

KYRGYZ TEXTILE COMPANIES' RESILIENCE FEATURES IN THE POST-SOVIET REGIONALIZATION PROCESSES

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Abstract: *Kyrgyz textile industry is a fast growing sector since the last decade. The combination of international market conjuncture and low input factors were main reasons for the textile sector development. International trade legal modification is a risk for the whole industry resilience. The purpose of the paper is to identify the vulnerable points of doing business in the context of economic transformation from planned Soviet to free market economy.*

Keywords: *Kyrgyz apparel, organizational resilience, regionalization, Customs Union,*

Introduction

Kyrgyz economy had severe disturbances of shock therapy of transition from centrally planned to free market economy after the Soviet Union collapse in the 1990s. The perturbation of economic transformation caused major damage to industrial production that in 1995 represented 27% of its production volume of 1990. Decline of the production volume in the whole Kyrgyz industry was more than 50% but 73% for the textile sector (Ermekebaeva, 2012). The textile industry's structure was fragmented during the transitional period, due to changing environment. The national policy of liberalization of international trade and fast privatization of industrial entities bankrupted most of textile companies. During the economic transitional period the structure of the textile sector was modified. If during the Soviet period production of fabric and thread represented 80% of the textile industry, in 2010 apparel production counted 82.5% and became the economy forming sector. Another change is in the legal organizational form of textile actors: a shift from large factories to multiple SMEs.

From the beginning of the 90s Kyrgyzstan has been passing from the command Soviet economic system, that continued for 70 years, to the free market system. This period of economic transition can run 20-30 years. In the transitional economy environment, business continuity of textile SME is a challenge. The resilience of new actors in the textile sector has to be developed to withstand crises that are more frequent during the transitional period.

Kyrgyzstan is the first member of the WTO among the Commonwealth of Independent States (CIS) since 1998. The globalization process of Kyrgyz international trade influenced the Kyrgyz textile sector by modifying its structure. Liberalization of borders with China and introducing weight-based customs duties lead to redundancy of cheap raw materials and machineries for the development of an apparel cluster. On the other hand, huge domestic producers of fabric and thread lost their market share and could not compete with fashionable Chinese production on the local market. Due to the CIS agreement of free trade zones Kyrgyz apparel could meet demand on Russian and Kazakh markets that were protected from Chinese and Turkish textile productions. Development of the textile sector was possible with favorable international market conjuncture as well as governmental SME support policy and low input factors. With the last modification of regional integration, especially with the creation of a Customs Union between Kazakhstan, Russia and Belarus, Kyrgyz apparel sector has to seek new ways of being resilient.

The paper seeks to identify the vulnerable points of Kyrgyz textile companies to build up organizational resilience in the context of economic transformation and regional integration processes. The frequent market fluctuation, due to the transitional economy, makes classic resilience remedies insufficient. Energetic crisis issues, informal financial redundancy, and corruption matters are to be solved to insure business continuity in the post-Soviet economy. International trade integration changes require challenging

adaptation capacity in enlarging production networks by diversification and participation in triangle manufacturing with deep specialization in the assembly part for the Customs Union market.

Mainly the subject is treated through the prism of theories of transitional economy, organizational resilience, international trade and supply chain management. Information sources for the paper were official statistics data of the National Statistics Committee, the Ministry of economic regulation of the Kyrgyz Republic, the Ministry of labor and migration of the Kyrgyz Republic, the Association of light industry enterprises "LegProm", and the Association "SouzTextile". The analysis is based on interviews with representatives of government bodies, heads of associations and entrepreneurs of the textile sector in Kyrgyzstan.

