"Connecting Central Asia with the World"

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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 is centrally located on this super-continent. Its 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 its role is key. At the same time, Eurasian economic integration represents a major opportunity for Central Asia, as it moves from being 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.

Figure 1. Central Asia at the Center of Eurasia

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The purpose of this note is to frame a range of key issues facing Central Asia and its partners in the international community for discussion at the First Eurasia Emerging Markets Forum.

The issues explored are the following:

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

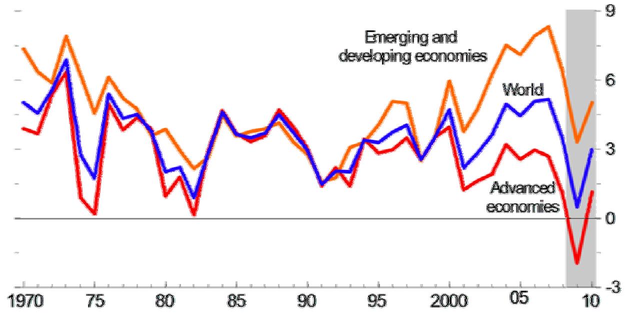
For each of the issues, the paper presents a brief analysis and concludes with a set of questions for further consideration.

Issue 1: How severe is the current global financial and economic crisis and its impact on Central Asia?

During 2008 the world entered a severe economic crisis whose depth and extent is not yet clear. 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 worlds 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. Seen against the history of the last forty years, Figure 2 shows IMF projections for 2009 and 2010 as of January 2009 (IMF 2009). These projections show that the growth of the world economy in 2009 will be down to a mere ½ percent, while major advanced economies are expected to contract at rates between -1.5 percent to -2.5 percent. China's growth is down to under 7 percent and Russia's down to -0.7 percent.

Figure 2. GDP Trends for Emerging Markets and Advanced Countries, 1970-2010



Source: IMF 2009

Expectations about the depth of the downturn and timing of recovery vary, but as of January 2009 a widely shared expert opinion is that the current recession in the advanced countries will be the worst since the Great Depression and that a recovery is not expected before 2010, and then possibly only weak. Much will depend on the policy response especially by the industrial countries, but increasingly also by the emerging market economies. So far the policy response has been at best partial, uncoordinated and with no clear impact.

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, potentially replacing the G8 as the apex of global governance institutions. With a follow-up G20 summit set for London on April 2, 2009 and 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 progress with Doha Round of WTO negotiations – 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, Linn and Martin, 2008).

Since 2000 Central Asian economies[1] have experienced rapid economic growth. (Figure 3) A combination of factors supported this outstanding performance, although to a different degree for each country in the region: a rebound from the severe recession caused by the break-up of the Soviet Union and by the Russia

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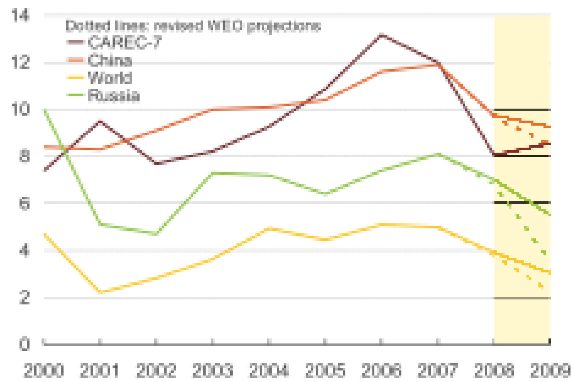
[1] For the purposes of the First Eurasian Emerging Markets Forum Central Asia is defined to include Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan. Figure 2 shows a somewhat broader definition, includes Afghanistan and Mongolia, but excludes Turkmenistan, due to the definition employed by the IMF in connection with its presentation at the CAREC ministerial conference.

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 glaring exceptions, economic reforms and improvements in economic management.

