic growth not only across the world but also especially among its leading partners, including Russia, Kazakhstan and China, will hurt the Kyrgyz economy further. In other words, a decline in Kyrgyzstan's economic situation is surely expected with falling remittances and slowing Russian and

Kazakh economies as key factors. Also, expected lower production of gold will be set to hit GDP growth with wider fiscal gap and contributed to slower economic growth in Kyrgyzstan eventually. So, we can't overly emphasize the importance of FDI for economic development in Kyrgyzstan. However, there has been growing hostility against FDI in Kyrgyzstan recently, especially since the Kumtor gold mine became a national issue. Without easing such hostility, it would be very hard for Kyrgyzstan to attract FDI into Kyrgyzstan (Lee and Tugut, 2008).

It is absolutely necessary for the Kyrgyz public to understand that there are many advantages and benefits host countries receive directly and indirectly from FDI. Among them, the following six areas should be the very first ones Kyrgyzstan must recognize as the main benefits from FDI: economic growth, entrepreneurship, long-term commitments, positive effect on local firms, employment effects, and improved export markets. Additional benefits may occur in Kyrgyzstan, but these are considered to be the most important additions to the Kyrgyz economy.

#### **4.1 Economic Growth**

Perhaps the most obvious effect of FDI in any country is the economic growth brought about from the investment. Those foreign companies investing in developing countries simply have access to financial resources not available to the host countries. With those financial resources, they establish more businesses and help the national economy to be grown. As a result of economic growth, developing countries usually see a reduction in the poverty level of their country, and an increase in national income. Additionally, FDI results in greater competition among firms, increasing productivity, innovation, and efficiency, and ultimately driving down prices. Increased competition in the long-run usually results in an increase in research and development, eventually spurring the economy to grow even more.

Sometimes overlooked are the long-term economic effects on the host country. First, a certain amount of the profits generated by the company are reinvested in the same country, allowing for further growth and development in the host country. Reinvestment by the foreign companies creates additional job opportunities or allows for further training of local personnel. Second, those foreign companies pay corporate taxes, sales taxes, tariffs, and other required obligated burdens to the host country, which hopefully results in an increased economy.

#### **4.2 Entrepreneurship**

Important to any economy, but especially emerging economies, is the willingness to take risks and develop new enterprises, or simply entrepreneurship. Some people argue that the existence of FDI discourages local entrepreneurs. While this may be the case in some industries, the opposite is true for most. FDI in developing countries serves as a springboard for entrepreneurship, promoting the ideas of innovation and discovery (Lee, 2007). Without the knowledge and expertise gained through foreign companies, those entrepreneurs would not know where to begin. Multiple studies of different countries support this idea. For example, in Latin America, managers of several local firms began their careers with foreign companies brought about through FDI.

#### **4.3 Long-term Commitments**

Closely related to the factors discussed with regards to economic growth, the level of risk taken by companies participating in FDI is much less than the traditional debt financing. Due to the simple nature of foreign direct investment, and the fact that much of the investment is in long-term 'hard assets,' it is much less likely for the country to lose their investment. Tangible assets such as property, plant and equipment are much more difficult to get lost in the shuffle than the more volatile assets such as cash, bonds, or loans. Simply, FDI is much less vulnerable than debt flows. Firms have such great capital outlays and investments in the countries they are in, which results in a lesser likelihood of the company picking up and leaving when the future looks and feels uncertain. Thus, the risks for both the country receiving the inward FDI and the company providing the investment are much lower than capital market outlays.

#### **4.4 Effect on Local Firms**

Another benefit from FDI is resource transfer effects. In addition to capital resources, technological and management resources are also transferred to the host country as a result of FDI. The vast capital resources available to many home countries are resources that a host country would never dream of obtaining. This factor



alone is often a major contributing factor as to the initial welcoming of foreign direct investment into developing countries. Monetary resources, along with several other factors, have played a large role in the growth of FDI over the past few decades.

Besides the impact from invested capital resources on the local firms, a technology transfer phenomenon has been observed more significantly with respect to FDI. Through the rise of competitive pressure as well as integration with local firms, lesser developed economies gain access to technology that would otherwise not be available to them. The importance of technology in today's economy cannot be overstated, as it stimulates economic development and innovation. (Hill, 2005). Finally, the transfer of management related skills cannot be overlooked either. While an overabundance of managers in well-developed countries may downplay the importance of talented leaders, lesser developed countries need these types of people. However, they need to be indigenous to the country, not someone brought in who knows nothing about the cultural values and norms of the country. By training foreign managers in the latest and greatest techniques, the efficiency of operations tends to noticeably increase. Additionally, in the event that these aforementioned trained personnel leave the firm, they will take with them the skills they gained and pass them on to local firms. Closely related to this is the effect that better management will have on local firms, forcing them to improve or be shut down by the competition.