1. Background of Kyrgyz textile development

The development of Kyrgyz textile industry came with the beginning of the Soviet period of Kyrgyzstan. During the Second World War many textile production facilities on affected territories of the western side of Soviet land were relocated to Kyrgyzstan. Due to agricultural predisposition of the region for rentable cotton, silk and wool production most textile production in the region continued to develop till the end of the Soviet period. The structure of Kyrgyz textile sector was dominated by the production of fabrics that represented 80% of all textile production. After the collapse of the Soviet Union the Kyrgyz integrally self-sufficient textile chain was broken. Related sectors of textile industry were developing independently from each other, and because of a combination of factors of market conjuncture, economic policy and international trade policy each subsector now is at a different level of development. The transitional economy affected all textile sectors toward decline. Specific gravity of textile industry production in all Kyrgyz industry was at 28,8% in 1990 and declined to 5,16% in 2010.

1.1 Textile production decline during transitional economy

State policy for SME development and fast international trade liberalization¹ had double effect in short and long term aspects. In the long term the fragile sector of fabric and tread production heritage of Soviet Union collapsed. Privatization of most of the enterprises during the 90s created lack of capital investment in the sector with high capital density. Poor use of production capacity did not let them use economy of scale. Old technology used without any modification from the Soviet period resulted in production of costly and out-of-fashion fabrics that did not sufficiently meet internal market demand. After the weight-based custom duties were introduced, the internal market was saturated by cheap and fashionable imported raw material that smashed vulnerable upstream level production companies. Demand shifted from domestic to imported fabrics because of used old technologies, old fashion, high price and low quality. Nowadays less than one thousand people (against 200 thousand in the Soviet period) work in this subsector and they produce 0.1% of GDP.² The volume of fabrics production sharply declined since the 90s, and in 2008 it represented only 10% of the fabric production of 1998.

On the other hand it facilitated an acceleration of sewing subsector development, providing with cheap raw materials in a medium term perspective. Of course there are other concomitant favorable factors of renaissance of cut, make and trim (CMT) companies, like the development of several open air markets next to Bishkek, where apparel manufacturers could find Chinese and Turkish inexpensive fabrics and accessories. Low input cost in cheap electricity, local rents and wages as well as informal business opportunities and requests for high investment in other sectors were other favorable factors for fast development of the sewing sector.

Thereby, garment production of Kyrgyzstan passed from a share of 15% in the whole textile industry in 1998 to 82,5% in 2010 and became the leading branch of the sector.³ The rise of the branch is even more important, if we consider that 95% of Soviet large enterprises of the sector were closed, and others were divided into small and micro-sized enterprises.

¹ Establishment of weight based import custom duties of US \$ 0.15 for each kg consumer goods in 2002

² National statistic Committee, 2008

³ Sectorial analysis of textile and sewing production in Kyrgyz Republic, Kyrgyz National Institute of strategic researches, 2012

1.2. Actual state of textile sector

Nowadays Kyrgyz apparel production is based on assembly in the form of cut, make and trim (CMT) enterprises, full price production for Russian customers and original equipment manufacturers (OEM) interacting between each other. There are some differences with East Asian textile manufacturers in absence of triangle manufacturing (Gereffi and Fernandez-Stark, 2011), due to poor networking with both Asian OEM producers and Western retailers and high dependency on both the upstream and downstream levels, due to non-diversification of raw material sourcing and exporting market. Kyrgyz textile industry is based on intermediate wild assembly of apparels between globally integrated WTO members, viz. upstream textile producers like China and Turkey, and regional consumer markets being integrated Customs Union (CU) members. The Kyrgyz interior market consumes only 5-10% of internal apparel production. Main destination is Russia (almost 70%) and Kazakhstan. If by the result of the 2011 Kin classification of apparel on the Russian market Kyrgyzstan occupied fifth place, in 2012 its place upgraded to third.⁴ The membership of Russia in the WTO and the Kyrgyz government decision to integrate in the CU show that all modifications of trade policy of both parties can nastily influence the organizational resilience of Kyrgyz textile companies.

Apparel industry production reached 82% of the gross textile industrial production in 2010 and involved 24% of Kyrgyz industry employees. This fast developing subsector is very vulnerable, because of the transitional period from planned to free market economy of Kyrgyzstan. A mountainous geographical situation and low development of logistics infrastructure make companies specialize in basic and seasonable garment production. Upgrading the Russian market position of Kyrgyz apparel makes it produce more fashionable garments and review the resilience of its supply chain in an accelerated logistics context by handling aggravated vulnerabilities related to such upgrading to higher value production.