Figure 3. Economic Trends in Central Asia[2]



Source: IMF, Presentation at the CAREC Ministerial Meeting, November 2008
Note: "CAREC-7" includes Afghanistan, Azerbaijan, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan, and Uzbekistan

Central Asia's outstanding economic performance 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 overextended 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 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, Central Asia has now begun to be seriously affected by the world-wide financial and economic crisis. Many of the factors which had driven Central Asia's expansion through 2007, have gone into reverse: Energy and minerals prices

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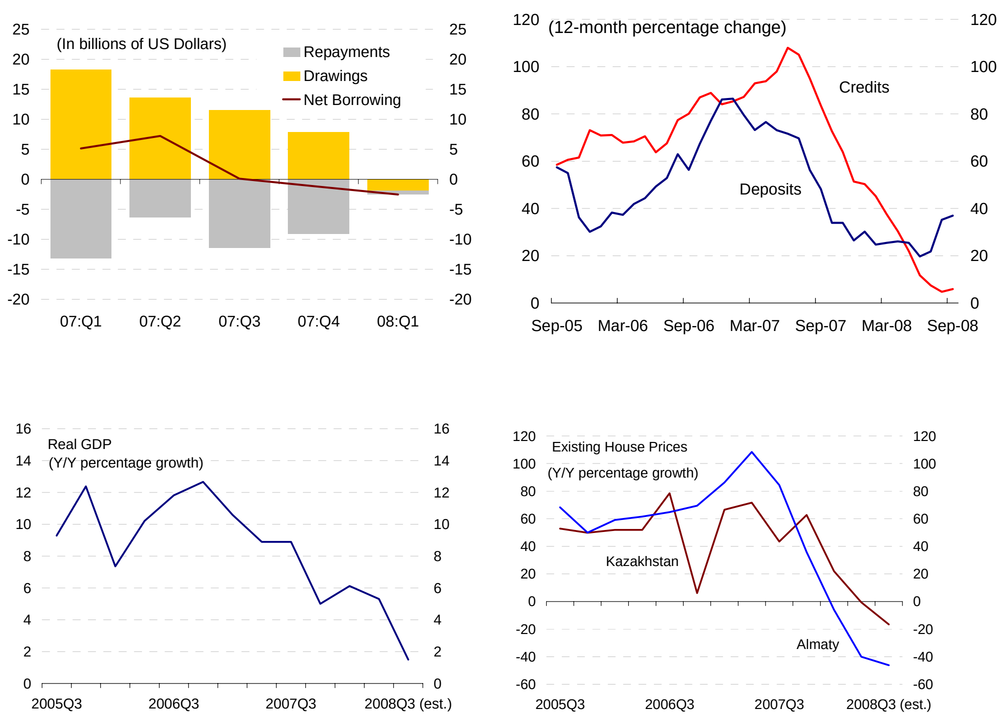
[2] Comparable country-specific projections for Central Asia in 2009 are not available at this point, but growth rates are likely to be substantially lower than in 2008 and for some countries possibly negative. The IMF projections shown in Figure 3 are as of November 2008 and do not reflect the substantial downward revisions in January 2009 (IMF 2009). Note that the dashed lines in Figure 3 represent the November 2009 projects, while the solid lines refer to projections of September 2008. As indicated in Figure 2 and in the text, the January 2009 projections for global growth are substantially lower yet than those reflected in Figure 3, including for China and Russia.

have dropped precipitously, China's and Russia's growth engines have begun to sputter, migrant workers in Russia are being laid off, foreign direct investment is dropping off. The economic situation in Kazakhstan is particularly troublesome, as its performance affects many of the other countries in the region. Its banking system gummed up, real GDP growth dropped towards zero and the real estate market went in reverse. (Figure 4) Due to its significant reserves' cushion and cautious economic management the country has been able to avert a balance of payments crisis, but significant pressures remain, especially as the world- and region-wide crisis continues to deepen.

Figure 4. Recent Economic Indicators for Kazakhstan: External Borrowing, Credit, GDP and House Prices



Source: IMF, Presentation at the CAREC Ministerial Meeting, November 2008

Other countries in the region are also affected to varying degrees. Azerbaijan, like Kazakhstan, will suffer from the loss of oil and gas revenues and of migrant remittances, and hence will see its extraordinarily high growth rates of recent years (20-30% p.a.) severely curtailed. But Azerbaijan has a cushion it its reserves and its national oil fund, which will allow it to protect its budget from drastic cutbacks at least temporarily.

