



FINANCIAL SYSTEM DEVELOPMENTS IN TRANSITION ECONOMIES: THE CASE OF KYRGYZ FINANCIAL SYSTEM*

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Abstract

After the collapse of the Soviet Union, the Central Asian republics have chosen market economy as their economic model. The need for developing a financial system is a reality for those countries. During the 16 years of transition period, unfortunately those countries have not been able to establish an effective financial system. In the case of Kyrgyzstan, it has problems in financing economic growth, namely weak banking sector and stock exchange organizations restrain funding opportunities for investments. Moreover, unsuccessful experience of privatization, bankrupts of banks and corporations, insufficient amount of public savings have negative effect on Kyrgyz financial system. On the other hand, activities of international organizations like World Bank, Asian Development Bank, NATO, various foreign direct investments to financial sector, and efforts on integration to global financial system have positive effect on financial system developments of Kyrgyzstan. All foreign activities and assistance are very important for the global security because the financial systems of those countries are under risk with the problems of the organized crime, money laundering, and corruption as well as major threats to global security. In order to develop a better financial system in Kyrgyzstan ex-ante preventive actions must be taken especially in legal and political systems. This paper tries to assess the obstacles for establishing an efficient financial system in Kyrgyzstan.

Key Words: Financial system development, financial system security, Kyrgyzstan, transition economies.

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GEÇİŞ EKONOMİLERİNDE FİNANSAL SİSTEMDE GELİŞMELER: KIRGIZ FİNANSAL SİSTEMİ ÖRNEĞİ

Özet

Sovyetler Birliği'nin çöküşünden sonra Orta Asya cumhuriyetleri ekonomik model olarak piyasa ekonomisini seçmişlerdir. Bu ülkeler için bir finansal sistem geliştirilmesi gereği bir gerçeklik olmuştur. Ne yazık ki bu ülkeler 16 yıllık geçiş dönemi süresince etkin bir finansal sistem geliştirme konusunda başarılı olamamışlardır. Kırgızistan örneğinde ekonomik büyümeyi finanse etmede sorunlar yaşanmaktadır, diğer deyişle zayıf bankacılık sektörü ve sermaye piyasaları yatırımlar için fon imkanlarını daraltmaktadır. Buna ek olarak başarısız özelleştirme deneyimleri, banka ve şirket iflasları, yetersiz iç tasarruflar kırgız finans sistemini olumsuz etkilemektedir. Diğer yandan Dünya Bankası, Asya Kalkınma Bankası, NATO, çeşitli dış yatırımlar ve küresel finansal sistemle bütünleşme yönündeki çabalar Kırgızistan'da finansal sistemin gelişimini olumlu etkilemektedir. Tüm dış yardımlar ve çalışmalar küresel sistemin güvenliği bakımından çok önemlidir, çünkü Orta Asya ülkelerinin finansal sistemleri, küresel sistemi tehdit eden örgütlü suçlar, para aklama ve yolsuzluklar gibi problemlerin riskleri altındadırlar. Kırgızistan'da daha iyi bir finansal sistemin geliştirilmesi amacıyla özellikle yasal ve politik sistemlerinde önleyici önlemler almak bir zorunluluk olarak görülmektedir. Bu çalışma, Kırgızistan'da etkin bir finansal sistemin geliştirilmesi önündeki engelleri belirlemeyi amaçlamaktadır.

Anahtar Sözcükler: Finansal sistem geliştirme, finansal sistemin güvenliği, Kırgızistan, geçiş ekonomileri

Literature Review

The literature on financial system development of Kyrgyzstan is not so much especially in English. Most of the literature is written in Russian language. But, the international economic organizations like World Bank, International Monetary Fund, European Bank of Reconstruction and Development, etc. are preparing and publishing reports about the issue. Beside them, National Bank of Kyrgyzstan Republic (NBKR) has publications in English titled Banking System Development Trends, Inflation Report, Balance of Payments, Bulletin of NBKR and Annual Report

Financial Systems in Transition Economies

The economies of the former socialist countries and states of the former Soviet Union are named as the transition economies, which in the early 1990s started the transformation of their economies from a socialist to a market system. Building a market type financial sector constituted a key element in these transformation efforts. However, after fifteen years of these transitions, the results and the experience are mixed. Most transition economies still have a long way to go to build a robust and efficient financial system. Although the Baltic States were able to build quite successful financial systems, in the CIS countries financial systems remain a major obstacle to economic growth. The hyperinflations of the early 1990s, the financial scandals that followed the collapse of monobank systems, and subsequent incomplete progress in constructing non-bank financial institutions and effective regulatory structures have had adverse consequences. These include weak bank balances sheets, high real interest rates,

and poor access to capital for small enterprises and start ups. With a few exceptions, nontransparent regulation, inadequate disclosure frameworks, and weak protection of shareholders rights continue to limit investor participation in CIS financial markets (Golodniuk, 2005).