The fast development of the Kyrgyz textile industry in the context of the post-Soviet economy period makes investments opportunities for domestic free capital attractive. Low entrance barriers, low input factors and low capital density of the apparel assembly subsector provides a position for SMEs in textiles. Half of them work in shadow and about half of them are unstable and go bankrupt each year. New actors take over localities and machinery of bankrupted SMEs and try the chance.

2. Vulnerabilities of doing business in the transitional period

First steps of the shock therapy of transition were cancelation of the planning system, wide privatization of economic activities, cancelation of the mono-bank system, and trade and market liberalization at national and international levels. Those measures catastrophically declined economic growth in short and medium terms. Kyrgyz textile companies had to compete with a cheap and fashionable Chinese textile production invasion. Old machinery, high competition, and lack of experience of doing business in the free market of the enterprises' new managers, caused a declined interior production, and most of the enterprises went bankrupt. Transition economy context still represents a lot of obstacles for doing business and requires specific abilities to be resilient and confront disruptions yielded by the period, such as energetic crises, informal economy costs, lack of labor, low development of financial banking system, corruption, and social, political and economic disruptions.

2.1. Informal economy context

The shock therapy of the transitional economy, a high level of corruption, a high level of taxation in context of raised competitiveness with Chinese production and weakness of governmental bodies made the development of doing business in informal economy possible during the economic transition period. The share of the Kyrgyz informal economy in the whole textile industry was estimated at about 90% in 2002. The resilience of such textile companies became obsolete, as any raid check of a governmental supervisory authority can impose a fine or even shut down the production. The two essential reasons for a trend since 2004 of doing business out of shadow were that the development of export to Russia required official certification documents, and tax facilitation measures of the Kyrgyz Government from 2002.

⁴ Interview with director of Association of textile producers of Kyrgyzstan

2.2. Lack of labor in the textile sector

Employment in the textile sector of Kyrgyzstan is very important for government in a social, gender and economic balance meaning. A big blockage of the potential of development is lack of qualified labor for the Kyrgyz textile sector. The association of Kyrgyz textile companies "LegProm" affirms the need of 10-25 qualified workers in almost all sewing companies. If we consider that most of sewing companies of Kyrgyzstan are SMEs, the indicator has a crucial meaning.

The labor qualification problem results from the low financial remuneration in the sewing sector. The high demand on labor keeps remuneration low in comparison with other sectors. The average salary of a sewer is USD 200 and for low qualification workers USD 150. New personnel comes from other sectors to work as unqualified employees where vocational training is made by producers within the production or in special qualification centers. For producers it is an additional expenditure, in form of the risk of machinery broken by inexperienced workers, more non-conforming goods, financial and time expenditures that must be funded back. Moreover, weak social guarantees and informal recruitment preferences open possibilities for employees to shift to other better paying companies after the training. Experienced workers can also move to Kazakhstan or Russia for higher wages.

2.3. Financial redundancy quest

The beginning of the transitional period was characterized by the collapse of the mono-bank system and liberalization of the financial market with little intervention of the Kyrgyz Central Bank. That led to the appearance of a lot of fragile private banks and financial pyramids for savings in the beginning of the 90s. Most of them were bankrupt by the end of the 90s implying total loss of confidence of the population for the banking system. Kyrgyzstan still could not establish a robust financial system that could support economic growth: weak banking sector and exchange organizations restrain funding opportunities for investments. The rate of commercial loans is very high, because of exchange rate fluctuation, political instability, and lack of capital supply, combined with high demand for short term loans for the alternative trade sector. So the private sector credit declined from 66% in 2004 to 21% in 2005, representing 8 % of GDP. The lack of confidence and competition for deposits makes the difference high between deposit and credit rates. The fast rise of prices for real estate served as substitution of private business credits by higher rated, less risky and more confidential mortgage credits. The latest global financial crisis restrained Kyrgyz commercial banks to limit the mortgage and also business credits. Actual average of commercial loans for business development proposed by Kyrgyz commercial banks is 20-25% per year.