Kyrgyz Republic and Tajikistan, the poorest countries in the region, will suffer most from the expected loss of workers' remittances from Russia and Kazakhstan, from the drop in demand and prices for their exports of agricultural products and minerals, and from a lack of access to private capital. Since their economies were already relatively weak to start with and they are also hardest hit by drought and electric power shortages, they have no cushion to offset the external shock and hence the combination of unfavorable events could bring them to the brink of crisis.

Turkmenistan and Uzbekistan will both lose revenues from gas exports, but since gas prices are determined by longer-term contracts they react with a lag. Uzbekistan will also see its worker remittances and non-energy exports suffer, especially for cotton. But beyond this, both countries will likely be the less affected than their neighbors, as their economies are least integrated with the region and beyond.

The international community should stand ready to assist the hardest hit Central Asian economies with counter-cyclical financial support. This is especially urgent for the two poorest countries, Kyrgyz Republic and Tajikistan. The IMF has already provided a $100 million facility to Kyrgyz Republic and is in the process of preparing a similar facility for Tajikistan. But increased official development assistance from multilateral donors (IDA, Asian Development Fund) and from bilateral donors (including from China and Russia) would also be highly desirable to help reduce the sharp economic and social impact of the global crisis in these countries.

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

1. How long and severe will the global economic recession be and will global action be effective in addressing the crisis?
2. How can the Central Asian countries best cope with the economic crisis in terms of policy response and in mitigating the social and political consequences?
3. What will be the response of the international community in helping the most affected countries (especially 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 (China, India and Russia).

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). This process of integration gives rise to great economic, political and institutional opportunities and challenges.

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

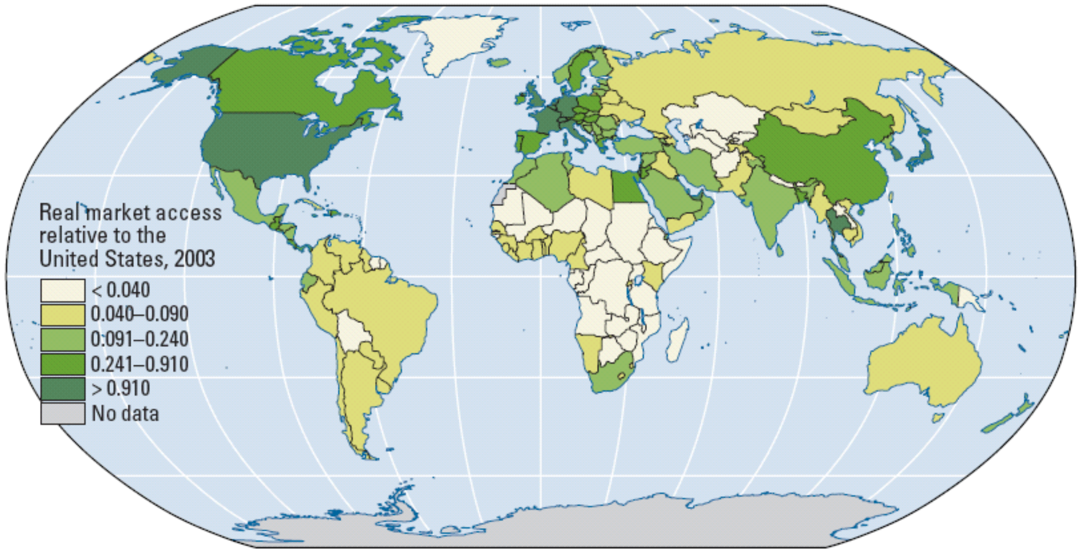
- What are the prospects Eurasian economic integration and its significance for global economic and political development?
- What can be done to make Eurasian economic integration a productive and peaceful process?
- Are there institutional initiatives that could support the Eurasian integration process?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

Issue 3: What are Central Asia's need and potential for economic integration and cooperation?