Kyrgyz Financial System

The Kyrgyz Republic is one of the more liberalized countries in Central Asia. Soon after independence, the country embarked on a comprehensive reform to transition to a market economy. The strategy included the divestiture of state-owned assets, the introduction of the Som, the national currency, and the establishment of a modern financial and legal infrastructure to support private and financial sector development. The Kyrgyz Republic is also the only country in the region that is a member of the WTO (1998).

Despite the intense reform efforts of the early 1990s, Kyrgyz Republic has remained one of the poorest countries in the CIS, with a per capita GDP of about US\$308 in 2001. This is due to the country's geographical isolation, the scarcity of natural resources, heavy dependence on gold and agriculture output, and the effects of the Russian crisis of 1998. Despite these adverse conditions, the country's macroeconomic performance has been improving significantly since 1998 – real GDP grew at an average annual rate of 5.5 percent during 1996–2001, although it is expected to turn slightly negative in 2002.1 Inflation is under control as the 12-month average inflation rate has declined from 23.5 percent in 1997 to 2 percent in 2002.

Main Indicators of Economic Development of the Kyrgyz Republic				
Data Category and Components	1992	1996	2000	2004
Macroeconomic Indicators				
Real GDP index (1990 = 100)	79.4	54.3	66.6	80.4
Real GDP average annual rate of growth, in %	-10.9	-9.5	5.2	4.8
Consumer prices index, in %	2132.7	134.8	109.6	102.8
Public Sector				
State budget revenues, % of GDP	17.3	15.9	15.2	19.5
Tax revenues, % of GDP	15.1	12.7	11.7	14.9
State budget expenditures, % of GDP	31.2	24.8	25.4	24.5
Public investments, including PIP, % of GDP	NA	3.8	8.1	4.5
State budget deficit, % of GDP	-13.9	-8.9	-10.2	-4.5
External Sector				
Economic Openness, % of GDP	83.2	77.9	77.3	75.3
Current Account Balance, % of GDP	-4.3	-23	-10.4	-3.4
Total External Debt, end of year, % of GDP	0	66.6	124.6	95.1

Source: UNDP KG

Enterprises of Financial Sector of Kyrgyz Economy					
Data Category and Components	2002	2003	2004	2005	2006
Commercial Banks*					
Number	30	30	30	30	30
of which acting banks	21	21	21	21	22
Number of branches	164	175	179	181	187
of which acting banks	158	162	170	179	187
Charter capital (mln. soms, at the end of period)	2168,5	2221	2692	3115,1	4053,9
of which acting banks	1861,4	1844,9	2319,7	2754,2	3693,1
Insurance Company					
Number	30	31	24	13	17
Number of branches	39	40	33	19	26
Charter capital (mln. soms, at the end of period)	53,1	55,9	77,5	63,8	149,6
Investment funds					
Number	11	11	8	7	8
Number of branches	11	10	8	7	8
Charter capital (mln. soms, at the end of period)	9,2	10,2	8,3	7,4	11,4
Non bank financial and credit organizations					
Number	374	437	470	528	567
Number of branches	35	31	45	56	65
Charter capital (mln. soms, at the end of period)	435,2	503,4	551,1	674,7	1435
Stock exchange					
Number	4	3	3	3	3
Number of branches	-	-	-	-	-
Charter capital (mln. soms, at the end of period)	27,3	27,3	27,3	28,3	28,3

* Including banks, which are at the stage of liquidation.

Source: <http://www.stat.kg/Eng/Annual/Enterprises.html>

Financial Markets

Kyrgyz capital markets, insurance and pension sectors are extremely small. The development of these sectors should remain a long-term objective, as the supervisory and regulatory framework and enforcement capacity are extremely weak (The World Bank, 2003).

Government securities' market is also true in the same way; just a small part of the budget deficit is already financed locally by issuing treasury bills and bonds. However the secondary market for government securities is still very small, turnover is minimal and the investor base has to be broadened. Participants in auctions of government securities can be only licensed Primary Dealers and Finance and Credit Organizations. The elementary phase of the government securities' market also has a negative effect on the effectiveness of monetary policy and the lack of clear price signals prevents the

financial sector from the optimal allocation of funds for public and private projects (SDC, 2006).

