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# EURASIA EMERGING MARKETS FORUM

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Connecting  
Central Asia and  
the Caucasus  
with the World

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Johannes F. Linn

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Markets  
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# Connecting Central Asia and the Caucasus with the World

Johannes F. Linn<sup>1</sup>

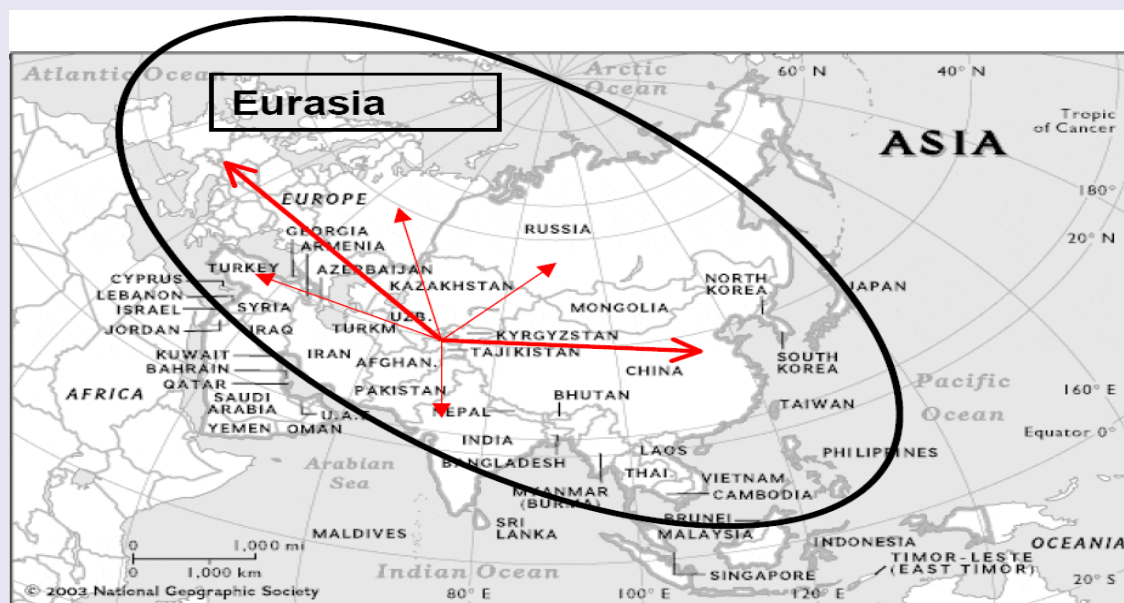
Eurasia, along with Africa, is the last big frontier of global integration for the 21st Century. While the previous two centuries were marked by rapid economic integration across the Atlantic and Pacific oceans, this century will see a catch-up across the vast continental space of Eurasia, home to a majority of the world's population and to the most dynamic of emerging market economies, and repository of much of the world's natural resource wealth.

Central Asia and the Caucasus are centrally located on this super-continent. Their development will be one of the critical factors for the effective integration of Eurasia (Figure 1). As a transit hub, as a source of energy and

other minerals, and as a potential source of stability or conflict, the role of this region is key. At the same time, Eurasian economic integration represents a major opportunity for Central Asia and the Caucasus, as it moves from being largely a land-locked region far from markets to one positioned at the core of a dynamic and rapidly connecting economic space with access to the major new markets and sources of finance, knowledge and power in the world.

The purpose of this note is to frame a range of key issues facing Central Asia and the Caucasus<sup>2</sup> and their partners in the international community for discussion at the First Eurasia Emerging Markets Forum.

Figure 1 | Central Asia and the South Caucasus at the Center of Eurasia



<sup>1</sup> Paper prepared for the First Eurasian Emerging Market Forum in Thun, Switzerland, January 23-25, 2010. The author serves as Senior Economic Adviser to the First Eurasian Emerging Markets Forum. He was formerly the Vice President for Europe and Central Asia of the World Bank and is currently the Executive Director and Senior Fellow at the Wolfensohn Center for Development at Brookings in Washington, D.C., USA. Mr. Linn also serves as Special Adviser to the Central Asia Regional Economic Cooperation Program (CAREC). This paper is adapted from an earlier version presented by the author at a preparatory meeting for the Forum on January 31-February 1, 2009 in Gerzensee, Switzerland. The author wants to acknowledge the comments of Harinder Kohli and of the participants of the Gerzensee meeting, but he remains solely responsible for the content of the paper.

<sup>2</sup> For the purposes of the First Eurasian Emerging Markets Forum Central Asia is defined to include Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan. Mongolia, Western China and Afghanistan are also treated at times as part of the geography and economy of Central Asia. These three countries are members of Central Asia Regional Economic Cooperation Forum (CAREC). For a brief summary of trends and prospects in Mongolia, see the box on p.4.

The issues explored are the following:

1. How severe is the current global financial and economic crisis and its impact on Central Asia and the Caucasus?
2. What are the implications of the Eurasian economic integration process?
3. What are the need and potential for economic integration and cooperation in Central Asia and the Caucasus?
4. How to reap maximum benefits from the region's energy and water resources for the countries in the Central Asia and the Caucasus?
5. How to facilitate trade and transit within the Central Asia and Caucasus region and with the major neighbors?
6. What can be done to improve the private business climate in Central Asia and the Caucasus?
7. Other possible issues of concern.