#### **4.5 Employment Effects**

As a direct result of their background and greater capital foothold, firms taking advantage of the opportunities afforded them due to FDI can afford to pay local employees better and then train them better than local firms. According to a recent study performed by the Indian Council for Research in International Economic Relations, wages rise substantially in industries that enter the market on a large scale (Hill, 2005). This creates a huge benefit to the laborers of the host country, as evidence suggests that this forces domestic firms to improve working conditions and pay higher wages due to the newly acquired skills of these individuals. Jobs are created as a result of FDI, and the skilled labor pool keeps increasing exponentially. Indirectly, citizens of the country can now afford to spend more money, providing a boost to their economy, and allowing a virtuous cycle of creating more jobs to continue.

#### **4.6 Improved Export Markets**

As foreign companies move in and invest in the host country's economy, the export market is greatly improved. Improvement in shipping and logistics, as well as infrastructure, account for a large portion of these improvements, but resource transfer also plays a significant role in these environments. As an example, China has increased its exports continuously as it attracted FDI more and more every year since its openness. Subsidiaries of foreign nationals were responsible for more than 50% of all Chinese exports in 2001, solidifying the effect of foreign direct investment on export markets (Hill, 2005).

Without any doubt, Kyrgyzstan needs more FDI to develop its economy and maintain sustainable growth with more jobs created for its people. For attracting more FDI, Kyrgyzstan should create an open and market-based system with guarantees of national treatment, non-expropriation, repatriation of funds, stability in the legal system, access to international arbitration and incentives for FDI. The country's desire to create a more attractive investment climate should be pumped from recognizing those benefits Kyrgyzstan could get as a result of FDI.

### **V. Strengths, Weaknesses, Opportunities and Threats of Investment Environment in Kyrgyzstan**

The SWOT Analysis is a very useful tool for analyzing environmental strengths and weaknesses and identifying both the opportunities open to the investors and the threats those investors face. Used in a business context, it helps investors carve a sustainable niche in the investment markets. What makes SWOT particularly powerful is that, with a little thought, it can help investors uncover opportunities that they are well-placed to exploit. And by understanding the weaknesses of the business environment, investors can manage and eliminate threats that would otherwise catch them unawares.

Actually the SWOT analysis of the Kyrgyz investment environment will help both foreign investors and the Kyrgyz government understand what they should do regarding foreign direct investment in Kyrgyzstan. Foreign investors, by looking at Kyrgyzstan and its overall environment using the SWOT framework, could start to craft

a strategy that helps them distinguish themselves from their competitors, so that they can do their businesses better and compete successfully in Kyrgyzstan. Also, through the SWOT analysis, the Kyrgyz government could understand what Kyrgyzstan should do to improve the overall investment climate and attract more FDI into Kyrgyzstan.

### **5.1 Strengths**

Although Kyrgyzstan is less known to outside of Central Asia, there are many strengths that are good enough for investment. First, natural resource endowment of this country has very huge resources of hydro-energy and minerals and will be attractive exploration potential for additional discoveries. Together with gold which is the key sector attracting foreign investors, Kyrgyzstan has also world class natural resources of coal, uranium, aluminum, lead, copper, and other rare earth elements, etc. Kyrgyzstan also has abundant resources of mountains which can be used for livestock-based agriculture, with lots of natural resources from those mountains.

Second, Kyrgyzstan is a sizeable market for investment not only in the mining sector but also in infrastructure, and consumer goods, and in services, especially in those areas where foreign supply through imports is not profitable because of large distances and/or high transportation costs. Although Kyrgyzstan's geographic position could be considered as a weakness in attracting FDI for global markets, Kyrgyzstan is at the crossroads between East and West along with the historic Silk Road, which should be a potential strength. In other words, this is a transit country with great potential to become a major transit route for the movement of goods and services among those neighboring countries, including China, Russia and other Central Asian countries. Kyrgyzstan's location in close proximity to the emerging markets of Central Asia and China presents opportunities for this country to serve as a hub for transport and other services, as well as to serve as an export platform (Lee and Tugut, 2008).

Third, Kyrgyzstan has well educated, skilled and motivated workforce with the needed levels of education and skills, even though there is a shortage of skilled labor in some areas. Lastly, Kyrgyzstan has abundant amount of water, which provide an excellent condition of developing some agriculture sectors as well as hydro-energy generation sectors. Also, beautiful and clean nature with mountains and lakes will provide another dimension of developing nature-based tourism as well as other related businesses easily.