In 1994 the Kyrgyz Stock Exchange (KSE) was founded by ten local private companies and banks and started as a market for trade of privatization coupons. On 25 May 1995, the first stocks trading took place, whereas a privatization practice was in height. And in May 2000 it was transformed into a closed joint-stock company. Currently, the KSE is a closed-type non-profit joint-stock company with 17 shareholders. Among them 14 shareholders are local companies and 3 are foreigners.

Two of those foreign investors are the Istanbul Stock Exchange and Kazakhstan Stock Exchange. Also the Swiss Agency for Development and Cooperation (SDC) and US Agency for International Development (USAID) are helping Kyrgyz authorities to develop a better financial market.

Official listed companies of KSE are categorized into three groups of 10 companies with total capitalization of 3,668.86 mln. som (app. 95.27 mln. \$) calculated based on the deal prices. And statistics about the transactions are as follows;

	Trade's volume, \$	Security's quantity	Number of transactions	Primary market, \$	Secondary market, \$	Listed market, \$	Unlisted market, \$
2003	13,275,709	48,778,638	1,865	4,147,081	9,128,622	2,969,019	10,306,690
2004	57,384,945	44,899,366	2,305	32,030,774	25,354,171	7,826,694	49,558,252
2005	32,358,686	51,008,715	1,745	16,368,847	15,989,839	14,604,340	17,754,345
2006	101,722,130	139,430,925	2,284	30,662,104	71,060,026	21,837,644	79,884,488
2007	120,079,729	359,262,538	3,785	27,021,620	93,058,109	23,247,397	96,832,332

Source: Kyrgyz Stock Exchange, 2007

Anyway, the KSE has been criticized by UNDP that too much authority was given to this organization: all share transactions must be registered with the KSE; nevertheless, the KSE role is limited by the lack of stock market participants: the population has no money, and there are practically no institutional investors; as a result, KSE does not implement any of the most important functions of the stock market, i.e. market evaluation of enterprises and provision of capital.

Banking

The Kyrgyz financial system is dominated by commercial banks and to a lesser degree by non-bank financial intermediaries that are mostly donor funded. Financial sector intermediation continues to increase, although slowly. This is mainly due to developments in banking, which dominates the financial sector. Banking assets increased from 13.4% of GDP in 2003 to 18.8% in 2004 and 20.9% in 2005. The total capital of commercial banks increased from the equivalent of 1.3% of GDP at the end of 1999 to 2.5% of GDP in December 2004 and 3.1% in December 2005 (\$77 million), mainly due to higher capital requirements and increasing foreign direct investment. Foreign investors (mainly international financial institutions and Kazakh banks) increasingly control the banking system. At the end of 2005, 65% of the system's assets were foreign-owned.

There are 19 commercial banks in the Kyrgyz Republic. In terms of total assets, the banking sector is small and fragile, but on its way to recovery from the crisis in 1998.

The crisis brought inflation and devaluation, the collapse of the largest energy conglomerate and the bankruptcy of two of the largest banks in the country. The Kyrgyz State currently owns two banks, the Savings and Settlement Corporation (SSC) and Kairat, which together represent about 12 percent of total assets of the banking sector. (The World Bank, 2003).

On 13 April, Russian "Kommersant" released a list of the biggest 1,000 banks in the former Soviet republics. The Bishkek-based AsiaUniversalBank is on the 290th place in it with the actives of \$107.6 million, the Ineximbank is the 437th (\$57.1 million), Kyrgyzstan is the 550th (\$40.8 million), the Demir Kyrgyz Bank is the 639th (\$31.4 million), the KazKommerzBank-Kyrgyzstan is the 714th (\$24.7 million), the Energobank is the 730th (\$23.7 million), the Kyrgyz Investment Credit bank is the 733rd (23.6 million), the Saving Company of Kyrgyzstan is the 754th (\$22.3 million), the PromStroiBank is the 780th (\$21.2 million), the Bakai bank is the 900th (14.6 million), and the EcoBank is the 988th (10.4 million) (Eurasianet, 2007).