For each of these issues, the paper presents a brief analysis and concludes with a set of questions for discussion. It draws on a number of background papers prepared for the First Eurasian Emerging Market Forum.

### **Issue 1: How severe is the impact of the current global financial and economic crisis on Central Asia and the Caucasus?<sup>3</sup>**

During 2008 the world entered a severe economic crisis. Triggered by the sub-prime mortgage collapse in the United States following a cooling of the housing market in 2007, the emerging financial crisis quickly spread to the U.S. financial institutions and from there to the European financial markets. The emerging markets, which once had been deemed to have decoupled from the industrial market economic and financial dynamics, were also drawn into the downward spiral. As a result the major stock markets lost half or more of their

capitalization and many of the world's premier financial institutions had to draw on the support of their governments to survive.

As the financial system deleveraged itself painfully and asset values dropped, the real economies began to suffer from a lack of credit, from drops in investment, consumer and export demand, and from plummeting commodity prices. Economic growth dramatically dropped from the high levels experienced from 2003 to 2007. IMF projections for 2009 and 2010 as of October 2009 (IMF 2009) show that the growth of the world economy in 2009 will have been negative at -1.1 percent, while advanced economies are expected to contract by -3.4 percent and Russia by -7.5%. The IMF also predicts a recovery of the world economy in 2010, with world output projected to grow at 3.1%, led by the emerging market economies, especially China and India. However, there remain risks that the recovery will slow or will not be sustained.

As a sign of the changing times and shifting global economic weights, outgoing U.S. President Bush convened the first-ever G20 summit in Washington on November 15, 2008, now in effect replacing the G8 as the apex of global governance institutions. With follow-up G20 summits in London and Pittsburgh during 2009 an ambitious agenda of joint crisis response by the leading economies in the world – including counter-cyclical fiscal action, improved supervision and regulation of cross-border risk exposure of major international financial institutions, a strengthening of the International Monetary Fund and Financial Stability Forum, and an agreement to establish the G-20 summit on a permanent basis – there is hope that the new summit forum will be more effective than the G8 in the past in addressing the current economic crisis and long-term challenges facing the world (Bradford and Linn, 2009).

Between 2000 and 2008 the economies of Central Asian and the Caucasus had experienced rapid economic growth, more rapid than most other developing country regions. A combination of factors supported this outstanding performance, although to a different

<sup>3</sup> For a detailed analysis of the impact of the crisis on the region, see Mitra (2009)



degree for each country: a rebound from the severe recession caused by the break-up of the Soviet Union and by the Russia financial crisis of 1998; high natural resource prices; rapid growth of trade and investment driven in part by strong growth of China and Russia; a rapid increase in receipts from migrant remittances; and, with some notable exceptions, economic reforms and improvements in economic management.

The outstanding economic performance of the region received a jolt in August 2007, when Kazakhstan was one of the first emerging market economies to feel the impact of the incipient world financial crisis. When US and European banks pulled back from over-extended positions after the sub-prime bubble burst in the US, Kazakh banks, which had borrowed heavily in international markets, faced difficulties in refinancing themselves. This in turn slowed the economic boom of Kazakhstan, whose economy had shown signs of overheating already in 2006 with rapid wage and real estate inflation and negative real interest rates. The impact of the Kazakh economic slow-down was felt throughout much of the region, as Kazakh banks had expanded their presence rapidly through 2007, especially in Georgia and Kyrgyz Republic, and Kazakhstan had attracted migrants from the rest of the region in growing numbers.

While Kazakhstan was able to avoid a full-blown crisis in 2007 and early 2008, all of Central Asia and the Caucasus were seriously affected by the world-wide financial and economic crisis of 2008/9. Many of the factors which had driven the region's expansion until 2008 went into reverse: Energy and minerals prices dropped precipitously, China's and Russia's growth engines slowed down or reversed, migrant workers in Russia were laid off, foreign direct investment dropped off. The short war between Georgia and Russia in August 2008 created additional disruptions and uncertainties for the Caucasus sub-region at the outset of the crisis.

On average the impact of the global crisis on the Central Asia and Caucasus region was less severe than for Russia and the Commonwealth of Independent

States (CIS) as a whole (the CIS is expected to have experienced negative growth of -7 percent in 2009). But perhaps the most striking aspect of the crisis is the vastly differing impact across the region, showing what great differences have emerged among the economies of Central Asia and the Caucasus twenty years after the breakup of the Soviet Union.

Despite the substantial drop in energy prices, energy exporters in the region were less severely affected by the global crisis than energy importers, partly because the former were shielded by long-term gas price contracts and had ample reserves with which to finance countercyclical spending. Azerbaijan and Uzbekistan are projected by the IMF to have grown by some 7 percent and Turkmenistan at 4 percent in 2009, while Kazakhstan's economy declined by 2 percent due to the overhang of its financial problems. Among the energy importers, Armenia has been hit hardest, with a projected decline by 16 percent in 2009, while Georgia's economy dropped by 4 percent. Kyrgyz Republic and Tajikistan, the region's poorest countries, are expected to show growth rates of about 2 percent, better than feared at the outset of the crisis, but still a substantial drop in growth from the preceding decade and resulting in a slight decline in per capita income.<sup>4</sup>

The recovery projected for 2010 will similarly differ across countries: While energy exporters are expected to grow at over 5 percent on average, energy importers will likely grow only at some 2 percent. (IMF, 2009) Energy exporters will benefit from the recovery of oil and gas prices, while energy importers will be affected by the slow recovery projected for Russia (only 1.5 percent in 2010) and hence the lagging recovery of trade and remittances. Accordingly, the social stress caused by the crisis will continue to linger especially in the poorer countries of the region and with it political risks will continue to face many of the governments in the region.