### **5.2 Weaknesses**

Kyrgyzstan is a landlocked country which is viewed by investors as a weakness. Also, the problems in public policy, legislation and its implementation resulting in unfavorable business conditions are identified as significant weaknesses. Here are the most critical weaknesses. First, being a landlocked country could be a significant weakness for the development of any export-oriented industry, especially if the industries are based on the processing of imported commodities for re-export. The Kyrgyz government has prudently emphasized the Kyrgyzstan's position as being at the crossroads between East and West along with the historic Silk Road, therefore, implying the ability to supply either markets, and to benefit from being a linkage in trade between the areas. At the same time, Kyrgyzstan can be perceived as being equally remote from the major markets of both East and West. Kyrgyzstan's dependence on other countries for overland transportation (road, rail and pipeline) is a significant weakness for attracting FDI in some sectors.

The next one is poor infrastructure for business. The underdeveloped infrastructure hurts massive development of economy as one of impeding factors of developing high-valued industries. Kyrgyzstan now faces lots of problems with infrastructure in transportation, telecommunication and energy. While the country has extensive energy resources, the energy transportation infrastructure is underdeveloped, both for export and for delivery to domestic markets. In addition, significant improvements are needed in the hydro-electric generation sector and in municipal utilities (Lee and Maichinova, 2013).

Another one is inconsistent legal systems with poor legal protection of business, especially foreign investments, with unclear legal procedure and regulations. Although the Kyrgyz government has made great efforts in improving foreign investment legislation, most of those main concerns remain the same, and that includes the vagueness of laws, contradictory legal provisions and poor implementation. Bureaucracy is another leading competitive disadvantage of the business environment in Kyrgyzstan. Unfortunately, many investors claim to have encountered excessive delays, which hinder the establishment of new investment, the conduct of ordinary business operations and reinvestment. Transparency of laws remains a major problem in Kyrgyzstan and an

obstacle to expanding business and investment. Foreign investment is generally welcomed, however, some foreign investors claim that the Kyrgyz government is not always even-handed and sometimes reneges on its commitments and obligations. Corruption is widespread and encouraged by the lack of transparency in the legal system. (Abdynasyrov, 2015).

### **5.3 Opportunities**

Kyrgyzstan provides two strategic opportunities to foreign investors: the opportunity to develop industries in compliance with its national advantages and the opportunity to become the preferred investment location in the region. The preferred investment location for a regional market is guaranteed by the opportunity to become a production and services base for the wider regional market of 56 million people in Central Asia. That attracts a large amount of FDI including investments of reputed international investors which could bring with them financial resources, know-how and best international practices. These connections improve the capacity of local companies and managers could be substantially improved. Ensuring sustainable economic growth is not easy due to the challenge that the country is facing in terms of increased importance of the gold mining sector and the volatility of gold prices. In this regard, the economy has to be more diversified to better withstand future commodity price shocks and offer economic opportunities to the population outside the mining sectors. (Lee and Tugut, 2008).

Kyrgyzstan possesses a tremendous economic growth potential as the country continues its transition to a market economy. In reality, as a newly emerging transition economy, there are numerous untapped business opportunities in the country. For example, privatization initiatives play a critical role in Kyrgyzstan's transition to a market economy. However, the state still owns controlling shares in large Kyrgyz enterprises in mining, energy, telecommunications and several other key sectors (Lee and Maichinova, 2013). Since privatization of these establishments requires a huge amount of financial resources, the Kyrgyz government aims to attract foreign investors to provide the capital, technology, and technical expertise needed to revitalize these industries with new and efficient enterprises. This provides lots of opportunities to foreign investors.

Kyrgyzstan suffers from a severe problem of inadequate transportation and telecommunications systems. Due to the mountainous terrain, there is no major transportation infrastructure connecting all major regions in the country effectively. Telecommunications systems in the country are quite inefficient to support the needs of the population. So, there is an immediate need to replace the outmoded equipment and upgrade the existing telecommunications technology. Also, telecommunications services are not available in the remote areas which are isolated from the population centers by the mountains. As a result, Kyrgyzstan desperately needs widespread phone and broadcasting services as well as other digital communications systems. Such weak transportation and telecommunications infrastructure creates excellent business opportunities for foreign investors. Also, agricultural processing is one of the most attractive sectors for foreign direct investment as agriculture is a big part of the Kyrgyz economy. Kyrgyzstan needs multinational investors that can provide the much required capital to upgrade its agricultural establishments.