The Kyrgyz banking system is also represented by non-bank micro-credit organizations. Their credit ability is limited, and the rate is about 30-40% per year for a short term loan. For most SMEs it represents a rescuing short term credit opportunity that has a less bureaucratic deposit system. Kyrgyz apparel manufacturers are represented mostly by SMEs with limited resources in the competitiveness environment and tend to have a minimum of own financial recourses. Rapid access to financial resources for better liquidity and leverage ratios is highlighted by Pal and Torstensson (2012) as antecedent resilience factors for SME's.

3. International trade integration processes effects on textile industry development

Kyrgyzstan's strategic trade partners are located in the region. The share of international trade with CU countries is 42.7% (Russia 27.6%; Kazakhstan 12.7%; Belarus 2.4%). While the main export of Kyrgyzstan is gold with 42%, export to these countries is diversified. Regional integration aims of the Kyrgyz Government is pressed by geopolitical re-estimation of Russian presence in the region and a sort of demonstration of foreign policy priority of Kyrgyz authorities. The economic interest and gain of the regionalization is secondary after political reasons. However, the purpose of the paper would be in analyzing possible economic effects on the textile sector of the integration.

3.1. Regional integration processes

The CU is effective between Russia, Belarus and Kazakhstan since June 2010 and represents an upgraded form of the excited Eurasian Economic Community between Belarus, Kazakhstan, Kyrgyzstan, the Russian Federation and Tajikistan, established after signing agreement in 1996 and reorganized as

international organization in 2000. A new format of regionalization has developed for the purpose of liberalization of financial and commercial movements between member countries. On the example of European Union the CU aims at creation of a supranational organism, regulating distribution of importation taxes between members, aligning the external trade policy, deleting customs borders between member countries and establishing common external border. The main purpose of the CU is development of economies by a reduction of lead time by a factor four, due to absence of physical customs borders, and development of intraregional trade for stimulation of economic growth in a long term perspective.

Tariff rates for most export to CIS countries are based on the agreement of free trade of CIS countries signed in April 1994 and updated in October 2011. This agreement is a basic level of regional integration that does not mean aligning trade policy of countries and does not exclude bilateral tariff modifications of trading partners on different goods. At present the agreement was successful for Kyrgyz textile export and also for the development of Kyrgyz apparel industry. The agreement can be applied only for goods that have more than 30% added value in the exporting country to exclude re-exportation of goods. Certified laboratories for estimation of level of added value are located in CU member states, but whose methodology of analysis can differ. The level of material and components used to create final products is arguable and any transparent standardization will have the purpose to delimit trade procedures and import barriers of the CU. One can affirm that in addition to bilateral modification of tariff rates, exportations are exposed to non-tariff barriers, such as re-exportation restrictions, and sanitary and phytosanitary barriers. So, certification transparency and standardization processes could facilitate intraregional trade and contribute to a resilient Kyrgyz apparel cluster development.

3.2. The role and gain of Kyrgyz apparel sector in the Customs Union

After the accession of the Russian Federation to the WTO in December 2011, tariff and non-tariff barriers of the CU would be modified for diminution. On one hand Kyrgyzstan will not have the obligation to conserve high import rates for Chinese textile raw materials, but on the other hand textile producers, represented mostly by developing countries, will force Russia within the framework of WTO to decrease its import rates and to apply non-discrimination principles to other countries. Hence Kyrgyzstan can lose its preference in the Russian textile market. The comparative advantage of Kyrgyz textile production in the Russian market has to take the challenge of competing cheap Chinese analogs by its adaptive ability. The globalization of the supply chain of Kyrgyz textile companies highlights the question of making the sourcing resilient by diversification at upstream as well as downstream levels.