The international community responded to varying degrees and in different ways: The IMF provided support to four countries under new or augmented

<sup>4</sup> See IMF (2009) for details.

Box  
1**Mongolia: Trends and Prospects**

Mongolia (population of 2.6 million) is wedged between China and Russia with no direct links to other Central Asian countries. Like the rest of Central Asia it experienced rapid economic growth after 2000, benefitting from the dynamism of its two neighbors. With its heavy dependence on agriculture and mineral exports, Mongolia was seriously affected by the global economic crisis, with growth in 2009 expected to have dropped to under 1 percent from 9 percent in 2008. In the face of a lingering banking crisis, drastic reductions in tax revenues and only limited fiscal and financial reserves, the country had to slash budgetary spending and turn to the IMF and other IFIs for assistance. These economic hardships compounded a political crisis following national elections in 2008, when violence erupted in the streets of the capital city. The recovery of commodity prices and the continued high growth in China are expected to higher growth in 2010 and 2011, but it may well remain in the neighborhood of 2-3 percent. One of the upsides of Mongolia's economic prospects is the recent agreement with Ivanhoe, the Canadian mining company, to develop Mongolia's copper and gold resources. However, the financial and economic benefits of the expected investments will take time to materialize and will bring with them the risks of a commodity export boom. It is encouraging that the government is exploring the establishment of a natural resource fund with the assistance of the World Bank. As part of the transport and trade facilitation action program agreed under the Central Asia Regional Economic Cooperation Program (CAREC), Mongolia expects to improve its transport and trade access to Russia and China, and through them to Central Asia and the rest of the world.

*Source: The Economist Intelligence Unit, November 2009*

programs (Armenia, Georgia, Kyrgyz Republic and Tajikistan) in 2009 and multilateral and bilateral donors offered enhanced budget support to these same four countries ranging from under 1 percent in Armenia to almost 6 percent in Kyrgyz Republic. (IMF 2009) In addition, Russia provided bilateral support to some countries in the region (esp. Kyrgyz Republic). China supported Kazakhstan with a sizeable line of credit. And donors pledged support for a large program of post-war reconstruction of Georgia. For the future, Mitra (2009) argues that more concessional funding is needed to support the poorer countries in the region and to allow them to develop and implement adequate social safety net program along with continued structural reforms for enhanced competitiveness.

The world and the countries in the Central Asia and Caucasus region now face five key questions:

1. How rapid and sustained will be the global economic recovery and how effective global action in addressing the causes of the crisis and preventing future recurrences?
2. How can the countries of Central Asian and the Caucasus countries best cope with the impact of the economic crisis in terms of policy response and in mitigating the social and political consequences?
3. How can the international community continue to help the poorest and most affected countries (especially Armenia, Georgia, Kyrgyz Republic and Tajikistan) to adjust to the crisis?
4. What will be the impact on the domestic political stability in each country?
5. How will the countries' readiness to cooperate with each other be affected by the current economic crisis?



## Issue 2: What are the implications of the Eurasian economic integration process?

The Eurasian super-continent is home to a large majority of the world's population, produces more than half of the world's GDP, contains much of the world's energy resources, and currently has the most dynamic large emerging market economies on the globe (especially China and India).

However, only with the opening up of China in the 1980s and with the disintegration of the Soviet Union in the early 1990s did Eurasia begin a process of economic integration across the huge continental economic space. Before then the self-imposed isolation of China and the Soviet Union created serious obstacles – symbolized by the Bamboo and Iron Curtains. They prevented a participation of the continent in the post-World War 2 globalization process, which instead was driven by the rapid growth of cross-oceanic links between Europe and the USA and between the USA and East and South East Asia. Now, there is a rapid catching-up taking place across Eurasia (Linn and Tiomkin, 2006).<sup>5</sup> This process of integration gives rise to great economic, political and institutional opportunities and challenges.

Key issues that arise are: how will the energy resources of Russia and Central Asia be developed, accessed and shared across the Eurasian continent, especially natural gas and hydro power; how will transport and trade be integrated across the huge land space in competition with the traditional overseas transport and trading routes; how will capital markets be integrated and how effectively will capital flows, esp. private direct investment, be distributed and accessed; how will migratory flows and remittances will be managed in the face of glaring demographic and economic differences; and how will the common threats of climate change, drug trade, conflict potential and terrorism be handled.

One of the key challenges for the great continental

<sup>5</sup> There is some debate about how rapid will be this integration process. Richard Pomfret in his background paper for the First Eurasian Emerging Markets Forum expresses some skepticism about predictions of rapid integration due to the relatively high costs of overland transport.

powers will be to frame a political and institutional framework that will allow inevitable differences in national interests to be mediated to ensure that they do not prevent mutually beneficial integration of the continent or result in open conflict. In some regards, the combination of economic and political forces which Eurasia faces today is not dissimilar to the challenge which Europe faced a hundred years ago.