As a mountainous country, Kyrgyzstan possesses numerous mineral reserves such as gold, coal, copper, lead, uranium, zinc, mercury, and other rare earth metals. Although a major national geological survey of mineral deposits was conducted under the Soviet rule in the 1970s, the Kyrgyz government needs a more comprehensive thorough geological investigation to assess and evaluate the amount of such important natural resource deposits in Kyrgyzstan.

In addition, with many development initiatives well underway in numerous industries, there is a great need in Kyrgyzstan for logistical support services, including supply and distribution networks as well as warehousing. Since majority of the industrial activity is concentrated around the area of Bishkek, the rest of the country benefits from the goods and services disproportionately. This results from the lack of appropriate distribution channels and warehouses throughout the country. However, the country cannot achieve the targeted level of economic development without having a well-linked nation-wide distribution system.

Above all, there really exist untapped business opportunities for foreign investors in the field of IT (information Technology). Kyrgyzstan has bright prospects to become the IT services hub of Central Asia for several reasons. First, although there is an unsatisfied demand for IT services in the region, Kyrgyzstan's neighbors have so far not shown any interest in establishing this industry. Thus, foreign companies that would like to launch IT services in Kyrgyzstan can capture the massive combined market of Central Asian republics without large initial investments and competition. Second, the country has a well-educated and highly skilled workforce



to be employed in IT services industry. The Russian-speaking Kyrgyz personnel can offer IT support services to the entire Central Asia, most of those former Soviet republics and even Russia. Besides, with the economic growth, developments in financial services, tourism, and logistics will prompt an even increased need for IT services not only in Kyrgyzstan but also in the region. IT services represent a value added industry with a great potential to contribute to the advancement of Kyrgyzstan.

Furthermore, Kyrgyzstan possesses vast water resources originating from its mountain rivers throughout the country. This makes hydroelectric energy production one of the most promising business areas available in Kyrgyzstan. Kyrgyzstan's hydroelectric energy industry alone is capable of meeting the domestic electricity needs as well as producing surplus electricity for export (Oleynik et al., 2004). The demand for hydroelectric energy is expected to increase not only in Kyrgyzstan but also in neighboring countries. This will create an additional need for energy and electricity in the area of neighboring countries, including China and Kazakhstan. Additionally, Kyrgyzstan's plentiful water resources also represent other opportunities for foreign businesses. The country has an abundant supply of high-quality water that is ideal to be used as drinking water. However, the systems and equipment to process drinking water need to be replaced and new technologies in water management should be brought to Kyrgyzstan. Water is a scarce natural resource in all neighboring countries, including Kazakhstan, Uzbekistan, and Western China.

#### **5.4 Threats**

Many foreign business executives working in Kyrgyzstan says that political instability now tops the ranking as the most severe obstacle, followed by corruption as the second one. Also, they indicates that the resource nationalism has been growing significantly in the last several years and is a new threat to foreign investments. They believe the Kyrgyz public's hostility from the resource nationalism will be a more serious threat if the issues regarding the Kumtor mine will not be solved soon.

##### *(1) Political instability*

The Kyrgyz Republic has been in political turmoil since its independence in 1991. The inherent conditions were no doubt challenging; small, landlocked, poor and with little experience of the free market economy. Nevertheless, the Kyrgyz government has implemented ambitious economic and political reform programs and the country seemed to make progress quickly at the beginning of transition. However, things deteriorated over time. Like most of other countries in transition, political power became synonymous with control over economic benefits, causing intense competition between different elite groups. So, the centralization of power within the government or presidency was somewhat inevitable for the implementation of reforms, but the loss of checks and balances allowed the leaders to abuse their power for self-enrichment. Then corrupt leaders and governments created more problems, eventually brought in two revolutions. As a result, the country has witnessed repeated cycles of more open parliamentary politics followed by centralization of power and authoritarian tendencies, in turn followed by popular revolt. With this political instability, economic contraction and distorted economic policies has also followed (Muzalevsky, 2013).

The political instability has had large negative consequences on the economy. It creates uncertainty about the future rules of business investment and economic activities. Countries with much political instability therefore typically suffer from lower levels of investments. In Kyrgyzstan, investments have been held back as necessary reforms have been neglected and government turnover has caused insecure property rights when new leaders engage in appropriation, hostile take-over's and contract repudiation. Such political threats cause additional costs and economy and business are severely hampered by the political instability. So, the economic costs of political instability are huge to Kyrgyzstan, like other developing countries in the same situation.