Central Asia lies geographically at the center not of Asia, but of Eurasia. It has a population of about 70 million and is relatively poor. Its political and economic weight is quite limited. Conventional wisdom has it that Central Asia is a land-locked region far from seaports and hence that it faces huge, perhaps insuperable problems of access to markets. (See Figure 5 below from World Development Report 2009)

An alternative view now gaining traction is that Central Asia is centrally located at the core of the rapidly expanding and integrating Eurasian economic space, in close proximity to China and Russia and with potential ready access to Europe, Japan and the Indian subcontinent. (Linn 2006) It potentially represents a key transit hub for Eurasian transcontinental transport, trade, energy flows, migration and illicit drug flows. Moreover, it has substantial natural resources.

Figure 5. Central Asia's Market Access



Source: World Bank, 2008

Therefore, its stability and prosperity is of great interest for all the major Eurasian neighbors. If Central Asia were to descend into conflict, this would present Eurasia as a whole with serious challenges and would certainly impede the transcontinental integration process. (Linn, 2006) At the same time, Central Asia can substantially benefit from its central location in Eurasia, provided the countries of the region pursue effective policies in support of integration with each other and with the rest of the world.

However, for Central Asia to take advantage of its potentially favorable location, the countries of the region need to invest in the necessary 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 are still in the way of effective trade and transit in, with and through Central Asia, but estimates show that reducing these barriers from their current exceptionally high levels could result in a doubling of Central Asian GDP over 10 years. (UNDP 2005, Asian Development Bank, 2006) This would require action by each country, but would also benefit greatly from concerted action by all Central Asian countries as part of an effort of regional cooperation.

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)

Some efforts at regional cooperation have been made in the last 10 years and various regional organizations have been created to support these efforts (SCO, EurasEC, ECO, CAREC, SPECA, etc.)[3]. However, they remain mostly quite ineffective. Significant efforts would be needed to convert them into an effective institutional framework supporting regional cooperation and integration of Central Asia. SCO and CAREC appear to have the greatest potential for developing into effective platforms for regional cooperation. Countries also differ in their readiness to cooperate: Kazakhstan, Kyrgyz Republic and Tajikistan are the countries most ready to cooperate, Turkmenistan and Uzbekistan traditionally have kept more to themselves. Azerbaijan's focus has generally been more towards Western Europe, rather than Central Asia to the east.

Questions for further exploration include the following:

- Is there a shared sense in the region and beyond that integration and cooperation are key elements of a Central Asian development strategy?
- What are the priority areas for cooperation and integration?
- 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)?
- What can be learned from the Swiss experience?

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

Central Asia 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 regards oil and gas, Central Asian 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. However, this monopoly has eroded in recent years as Central Asian countries have begun to develop alternative transport links. The first one was the Baku-Tiblisi-Ceyhan oil pipeline, later followed by a gas pipeline following partly the same route.

[3] 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).

Kazakhstan has begun to develop oil pipelines to China, and Turkmenistan is investing in 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 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 over-land 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.

As regards water and hydro-energy resources in Central Asia, Soviet engineers 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.

At the same time a regional power grid was established and allowed the region-wide distribution of hydroelectricity 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 potentially 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. 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)[4]; and most recently 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, forthcoming).

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, which is expected to permit electricity exports from Kyrgyz Republic and Tajikistan to Afghanistan and Pakistan.

Questions for further exploration include the following:

- Will Russian efforts to maintain a monopoly over transit of Central Asian oil and gas resources reduce the ability of Central Asian producers to

[4] 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.

benefit from their energy wealth? Are alternative export routes a real option?

- 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?
- How will the current global economic crisis and its impact on Central Asia affect the investment plans for regional transport and trade facilitation?

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

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, 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. 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 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. Planning for this corridor is far advanced with financing expected from ADB, EBRD, IDB, 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, esp. of trade facilitation measures, will remain weak. And political obstacles may keep universal adoption of shared rules and practices (esp. 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.

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 for improving trade, trade-facilitation and transport?
- How can transport and trade corridors be converted in economic corridors? Should this be an explicit goal of government?
- 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 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?