Questions for further exploration include the following:

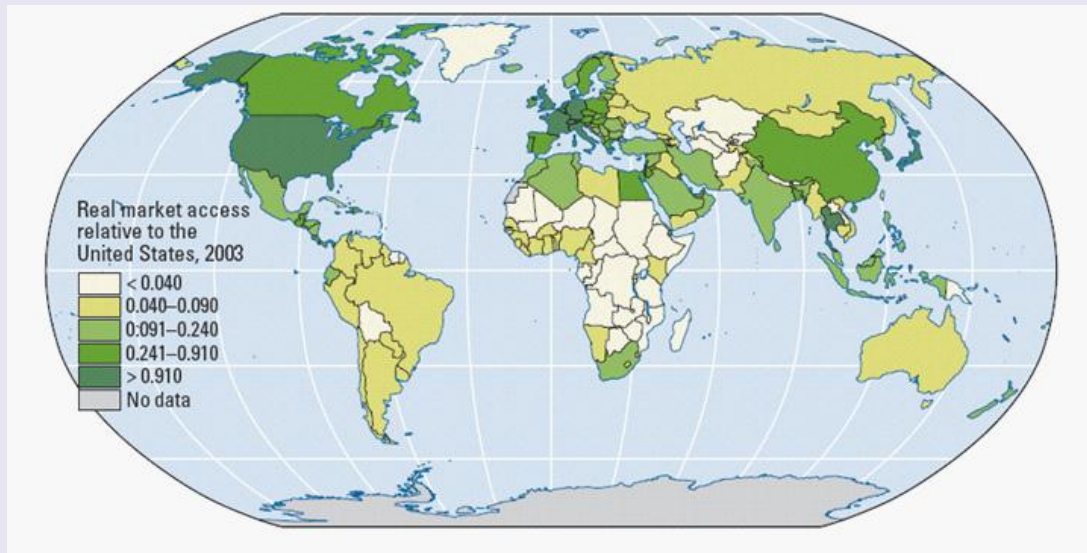
- What are the prospects for Eurasian economic integration and its significance for global economic and political development?
- What can be done to make Eurasian economic integration a productive and peaceful process?
- Are there institutional initiatives that could support the Eurasian integration process?
- What aspects of this process should future Eurasian Emerging Market Forums address?

## Issue 3: What are the need and potential for economic integration and cooperation of Central Asia and the Caucasus?

The Central Asia and Caucasus region lies geographically at the center of Eurasia. It has a population of about 80 million and is relatively poor. Its political and economic weight is quite limited. Conventional wisdom is to view the region as largely land-locked and far from seaports and hence that it faces huge, perhaps insuperable problems of access to markets. (See Figure 2 from World Development Report 2009.)

Therefore, the stability and prosperity of the Central Asia and Caucasus region is of great interest for all the major Eurasian neighbors. If it were to descend into conflict or see the emergence of failed states, this would present Eurasia as a whole with serious challenges and would certainly impede the transcontinental integration process. By the same token, the countries of Central Asia and the Caucasus can substantially benefit from their central location in Eurasia, provided they put in

Figure 2 | Global Market Access



Source: World Bank, 2008

place effective policies, physical infrastructure and institutional capacity that will allow them to expand trade with each other and with their great and dynamic neighbors and thus to develop their potential as an East-West and North-South hub.

Great barriers still stand in the way of effective trade and transit in, with and through the region, and estimates show that reducing these barriers from their current exceptionally high levels could result in significant benefits. For Central Asia the UNDP and ADB have estimated that effective regional trade integration could lead to a doubling of Central Asian GDP over 10 years. (UNDP 2005, Asian Development Bank, 2006) For this to take place each country would need to improve its own institutions and policy regime, but concerted action by all countries as part of an effort of regional cooperation would also be needed. Regional cooperation could and should take place in a number of priority areas, including not only trade and transport, but also water and energy, environment, migration, and natural disaster preparedness. (UNDP 2005)

To date, not much progress has been made in developing regional cooperation mechanisms. For Central Asia, there has been a lot of talk about fostering regional cooperation since independence and various regional organizations have been created to support these efforts (SCO, EurAsEC, ECO, CAREC, SPECA, etc.)<sup>6</sup> However, they remain mostly quite ineffective. SCO and CAREC appear to have the greatest potential for developing into effective platforms for regional cooperation. But as Martha Olcott demonstrates in her background paper for the First Emerging Markets Forum on the political economy of the region, the history and present political reality of Central Asia is such that competition among countries and leaders dominates and China and Russia generally favor bilateral arrangements. This impedes for now most regional and external efforts to create cooperative approaches and institutions.

For the Caucasus the picture is even less

<sup>6</sup> The acronyms translate into: Shanghai Cooperation Organization, Eurasian Economic Community, Economic Cooperation Organization, Central Asia Regional Economic Cooperation Program, and Special Program for the Economies of Central Asia. For a description of these organizations, including their membership and mandates, as well as a summary assessment of their see Linn and Pidufala (2008).





encouraging. The frozen conflict between Armenia and Azerbaijan over the territory of Nagorny Karabakh, the continuing tensions between Georgia and Russia and between Georgia and its breakaway provinces of Abkhazia and South Ossetia, and the closed border between Armenia and Turkey remain major obstacles to regional cooperation. Many efforts have been made also in the Caucasus to settle the conflicts and create regional initiatives and structures, but these have been at best very partial in geographic coverage and negligible in their impact. (Vasilyan 2006) The recent rapprochement between Armenia and Turkey gives some hope for an eventual thaw in their bilateral relations and an opening of their border. And new investments in infrastructure (including a railway line from Turkey to Azerbaijan through Georgia, and construction of a new road link from Georgia through Armenia to Iran funded by the ADB) are signs of possible improvements in regional economic links.