##### *(2) Corruption*

Corruption remains a big and growing problem in Kyrgyzstan. It presents serious threats to business and investment in Kyrgyzstan. The political environment has been particularly unstable over the past few years, as a result of large-scale corruption deals involving Kyrgyz high-level officials. Abuse of office and conflicts of interest are common in the public sector. Extortion and red tape significantly impede the operations of international companies that wish to expand to Kyrgyzstan.

Although Kyrgyzstan has an extensive legal framework for dealing with corruption, businesses suffer from inconsistent and selective enforcement of laws due to widespread bribery in the judicial system. Many foreign business executives also feel that Kyrgyz customs are especially prone to bribery and facilitation payments, with more than two thirds of companies expecting to give gifts when trying to clear goods at the border. More than a half of all companies report giving gifts in the process of obtaining licenses and permits. Companies also report making facilitation payments in their interactions with tax officials. So, Corruption runs rampant, causing additional costs and excessive red tape for any businesses trying to operate in the official part of the economy. Business and economy are thus severely hampered by the dominating culture of corruption in addition to the political instability and uncertainty.

### *(3) Hostility against FDI*

There has been growing hostility against FDI in Kyrgyzstan caused by two invisible sentiments: (1) a wrong perception about FDI; and (2) resource nationalism. Since the Kyrgyz people have been ruled by other countries or ethnic groups for a long time, they are naturally inclined to resist anything from other countries easily. From this reason, a large number of Kyrgyz people don't accept FDI just positively, and actually they are rather suspicious about the role and functions of FDI in Kyrgyzstan.

In Kyrgyzstan, political leaders would often abuse people for their personal benefits or wrong political purposes. For example, the Kumtor gold mine, which is one of the largest open pit gold mines in the world, becomes a national controversy since many political leaders have abused it to strengthen their political positions by inciting people to riots against the foreign company which has legally operated it with its investment, based on the agreements and contracts with the Kyrgyz government. In fact, the Kumtor case should be a relatively straightforward case of FDI in Kyrgyzstan. However, the Kyrgyz public encouraged by some political parties and leaders has been pressing the Kyrgyz parliament and government to call for the nationalization of the Kumtor gold mine. The Kyrgyz government's dubious policies with political leaders' misuse of Kyrgyz people's nationalism regarding the Kumtor mine have had more negative effects on Kyrgyzstan clearly than foreign investors. The widespread resource nationalism in Kyrgyzstan has hurt the image of Kyrgyzstan so badly and now becomes another real threat to FDI in Kyrgyzstan (Trilling, 2015).

## **VI. Major Issues, Strategies, Government Policies And Efforts For Attracting FDI**

The current stage of restructuring Kyrgyz economy highlights the problem of attracting FDI. Also, the importance of FDI in Kyrgyzstan cannot be overestimated considering the economic situation in Kyrgyzstan. Given the capital shortage with significant technological gap, Kyrgyzstan desperately needs FDI which could bring new technologies and modern management techniques with the financial resource.

Experience in many developing countries shows that the investment boom in an economy begins with the arrival of FDI which allows the host country to develop its own technologies. The role and scope of FDI has been steadily increasing in most developing countries as the gap of economy as well as technology between developed and developing countries becomes wider and wider. Also, Kyrgyzstan has its own issues regarding FDI mainly from its geographical conditions.

### **6.1 Major Issues as a Landlocked Developing Country**

For most landlocked countries, problems of distance are substantially compounded by the need to cross international borders and by the inability to regulate the transport process. As a result, the delivery costs of imports are higher, exports are less competitive and attraction of FDI is much harder. Landlocked developing countries usually have less opportunity to attract FDI inflows because of lack of territorial access to the sea which is a formidable obstacle. That is, geographical disadvantages are compounded by structural weaknesses that hamper their economic performance. In general, economies of landlocked developing countries have small and weak domestic markets with economic vulnerability to economic shocks. To overcome such geographical challenges as a landlocked developing country, Kyrgyz should concentrate on those industries where they have any kinds of advantages that less depends on transportation costs. Also regional integration with neighboring countries could make its economy more attractive for investment and expand its markets into other countries (Jenkins and Pevrah, 2001).

So, as a landlocked developing country, in order to succeed in attracting FDI, Kyrgyzstan needs to shift its strategy to focus on distance to markets rather than distance to ports. Focusing on key industries with competitive advantages is crucial for Kyrgyzstan to attract FDI. Most FDI to landlocked developing countries historically went to resource-seeking business projects. For such investments, low local production costs, the availability of transport infrastructure for exports and high international commodity prices may be more important than the risks and costs associated with long distances to markets.