From this perspective, a major factor of resilience of Kyrgyz textile companies would be the ability to tie relationships with CU country marketers and retailers. Participation of Kyrgyz apparel producers in triangle manufacturing (Gereffi, 2004) for CU markets would place Kyrgyz textile export in a legal international framework. A possible membership of Kyrgyzstan in the CU should represent its territory as having the lowest wage cost among CU members with a suitable geographical position. Pal and Torstensson (2012) identified relational networks in form of close relationships with suppliers, customers and marketing partners as a resilience factor for SME. At the first stage it would be difficult to establish interior complete value chains, due to different levels of textile subsector development. So Kyrgyz textile manufacturers could be attractive as CMT and full price partners for Western retailers and marketers, seeking to penetrate growing CU retail markets. Furthermore, Kyrgyzstan can be a destination of possible re-localization of apparel assembly from China, forced by wage cost raise and lack of labor. The geographical location and international trade regulation of Kyrgyzstan can be attractive as a nearby supplier source for Russian and Kazakh markets, in combination with other points, such as input cost for apparel industry (electricity – USD 0.03/kW, locality USD 5/m² per month, low labor cost), cultural and linguistic similarity, usage of same size gradation and popularity of labeling “made in Kyrgyzstan” on Russian and Kazakh markets as “quality for acceptable price”.

The actual value added chain with Kyrgyz specialization in apparel will undergo transformations in coming years. Absence of business network on new markets, additional logistical cost and absence of preferences make it difficult to compete with Asian apparel specialized country producers on the outside of CU markets. Kyrgyz textile producers' organizational resilience would be a function of time with the requirement to

bounce back from the demand shift crisis due to market shares lost in the CU. So actual regionalization processes redesign the present value chain scheme, because the facilitated period of raw material importation for Kyrgyzstan from outside the CU will be limited. One of the main issues of multilateral negotiations about integration in the CU is terms of temporary import facilities of textile raw materials.

Conclusion

The resilience of Kyrgyz textile companies is of extreme value in a changing environment. The transitional period is characterized for Kyrgyz textile companies as quest of financial redundancy, labor market penury, energetic crises and informal economy disadvantages. Internal labor market representation has to be redundant to sufficiently supply the needs of the textile sector for skilled labor force. International free movement of labor and capital would align the wage cost in CU members in a longer perspective. The ability to conserve cheaper wage cost by developing apparel cluster within the country would have the purpose to limit immigration of qualified workers of textile sector. Government budget policy and actions of SME support have to be continuous to provide flexibility to apparel manufacturers. Furthermore, an effective simulative monetary policy has to be undertaken for improving the business crediting system.

South-south trade, described by Milberg and Winkler, demonstrates the development of purchasing capacity of emerging countries like Russia or Kazakhstan. These countries, by the force of established logistical connections, historical preamble and language facilities, try to deal with other former Soviet countries. Moreover, regain of the geopolitical role of Russia in the Central Asian region by the regionalization process boosts development of the textile sector of the region. Shifted competitiveness on the market induces a need to re-estimate the risk management tools for mitigation of natural disasters by diversifying geographical density of sourcing or by addressing organizational resilience concepts to overcome unforeseen crises.

Organizational resilience, determined as the ability of a company to withstand disturbances and crises, is a challenge for Kyrgyz companies after the shock of international trade regulation modifications. The adaptive capacity of companies has to be tested by development of a new raw material sourcing map. Pal and Torstensson identify resilience essentials, such as investment finance and cash flow, material assets and networks and strategic and operational flexibility, for textile SMEs as discriminating factors between successful and failing companies. Beyond the transitional period, specific factors as energy independency, informal business ability, and resilience essentials for textile SMEs are crucial for Kyrgyz apparel companies during regionalization processes. Regional integration of Kyrgyzstan and globalization of the Russian market after accession to the WTO create a need to re-estimate comparative advantages of Kyrgyz apparel on markets of the Customs Union. The transitional period of integration of Kyrgyz economy in the Customs Union is the function of time during which Kyrgyz apparel has to develop internal raw material sourcing or establish alternative and complementary sourcing within the CU.

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