Questions for further exploration include the following:

- Is there any hope that the countries of the Central Asia and Caucasus region will cooperate with each other in significant ways in the foreseeable future?
- What are the priority areas for potential cooperation and integration and for which countries?
- What should be done if some countries stand aside and pursue policies of self-isolation and obstruction?
- What are suitable institutional responses to the need for cooperation and what lessons, if any, apply from other regions (e.g., the EU)?
- Is there anything the international community can do bilaterally or through multilateral channels to reduce the scope for conflict and help the countries turn from competition to cooperation?
- What can be learned from the Swiss experience?

#### **Issue 4: How to reap maximum benefits from region's energy and water resources for the countries in Central Asia and the Caucasus?**

The Central Asia and Caucasus region has great natural resource endowments, among them especially energy and water, but these resources are unevenly distributed across countries. During Soviet days, central planning directed and coordinated investments and use of resources across all of Central Asia, mostly for the benefit of the Soviet Union as a whole.

As documented in Martha Olcott's background paper on energy for the First Eurasian Emerging Market Forum the region's oil and gas resources were part of the integrated Soviet energy system and reached world markets through the pipeline infrastructure oriented towards the Soviet industrial heartland and Western Europe. Since the break-up of the Soviet Union, Russia has aimed and largely been able to maintain its monopoly over transit routes for oil and gas from Central Asia and the Caucasus. However, this monopoly has begun to erode in recent years as Central Asian countries have started to develop alternative transport links. The first one was the Baku-Tbilisi-Ceyhan oil pipeline, later followed by a gas pipeline partly along the same route. Kazakhstan has begun to develop oil pipelines to China, and Turkmenistan just opened a gas pipeline also to China. Other export routes are under consideration, including further routes towards Western Europe bypassing Russia (Nabucco) and towards South Asia. However, for now in the face of European bickering about a common energy security policy the major threat to the Russian monopoly over Central Asian energy transit appears to be China, rather than Western Europe or South Asia. In the long term, energy transit and markets are likely to be more rather than less integrated for the Eurasian continent as a whole, including possible overland oil and gas transport lines from the Middle East to East and South Asia. Since much of these will cross more than one border, regional and sub-regional agreements will be needed to facilitate and maintain these

energy transit routes.

The sharing of the rights to the energy resources under the Caspian Sea remains an unresolved issue among the concerned Central Asian states (Azerbaijan, Kazakhstan and Turkmenistan) as well as Iran and Russia, although this has not stopped the exploration and extraction of oil and gas from the Caspian seabed. However, the continuing uncertainties have slowed down development in some quadrants of the sea and have been a source of continuing friction among some of the riparians. A key question currently facing Turkmenistan and Azerbaijan, as well as their Western partners, is whether to develop a trans-Caspian gas pipeline that would link Turkmenistan's gas fields directly to Western markets.

Central Asia is endowed with large water and hydro-energy resources. Soviet engineers had constructed huge reservoirs in the upstream republics (Kyrgyz Republic and Tajikistan) and major irrigation schemes in the downstream republics (Kazakhstan, Turkmenistan and Uzbekistan), so as to permit the conversion of large tracts of desert into vast cotton fields. The intensive use of water from the Amu Darya and Syr Darya rivers led to the drying up of the Aral Sea in a matter of decades, causing a major ecological disaster of historic proportions. (UNDP 2005)

At the same time a regional power grid was established and allowed the region-wide distribution of hydro-electricity generated in the system. A core feature of this system was to restrict the generation and use of hydro power in the winter, so as to store up water for irrigation use in the summer. Upstream republics were rewarded for restricting the release of water – and hence power generation when they needed it most – during the winter months by the provision of gas, coal and oil fuel from the down stream republics.

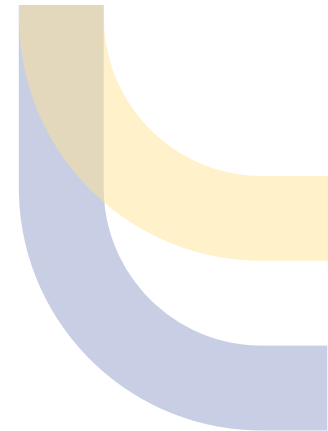
After the break-up of the Soviet Union the coordination and barter mechanisms that had kept the system operating were severely interrupted. In their place, increasingly un-coordinated activities took over and technically and economically suboptimal outcomes

prevailed, resulting simultaneously in great waste and underdevelopment of water and energy resources. (UNDP 2005, Linn 2006, Linn 2008a). Aside from the long-term issue of effective water and energy management, the breakdown in regional cooperation also created the potential for conflict among the countries about the allocation and use of water among them, especially since downstream countries discontinued the provision of free fuel supply in the winter, which forced the upstream countries to release water for hydropower generation instead, thus reducing the amount of water available to downstream countries for irrigation in the summer. So far, this conflict potential has been contained by ad hoc negotiations and agreements, but no longer-term solutions have yet been found.