Growth of private sector credit declined from 66% in 2004 to 21% in 2005, mainly due to the political events of March 2005 in combination with increasing risk awareness of commercial banks. Private sector credit was equivalent to 8% of GDP in December 2005. This is still comparatively low, but higher than in previous years. Growth of bank deposits decelerated from almost 60% in 2004 to 13% in 2005. Deposits amounted to 14.1% of GDP in 2005. The differential between deposit and lending rates remains high (20.8 percentage-points at the end of 2005), indicating weak competition for deposits and the need to increase confidence in banks (ADB, 2007).

Political System

Central Asia is characterized by the weakness of the states in the region and the related economic and social difficulties. At the time of independence in 1991, these states were poorly prepared for the post-Soviet reality. In fact, independence meant rather the destruction than creation of many attributes of statehood, including taxation capacity, control over coercion within given territories and the costly business of establishing independent institutions like militaries, border units, etc. (Engvall, 2006).

In Kyrgyzstan nationwide demonstrations in the spring of 2005 resulted in the ouster of President Askar Akayev, who had run the country since 1990. Subsequent presidential elections in July 2005 were won overwhelmingly by former Prime Minister Kurmanbek Bakiyev. After this change the political opposition organized demonstrations in Bishkek in April, May, and November 2006 resulting in the adoption of a new constitution that transferred some of the president's powers to parliament and the government. In December 2006, the Kyrgyz parliament voted to adopt new amendments, restoring some of the presidential powers lost in the November 2006 constitutional change. Current concerns include: privatization of state-owned enterprises, expansion of democracy and political freedoms, reduction of corruption, improving interethnic relations, and combating terrorism (CIA, 2007).

Until March of 2005, there had been no incidents of politically motivated harm to projects and installations. In March 2005, extensive looting in Bishkek caused millions of dollars of harm following the deposing of ex-president. After that, there have been almost no politically motivated incidents relating the damage of businesses (U.S. Department of Commerce, 2006).

Legal System

The legal system of the Kyrgyz Republic was shaped and developed within the framework of the Soviet state law. The legal system of Kyrgyzstan after getting independence has some features of the French, and the Russian Federation legal system. The first part of the Civil Code of the Kyrgyz Republic came into force on May 8, 1996 replacing the previous Civil Code of the Kirghiz Soviet Socialist Republic dated 30.07.1964. The second part of the Civil Code of the KR came into force on January 5, 1998.

Main divisions of the New Civil Code of the Kyrgyz Republic are as follows: general statements and regulations of civil-legal relationships; the law of property and other proprietary interests; obligatory rights including separate kinds of insurance; the law of intellectual property; inheritance law; application of norms of international and private law to civil and legal relationships. (Battalova, 2002)

Anyhow, the legal system of the Kyrgyz Republic is still developing. It is still heavily bureaucratic as a legacy of the Soviet era. Businessmen must overcome a great deal of red tape in order to do business (U.S. Department of Commerce Trade Information Center, August 2003).

According to American Chamber of Commerce in Kyrgyz Republic, the Kyrgyz legal system is frequently plentiful and paradoxical. How to deal with laws and regulatory acts that were adopted in violation of prescribed procedures; and how to resolve conflicts between and within laws are not established in legislation. The result is changeable application, disorder, and non-transparency in the legal system that leads many businesses to protest of unpredictability. In addition, contradicting laws are routinely used by some agencies and individuals of the Kyrgyz Government to extract bribes from business, as it is impossible for businesses in some industries to meet the conflicting requirements of all the applicable laws.

However, the Kyrgyz court system suffers both from corruption and a dependence on the executive branch of the government such that businesses are wary of taking their issues to court for fear that rulings will be determined by the whims of politicians rather than the rule of law.

- ◆ the continuing presence of judges who started their careers in the Soviet period and the political mechanisms of their appointment and dismissal;
- ◆ the inferior quality of the system of legal education and the natural resistance of the legal community to any drastic changes, including those required by democratization and market reforms;
- ◆ inadequate financing of the judicial system, including low salaries of judges and public prosecutors;
- ◆ non-transparent work of the judiciary, lack of effective enforcement of court decisions (UNDP KG, 2005).

Corruption

Corruption is a major social, economic and political problem in Kyrgyzstan and a serious obstacle to its further development. International ratings (for example, Transparency International) regularly place Kyrgyzstan among the most corrupt countries in the world. Anti-corruption programs prepared by local and international

experts in recent years have failed to yield the expected outcome since the former authorities did not take these recommendations seriously and were not able to implement them properly (UNDP KG, 2005).