Empirical evidence shows that small landlocked developing countries could attract large-scale FDI if they have successfully adjusted their economies to their geographical constraints. For example, landlocked countries, such as Austria, Luxembourg and Switzerland, have been recipients of steady and sizeable flows of FDI for many decades since they have developed their competitive industries by adjusting themselves to their inherent geographical conditions successfully. Also, there are some landlocked transition countries, such as the Czech Republic, Hungary and Slovakia, which are relatively successful in attracting FDI, compared with their neighboring countries which are not landlocked countries, by developing their key industries based on their competitive advantages with their given conditions.

## **6.2 Government Policies and Efforts for Attracting FDI**

The Kyrgyz government has taken many actions and initiatives with necessary legislation to improve investment climate in the last twenty five years. The Kyrgyz national statistics show foreign direct investment increasing yearly, due largely to growing Russian and Chinese infrastructure investment that is creating little employment in Kyrgyzstan. The government of Kyrgyz Republic has identified foreign direct investment as a key component to growing its economy and has created a strategic roadmap for economic development to facilitate this growth. The Kyrgyz government has been taking steps to streamline the process of starting a business as well as streamlining its tax regime. The country, however, still struggles with some of major issues as discussed earlier. For example, corruption is rampant and rule of law is weak. The judicial system is not independent and every sector of government struggles with capacity and resource shortages. For most areas of interest, a legal framework exists but enforcement is poor. Over 60% of the economic activity in Kyrgyzstan still occurs in the unregulated gray economy.

Also, the Kyrgyz Republic is on the verge of several major economic transitions and decisions as it became a member of the Russian-led Eurasian Economic Union (EEU) officially in May 2015. Although Kyrgyzstan hopes its entry into the EEU will lead to a FDI bonanza, many experts are skeptical about the real benefits and not optimistic about the effect of accession of the EEU. The accession process will alter both short-term and long-term economic conditions, particularly in relation to the gray economy, day trading and currency stability (Anonymous, 2014).

Even though the Kyrgyz government has implemented many initiatives and programs to attract FDI, the Kyrgyz investment climate is still characterized as one of the less favorable in the region according to the data of the United Nations. Actually, the “Country Development Strategy”, which is the Kyrgyz government’s main document for defining directions for development and activity of the country, has been regularly reviewed and updated to improve the investment climate in Kyrgyzstan. However, the reality shows that Kyrgyzstan is still far behind in creating a favorable environment for FDI. Also, the Kyrgyz Republic’s main legal framework for FDI remains in the “2003 Law on Investments” which has been unchanged to date. The justice system in the Kyrgyz Republic is inefficient and not independent, and most cases usually takes years to be resolved.

The Kyrgyz government has been trying to be more open to FDI and the government publicly recognizes that FDI is an important component to developing its economy. Although there are several laws existed that make the investment climate more favorable for foreign companies, the actual implementation and application of these laws, however, is now inconsistent, which can cause problems for and deter foreign investors. In addition, government’s unlawful intervention and interruption, including constant demands for renegotiation of signed contracts or agreements, invasive and time-consuming audits, levying large retroactive fines, and disputes over licenses are impediments to FDI.

In its 2013 Sustainable Development Strategy Roadmap, the government acknowledged that “attracting investment requires having transparent and well-functioning legislation that provides actual protection of rights of ownership and reduces interference from the state and eliminates corruption, and having a stable finance system with the ability to provide benefits to investors, and equal treatment for both foreign and domestic

investors.” The government is now working to lay the foundations for these key components. While there are no official limits on foreign control, a quite large number of foreign investors have found that the Kyrgyz government normally imposes investor-specific requirements such as a high percentage of local workforce employment or a minimum number of local seats on a board of directors and many other similar conditions beyond its laws.

## **VII. Suggestions with Actions Required**

Even though the Kyrgyz economy shows a visible improvement in many areas, there are still challenges that remain unsolved, including political instability with ethnic violence, corruption, hostility against foreign investment, inefficient public sectors, scarcity of adequate human resource and poor infrastructure. Therefore, these are the most important issues that must be addressed and resolved for creating a better environment in Kyrgyzstan for FDI as well as businesses.

It is obvious that all the issues regarding the mining industry, especially with the Kumtor gold mine, must be resolved reasonably as soon as possible in order to not jeopardize the overall environment for FDI. Then, after all, Kyrgyzstan should make a national master plan about developing the mining industry as a key industry in Kyrgyzstan, and should find an effectively transparent way to oversee the whole process of handling all mining business properly, based on the national plan, in order to not give a wrong signal to potential investors from other countries. More importantly, eventually the political situation should be improved with the government stability. Political instability creates a hostile environment for foreign corporations, and it discourages FDI.