An already complicated situation is further aggravated by the fact that the region faces a potential short-term crisis of water, energy and food security due to a recurring regional drought condition (Linn 2008b). Moreover, the potential impact of global warming on the region adds another layer of uncertainty and possibly serious risk, since it may threaten the survival of Central Asia's extensive glacier system and hence its supply of water for irrigation and hydro energy. (Eurasia Development Bank 2009) Pervasive shortages of water and electric power would seriously undermine the economic development of the region and could give rise to interstate conflict.

Efforts have been made by Central Asian countries, by regional organizations and by international financial institutions to support more effective and cooperative approaches to the management of water and energy resources. This includes the Aral Sea Basin Program supported by international donors; the regional water sharing agreements among key countries in the region; the regional energy strategy being developed under the auspices of CAREC (CAREC 2008a)<sup>7</sup> and most recently

<sup>7</sup> CAREC (Central Asia Regional Economic Cooperation Program) is a unique regional program in which eight countries and six international organizations participate: Afghanistan, Azerbaijan, China, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Uzbekistan; and Asian Development Bank, European Bank for Reconstruction and Development, International Monetary Fund, Islamic Development Bank, United Nations Development Program.



the efforts of the international community to assess the current threats to regional prosperity and stability from a possible crisis of water, energy and food security (UNDP 2009).

While there are great opportunities for and benefits from improved regional energy and water development in Central Asia, there are also great political, technical and financial obstacles. Ultimately governments have to work with each other, with private investors and with users to ensure effective solutions. The CAREC Energy Sector Strategy lays out the rationale and principles for cooperative development of these energy resources and identifies priority investment projects (over \$20 billion), technical assistance initiatives (\$13 million) and institution building requirements. Some key investments under the strategy are in an advanced stage of preparation, including the Central Asia-South Asia 1,000 KWh power transmission line (known as “CASA 1000”), which is expected to permit electricity exports from Kyrgyz Republic and Tajikistan to Afghanistan and Pakistan. However, recent developments have not been good: The CASA 1000 project is slow to take off due in part to security concerns in Afghanistan and Pakistan, and very recently Kazakhstan and Uzbekistan opted out of the Central Asia regional electricity grid, in effect ending one of the main regional cooperative arrangements held over from Soviet times and endangering the crucial winter supplies of power for Kyrgyz Republic and Tajikistan.

Questions for further exploration include the following:

- Will Russian efforts to maintain a monopoly over transit of Central Asian oil and gas resources succeed? Which alternative export routes – to Western Europe, to China or to South Asia – are the main alternative options?
- If regional cooperation on energy and water resource management is so important, why has so little actually happened?
- What can national and international action do to enhance the chances of cooperation in these two key areas?

- What institutional approaches might be helpful in addressing the water and energy issues of Central Asia? What lessons are available from other regions, including the experience of riparian agreements for Lake Constance and the Rhine?

### **Issue 5: How to facilitate trade and transit within the region and with the major neighbors?**

In the Soviet Union transport and trade connections, although economically inefficient, were highly integrated. After the breakup of the Union, intra-regional trade collapsed and only partially revived among the new republics following independence. At the same time, however, trade with the rest of the world picked up and developed rapidly, especially after 2000. The background paper by Richard Pomfret tracks the changes in trade relations, policies and prospects, with a special focus on Central Asia.

Three major factors combine to impede or support trade: trade policy (tariffs, non-tariff barriers, etc.), transport infrastructure and trade facilitation along the major transport routes. In Central Asia and the Caucasus, trade policy is relatively non-distortive (although there are important exceptions, esp. Uzbekistan). Transport infrastructure is generally well developed, due to heavy investments by the Soviets, but much of it was focused on connecting each republic with Moscow rather than with other republics or other neighbors. Hence there are major bottlenecks, including in connections with China, South Asia and Iran. Most important, there are serious weaknesses in trade and transit facilitation (border crossings, customs, country internal check points and harassment, weak logistics, etc.) that need to be urgently addressed. And some borders are closed entirely (Armenia/Azerbaijan) or partially (Tajikistan-Uzbekistan). According to UNDP and ADB estimates, costs and time requirements of shipping goods to and from Central Asia could be halved if standard trade facilitation practices were applied and transport infrastructure improvements

were made. (UNDP 2005, ADB 2006)

These issues are the subject of a regional transport and trade facilitation strategy and action plan which was prepared under the auspices of CAREC and approved by ministers in November 2007 (CAREC, 2008b). One of the key innovations of this strategy is to develop a network of priority corridors in Central Asia, linked with Eurasia-wide corridors, by improving transport infrastructure and trade facilitation through concerted inter-governmental action and by monitoring progress in terms of reduced costs and time requirements along the corridors.

The CAREC Implementation Action Plan for the Transport and Trade Facilitation Strategy, which was approved by ministers in November 2008 (CAREC 2008b), identifies a set of priority investment projects and technical assistance initiatives to be implemented over the next ten years for improvement of the multi-modal transport network (roads, rail, ports and air) as well as for improvements in border crossing, transit and logistics management along the priority corridors. The Action Plan also envisages an in-depth monitoring of reductions in transport cost and time along the corridors in order to ensure that the investments actually bring the intended benefits. The financing of these ambitious initiatives (\$21 billion for investments and \$69 million for technical assistance) will come from countries' own resources, from loans and grants by the multilateral institutions, and from other external financing, possibly involving public-private partnerships. An outstanding example for the kind of initiative is the planned multi-billion dollar investment in CAREC Corridor 1b, which will link Kazakhstan (and other Central Asian countries) with China to the East and with Russia and Europe to the West. Financing for this corridor is being provided by EBRD, IsDB, Japan International Cooperation Agency (JICA) and World Bank.