Corruption is a threat to stability, security, and welfare not only in recent emerging economies and transition countries, but in older states as well (Civelek, 2006). It is also a serious threat for Kyrgyzstan. Low level of salaries of government officials is one of the key issues in this problem. To date, measures targeting corruption and other such economic crimes have been selectively enforced (U.S. Department of Commerce, 2006).

But anyway the Kyrgyz Government is continuing to take steps to address corruption. As part of their IMF Poverty Reduction and Growth Facilitation program, the Kyrgyz Government has agreed to take actions to stop corruption (U.S. Department of Commerce, 2006).

Privatization

The privatization practice has become vastly politicized and detested, which has directed to populist calls to limit or even stop privatization and to evaluate earlier privation dealings (this was one of the slogans of the March revolution). In Kyrgyzstan, there are numerous significant groups which are not paying attention in privatization: some rent-seeking bureaucrats and enterprises, a disoriented population. This diminishes the rate of privatization and creates the real risk of renationalization and/or administrative redistribution of privatized property under the cause of correcting earlier privatization misuses (UNDP KG, 2005).

AML and CFT

Afghanistan, because of the instability in the country for a long time, became home of terrorist groups and opium producers. So that, the Anti-Money Laundering \ Counter-Financing of Terrorism (AML\CFT) issues in Kyrgyzstan became important to global security. Also quite often, new states have very weak state structures and they can not properly provide fight against soft threats. Therefore, soft threats can transform to hard threats such as terrorism (Sari, 2006).

As a result of increase in controls in Iran and Turkey, the opium smugglers route was shifted to the north that can be named as Silk Road. According to Alessandra Ceccarelli, as a result of this change;

1. because of the porousness borders and the high corruption level, there is a huge increase in narcotic trafficking and in other types of traffickings,
2. criminal activity has become the major income source of the region. So that the underground economy becomes a major issue.

Like interaction among Mexico and Colombia, there can be a similar interaction among Central Asian countries and Afghanistan. This interaction created problems in the economy of Mexico and Colombia, created huge international, political and economical difficulties (Ciotti, 2006).

Investigations of fraud and corruption of government officials and leaders sometimes occur in the region. Recent example of a public figure that has been the subject of money laundering allegations or investigations was the former Kyrgyzstan President (Bureau for International Narcotics and Law Enforcement, 2006).

Nonetheless, an anti-money laundering / counter-financing of terrorism law cannot operate without an effective public infrastructure. Judicial uncertainty, conflicts of laws and lack of enforcement tools for supervisors undermine legislative and regulatory efforts. Until the preconditions for an effective public infrastructure are in place, measures to address money laundering and financing of terrorism will be ineffective. Without support by each branch of the government, it will be difficult to implement a comprehensive legal and institutional framework for anti-money laundering / counter-financing of terrorism (IMF, 2003).

Shadow Economy

The economies of the transition countries are 'cash economies'. Their banking systems are still under construction; thus regular means of payment, such as checks, credit cards and bills of exchange, are still rarely in use. Therefore, everybody uses liquidity for payments. Control of inventories is very weak, and so this is a source for the illegal economy (Paparela, 2006).

Future Research Avenue

This study must be update periodically in order to reflect the changes in the financial system of the country. Also here, just the obstacles were discussed in briefly, but all these obstacles must be investigated separately to understand each other in a better way. And, some additional topics such as transparency of financial system and financial reporting, and transition to International Accounting Standards must be evaluated on this context.

Conclusion

The need for developed a financial system is a reality for transition countries in order to adapt market economy. Also having a strong financial system is important in order to create wealth and stability in the countries.

In general the uncertainty in political system and legal system creates the problems and by this way establishing an effective system and eliminating corruption are very hard. Firstly Kyrgyzstan must overcome these problems.

In order to support banking system, deposit insurance system must be established. Currently people do not trust in banking system.

Salaries of the governmental staff must be increased. Currently they dont earn enough to satisfy an acceptable living standard with their salaries, so that they see bribery as normal. This is the main issue. And then a combat against bribery can be successful.

Transparency must be satisfied in every governmental activity. Lack of transparency creates a corrupted environment.

Additionally, financial system security and development are very important for the global security because the financial systems of those countries are under risk with the problems of the organized crime, money laundering, and corruption as well as major threats to global security.

Unfortunately, establishing an effective financial system with its own experience and sources is really hard. So the activities of international organizations like World Bank, Asian Development Bank, NATO, various foreign direct investments to financial sector,

and efforts on integration to global financial system have positive effect on financial system developments of Kyrgyzstan. All foreign activities and assistance are very important in this context.

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