Overall business environment must be improved continuously to attract investors both domestic and foreign, and the economy must be well diversified to do that, so the investment risk and the cost of doing business in Kyrgyzstan should be low enough. There are several issues which need immediate actions required with a high priority. For example, building human capital is crucial for the country, and there is an acute skill shortage in Kyrgyzstan. Therefore, there is an urgent need of human resource development nationally to provide a better investment condition to foreign investors with steady supply of high quality labor.

Now, everyone in Kyrgyzstan agrees that Kyrgyzstan can't allow today's level of corruption any more since Kyrgyzstan is not able to make any economic, scientific, technological or social development with such wide spread corruption nation-wide. Corruption will eliminate any chance of progress or development in Kyrgyzstan because it will devour scarce resources that should be invested for the development of Kyrgyzstan. Indeed, Kyrgyzstan is urgently asked to adopt new powerful anti-corruption policies and strengthen its authorities in charge of anti-corruption policy coordination and prevention. Changes should be made in the current process of legislation for effective legislation regarding corruption, and all necessary actions should be undertaken immediately to thoroughly revise the legal framework in line with international standards. Kyrgyzstan should implement verifying and publishing asset declarations of public officials, improve its capacity of internal audit in public institutions immediately, launch a public procurement portal and establish a special court to handle all cases of public officials' corruption. Widespread corruption continues to be a major challenge for Kyrgyzstan's development, despite efforts to streamline its anti-corruption policy and strengthen the institutional framework recently. However, the anti-corruption legislation is still largely inconsistent with international standards and law enforcement institutions still lack sufficient cooperation and resources to fully enforce anti-corruption laws.

Here are some suggestions with actions required immediately to reduce corruption in Kyrgyzstan. First, Kyrgyzstan should declare the war against corruption as the most urgently critical national agenda. Then, the statements about the importance of fighting corruption must be backed up by real actions to ensure their implementation. Legislation for combating corruption should be strictly and effectively enforced. The principle of punishment for corrupt practices, regardless of the corrupt official's affiliation to ruling government or the opposition, should be strictly observed. Second, get involvement of highly qualified staff in the civil service, which requires to improve the system of staff selection and increase the attractiveness of the public service by developing an efficient system of remuneration and motivation. Third, provide anti-corruption education to all government officials, public servants and even citizens to make them all corruption fighters, not leaving them as greedy seekers. Such education should focus on prevention, more than punishment, from wrongdoings. Prevention is the best anti-corruption practice to avoid any wrongdoing which usually result in huge damages to the Kyrgyz society. In fighting against corruption, prevention is critical since it could stop the wide spread culture of corruption more effectively. Furthermore, prevention costs much less socially than punishment after damage. Also, it is much easier to change the culture of corruption through prevention.

At the same time, to improve the efficiency of its anti-corruption efforts, Kyrgyzstan should:

- strengthen monitoring of implementation of anti-corruption policy, by further analyzing results and impact on the level of corruption;
- ensure anti-corruption policy co-ordination and preventive institutions have sufficient resources, specialized staff and necessary independence;
- bring its legislation to fight corruption in line with international standards;
- improve separation of functions, level of cooperation and capacity of law enforcement anti-corruption bodies;
- implement the reform of civil service to ensure its professionalism and integrity;
- strengthen conflict of interests and ethics rules for public officials and focus on their effective implementation in practice;
- strengthen monitoring and transparency of financing of political parties and electoral campaigns;
- take measures without delay to ensure the integrity and independence of the judiciary.

Another issue Kyrgyzstan should take seriously is Kyrgyz people's hostile attitude against FDI. There has been growing hostility against FDI in Kyrgyzstan recently as the Kumtor gold mine became a national issue. Now, more and more Kyrgyz people have become politically radical and more nationalistic especially as the Kumtor gold mine became a national issue. Without easing such hostility, it would be very hard for Kyrgyzstan to attract FDI into its territory continuously for developing economy and creating jobs for the quality of life. The Kyrgyz people should appreciate what FDI could bring into their country. In regard to this, the Kyrgyz leaders' role is very important and critical. All Kyrgyz leaders should persuade the Kyrgyz public and ordinary people to understand why FDI is needed and what benefits Kyrgyz could get, etc.