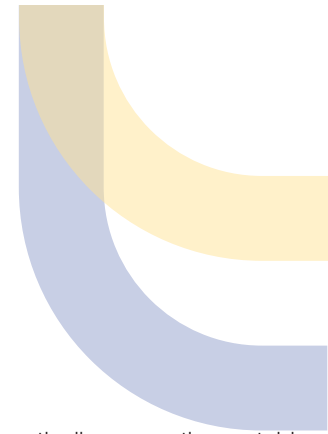
There are risks and challenges to this strategy and action plan. They relate to effective implementation, financing and development of institutional capacities. As long as governance is weak in the countries

implementation, especially of trade facilitation measures, will remain weak. And political obstacles may keep universal adoption of shared rules and practices (especially at the border crossings) from being implemented. The recent suspension by Uzbekistan of its membership in EurAsEC is a reminder of some of these difficulties.

In the case of the Caucasus no overarching regional transport and trade facilitation plan as yet exists, because of the continuing deadlock between Armenia and Azerbaijan over Nagorny Karabakh. Moreover, Turkey's borders with Armenia remain closed for now, and Georgia's trade with its breakaway provinces and Russia are severely curtailed. Bilateral improvements in transport infrastructure investments (Azerbaijan-Georgia road, Azerbaijan-Georgia-Turkey rail, and Georgia-Armenia-Iran road) are promising, but at best partial improvements in key regional transport links.

Two new aspects deserve mentioning: First, the Central Asia Strategy of the European Union which was adopted in 2007 stresses the integration of transport and trade links between Europe and Central Asia especially through the Caucasus as one of its key elements. However, as Emerson and Vinokurov (2009) point out this will require revision of the EU's transport network plan (originally developed under the acronym TRASECA) to achieve effective connectivity with the network of corridors for Central Asia developed by CAREC. Second, as Kuchins et al. (2009) point out, the recent strengthening of the Northern Distribution Network (NDN) developed by NATO for its northern supply routes to Afghanistan (as an alternative to the increasingly hazardous supply routes through Pakistan), while motivated by the needs of logistical support for NATO's military engagement in Afghanistan, may also help develop and improve the commercial transcontinental transport and trade routes from the Baltics through Russia and Central Asia to Afghanistan, as well as from the Black Sea through Georgia and Azerbaijan.

Questions for further exploration include the following:



- Is it possible for long distance transport over land to compete with shipment by sea or air? Under which circumstances, for which commodities?
- What is the right solution when some countries keep closed borders or otherwise do not wish to participate in regional schemes to enhance trade and communication?
- What are the lessons from Europe (including South-East Europe) for Central Asia and the Caucasus for improving trade, trade-facilitation and transport?
- How can transport and trade corridors be converted in economic corridors?
- How to develop public private partnership approaches to finance important infrastructure investments?
- How will the current global economic crisis and its impact on Central Asia and the Caucasus affect the investment plans for regional transport and trade facilitation?

### **Issue 6: What can be done to improve the private business climate in Central Asia and the Caucasus?**

As Dennis de Tray points out in his background paper for the First Eurasian Emerging Market Forum, most countries in Central Asia and the Caucasus suffer from the double handicap of being small and land-locked. Under these conditions, if countries want to attract private investment as a foundation for sustained growth, it is essential that their business climate is above average in order to compensate for the inherent constraints of size and locations which they face.

The countries in the region generally have a reputation of possessing a poor to very poor business climate (see, for example, UNDP 2005). And while there are some differences in rating and ranking depending on which business climate index is used, and there are considerable differences across countries in the region, the overall conclusion has to be that governments need

to focus much more systematically on creating a stable, open, business-friendly investment climate, complemented by improvements in transport and trade facilitation, energy and water infrastructure, all underpinned by overall improvements in governance.

Central Asia and the Caucasus generally have centralized and autocratic political systems in which governmental accountability and transparency are weak, civil society is underdeveloped (with the exception of Georgia and Kyrgyz Republic), the business community does not provide a strong voice for better governance, and the media do not function as an effective check on poor public sector management. As a result, their political and economic transformation, corruption and political freedom indexes are relatively poor. All of these factors feed back into a poor investment climate perception and reality for private business, both domestic and foreign. Finally, poor governance affects all the other areas and issues discussed above, since under conditions of poor governance it is difficult to manage improvements in sectoral policies and institutions and to forge strong and lasting regional cooperation arrangements. And of course, a poor investment climate in one country has negative spill-over effects in neighboring countries and hence reduces growth and diversification of the economies concerned. (UNDP 2005)

The countries of Central Asian and the Caucasus also face special problems because of their abundant natural resources. With high resource rents at the disposal of governments and/or private investors, the competition for a share of the resource endowments will be inevitable and governments will be under great pressure to act in a discretionary and even corrupt manner. (Linn 2008c) In short, high resource endowments tend to weaken governance and can easily undermine the quality of economic institutions and management. This is now generally recognized to be at the core of the so-called “natural resource curse”. Close adherence to the rules of the Extractive Industries Transparency Initiative (EITI) can help, as does establishment of natural resource funds. Some of the countries in the region

(Azerbaijan and Kazakhstan), but by no means all, are following these approaches.