The next area where the Kyrgyz government should take immediate actions for improving the overall investment environment is taxes and customs. So, the legislators recognized the importance of foreign participation in the economic growth and made efforts of legislating a new law to attract foreign capitals. The Article 20 describes the tax benefits for foreign investors in Kyrgyz Republic. In case if the company with foreign investments has complied with certain payment rules, it enjoyed profit tax exemption for the period of 2-5 years, depending on the subject of activity. After that period the company was obliged to pay reduced profit tax. Objectively, tax exemptions attracted foreign business people, by creating more favorable conditions for foreigners. However, after succession of Kyrgyzstan to WTO and subsequent accordance to the international treaties, limiting the unequal treatment of enterprises, the Government was obliged to annihilate this provision.

For helping attract more FDI, another one Kyrgyz legislators can do is to introduce a special law for the exemption of custom duties for the import of stocks of materials and capital equipment, raw materials and components, designated for formation of authorized capital stock, special-purpose deposits. In connection with the globalization of world economy and conduction of market oriented reforms Kyrgyzstan together with other developing countries took steps to revise old investment policy and come to the more liberalized and less regulative regime, which included the adoption of a new law governing foreign direct investment in Kyrgyzstan.

However, for fair taxation with transparency, the focus should be on particular priority taxation issues that pose serious problems to investors, including enforcement of transparency in tax regulations by interpreting critical cases and general terms of laws and regulations with creating a functioning appeals mechanism, and strengthening of enforcement of legislation and reduction the number of unnecessary audits and inspections.

Customs should also rearrange their policies and regulations in terms of the lengths of delays associated with transportation stoppages, and implementation of a comprehensive reorganization of customs to improve reporting and consultative relationships with other government agencies and private sector clients.

Government bureaucracy must be addresses as another major issue in regard to attracting FDI to Kyrgyzstan. While perceptions of interactions with the government have improved in general, experiences may show a more nuanced picture. Also, the quality of services provided to businesses by the government is worsening. The waiting times for services such as electrical and water connections, construction permits and operating licenses increased as it reflects more procedures and steps. The more procedures and steps, the longer time and a much higher cost for any business. Immediate actions should be taken on clarification of each agency's responsibility with removal of overlaps and duplications, and making rules and regulations for conducting all inspections that should be available to the public and more transparent for foreign investors.



In addition, there is a need for a very well prepared foreign investment policy, which will define the degree of state regulation and involvement, ownership of land and other investment property, legal protection and other critical issues of tax, etc. So, in order to ensure fair business registration especially for foreign investors, the Kyrgyz government must establish a centrally-coordinated business registration procedure and introduce an electronic database accessible to other government offices and the public.

### **VIII. Summary and Conclusions**

Following the collapse of the Soviet Union in 1991, Kyrgyzstan entered a significant economic transition period which has been defined by progressive restructuring efforts and supporting reform programs in the economic environment. Yet, to achieve a sustainable level of economic development, Kyrgyzstan desperately needs financial assistance from multinational firms. With the aid from foreign businesses, Kyrgyzstan intends to import the latest technology, products, and management know-how to modernize the country's industrial foundation.

Foreign direct investment will also have positive political and social implications and is the key to a speedier economic transition in the country. The Kyrgyz government has taken various initiatives to improve the country's business landscape in an effort to make Kyrgyzstan one of the most attractive markets in Central Asia for foreign investors. In fact, Kyrgyzstan has attracted more than US\$ 6 billion of foreign investment from three leading countries, Russia, Kazakhstan and China, for developing its economy in the last two decades although there have been some issues and challenges as a landlocked developing country in transition. Over 80 percent of all investment so far have been made in the mining and related sectors with a few investment projects of infrastructure development and improvement.

Kyrgyzstan has learned many lessons in the last two decades' reform: the country needs to expand and deepen its economic reforms and diversify away from the gold mining to protect its economy from external shocks. However, despite the tremendous economic growth potential, Kyrgyzstan has not received as much attention from the multinational companies as some other transition countries have. This is mainly caused by the country's adverse geographical environment which has physically isolated Kyrgyzstan from the world markets. In reality, as a newly emerging transition economy, there are numerous untapped business opportunities in the country. To achieve this, Kyrgyzstan must remove all barriers and obstacles, and offer opportunities for FDI in the non-mining sectors.

Also, in order to create an attractive environment for FDI and improve the national competitiveness with imported technologies and management skills along with FDI, Kyrgyzstan has to come up with consistent policies and transparent procedures which make investors feel comfortable in their investment in Kyrgyzstan, and through this way differentiate itself from its neighbors as the best place to do business in Central Asia.

Kyrgyzstan must be at the forefront in the region, in creating a great business environment although there are some geographical disadvantages. However, there are still many areas where Kyrgyzstan is far from being the best.

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