Questions for further exploration include the following:

- What is the reality of the business environment in Central Asia and the Caucasus? Is it as bad as its reputation?
- What are the best ways to improve the business climate country-by-country and region-wide?
- How can private business and civil society best exert their influence to improve the business climate, public administration and governance in Central Asia and the Caucasus?
- Is the link between political system and public sector governance a strong one? I.e., can authoritarian regimes as they are prevalent in Central Asia and less so in the Caucasus, provide credible assurances that they will improve economic governance and the investment climate?
- Is there much that outsiders can do to help improve a country's governance and investment climate?

### Other Potential Issues

Central Asia and the Caucasus face other important issues.<sup>8</sup> They include the following:

1. Capital market and financial integration: The current economic crisis has shown that financial integration has costs as well as benefits. It will be a challenge for the countries in the region to manage effectively the process of further financial integration, with appropriate development and regulation of the national financial markets and institutions and with harmonization of macroeconomic and financial policies across borders.
2. Agricultural development and link to food

security: Especially the poorer countries of the region still depend heavily on agriculture. And raising the productivity of the agricultural sectors is also a major challenge for the energy exporting countries of the region as they try to diversify their economies. At the same time, more efficient use of scarce water resources, especially in irrigated agriculture, and adequate food security for their populations are important tasks for the region's policy makers.

3. The human development challenge: The republics of Central Asia and the Caucasus had relatively highly developed human capital in terms of education and health conditions, when the Soviet Union collapsed. The public education and health systems in the region have since taken a severe beating, with private providers offering only a partial and imperfect substitute. For the region's long-term development, it will be critical that education and health services are upgraded significantly.
4. Environmental, climate change and natural disaster threats: Central Asia and the Caucasus face high risks of environmental damage, much of this the legacy of the bad environmental management during the times of the Former Soviet Union and neglect of important environmental challenges. Climate change also may affect the region severely, especially through the impact on the snow cover and glaciers in the high mountain ranges, which provide for the region's life-sustaining water supply. Finally, the countries of Central Asia and the Caucasus face major natural disaster risks, especially from major earthquakes. These issues require greater domestic policy focus and stronger institutional capacity, as well as more attention at the regional level.

<sup>8</sup> Many of them were explored in the UNDP's Central Asia Human Development Report (UNDP 2005) for Central Asia.



## Conclusion

Central Asia and the Caucasus make up an important region of the world, which deserves more attention and understanding than it generally receives from the diplomatic and development communities around the globe. A stable and prosperous Central Asian and Caucasus region is a key factor for a successful integration of the Eurasian continental economy and is in the interest of all major geopolitical actors, including China, Europe, Russia and the U.S.A. This overview paper identified some key issues facing this region that represent both opportunities and challenges. Ideally, the countries would work individually and together to make the most of these opportunities. Given the many interdependencies between the countries in water, energy, transport and private sector development, among others, a cooperative approach holds many opportunities for win-win outcomes. However, as the background papers for the First Eurasia Emerging Markets Forum demonstrate many obstacles – physical, economic, governance and political – stand in the way of such cooperation. In and of itself this is not surprising or unusual. There are few examples of close and effective regional cooperation and organization around the world. Indeed, much of what we now observe in the region is the result of a sense of pride in a newly acquired national sovereignty and of a quite common competition among neighboring countries. The risk is that the unwillingness to share any aspect of sovereignty and the urge to indulge in competitive maneuvers, especially when combined with a struggle for control over shared regional resources and with poor governance and interpersonal rivalries among leaders, will create significant barriers to the natural forces of economic integration and worse yet erupt into instances of open conflict.

While the scope for external engagement in pushing for closer regional cooperation is limited, the international community can assist the countries in the region in many ways to find a suitable and sustainable path of development through appropriate national policies

and where possible regional cooperation, despite the immediate challenges of the global financial crisis and competing interests within the region and among the international partners. It will take time – decades at least –, diplomatic ingenuity, financial resources and much patience and good will if the ultimate goal of a stable and prosperous Central Asia and Caucasus region at the heart of an integrated Eurasian economic space is to be achieved.

# Annex

## Selected Social Indicators for Central Asia and the Caucasus, 2007-2008

	2008 GNI (\$ billion) (Atlas Method)	2008 Populat-ion (million)	2007 Human Develop-ment Index (Rank)	2007 Life Expect. at Birth	2007 Primary Comple-tion Rate	GNI per capita (\$ PPP)
Armenia	10.3	3.1	0.798 (84)	72	98	6,310
Azerbaijan	33.2	8.7	0.787 (86)	67	101	7,770
Georgia	10.8	4.4	0.778 (89)	71	92	4,850
Kazakhstan	96.2	15.7	0.804 (82)	66	104	9,690
Kyrgyz Rep.	3.9	5.3	0.710 (120)	68	95	2,140
Tajikistan	4.1	6.8	0.688 (127)	67	95	1,860
Turkmenistan	14.3	5.0	0.739 (109)	63	n.a.	6,210
Uzbekistan	24.7	27.3	0.710 (119)	67	97	2,660
Mongolia	4.4	2.6	0.727 (115)	67	110	3,480
Russia	1,364.5	141.8	0.817 (71)	68	99	15,636
Hungary	128.6	10.0	0.879 (43)	73	96	17,790

Source: World Bank World Development Indicators 2009 and UNDP Human Development Report 2009



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