Central Asian countries generally have a reputation of possessing a poor to very poor business climate (see, for example, UNDP 2005). Taking a simple set of readily available data on net foreign direct investment (FDI) and specific, survey-based business environment indicators (Table 1) drawn from the World Bank's World Development Indicators show an apparently more differentiated picture. First, with the exception of Azerbaijan for special, one-off reasons in 2006, net foreign direct investment flows in Central Asia are not uniformly low. What these data do not reveal however is that much of the foreign investment is in natural resource extraction and processing industries (oil, gas, gold and aluminum) rather than in broadly diversified economic enterprises. Second, survey-based indicators of regulatory, corruption, informality and trade obstacles show a diverse picture across Central Asian countries, which overall do not necessarily score worse than Russia or even Hungary. Third, only in the areas of finance and infrastructure is there a clear picture of Central Asian business being generally and clearly worse off than Russian and especially Hungarian business (although Kazakhstan is close to or better than Russia even on these scores).

So why is it that Central Asian countries have generally a poor reputation when it comes to the business climate. The reasons vary from country to country: Turkmenistan has virtually no private business to speak of, and Uzbekistan's private business sector is also heavily regulated and constrained by the government in terms of access to licenses, trade, finance and foreign currency.

Table 1. FDI (2006) and business environment survey data (2005) for Central Asia

	Foreign Direct Investment (Net inflows as % of GDP)	**Regulations and taxes** (% of management time dealing with officials)	**Corrupt-ion** (% of firms making unofficial payments to public officials)	**Finance** (% of firms using banks to finance investments)	**Inform-ality** (% of firms that do not report all sales for tax purposes)	**Trade** (Average no. of days needed to clear exports through customs)	**Infra-structure** (% of sales lost due to power outages)
Azerbaijan	-2.9	5.2	37.8	0.6	38.7	1.6	5.9
Kazakhstan	7.6	3.1	45.1	15.4	23.2	6.8	2.2
Kyrgyz Rep.	6.5	6.1	66.3	7.9	43.2	4.1	4.1
Tajikistan	12.0	3.3	45.7	1.0	34.5	5.4	7.3
Turkmenistan	7.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Uzbekistan	1.0	2.5	36.8	3.3	14.6	5.1	8.7
Russia	3.1	6.3	59.9	10.2	40.3	8.2	2.0
Hungary	5.4	4.0	32.1	22.3	40.0	4.5	1.4

Source: World Bank, World Development Indicators 2008

This is why these two countries score very poorly on the EBRD's transformation reform indexes (Table 2), in particular the "2nd phase" reform index, which reflects improvements in the private business environment as a compound measure. Kazakhstan and Kyrgyz Republic generally are much further along in creating appropriate private sector rules of the game, as reflected in the better EBRD reform index scores, comparable to those of Russia, but much behind Hungary as comparators. Tajikistan falls half way in between.

More generally, Central Asian countries generally have centralized and autocratic political systems in which governmental accountability and transparency are weak, civil society is underdeveloped (with the exception of 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. (Table 2) All of these factors feed back into a poor investment climate perception and reality for private business, both domestic and foreign. Moreover, one of the key realities which Central Asia faces is this: Given its location and as yet poor connectivity to major markets, it will have to do better on the business environment than its competitors with better market access, if they are to compete effectively. 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)

Table 2. Central Asia's Reform and Governance Indicators

	Reform (1st Phase market "enabling" reforms) 2007 EBRD	**Reform** (2nd Phase market "deepening" reforms) 2007 EBRD	**Political And Economic Transformation Index** 2008 BTI (rank)	**Corruption Perception** 2007 TI (rank)	**Political Freedom** 2007 FH (polit. rights/civil liberties)
Kazakhstan	3.89	2.89	5.53 (68)	2.1 (150)	Not free (6/5)
Kyrgyz Rep.	4.22	2.67	5.80 (63)	2.1 (150)	Part. free (5/4)
Tajikistan	3.66	1.89	3.80 (106)	2.1 (150)	Not free (6/5)
Turkmenistan	1.89	1.00	3.34 (115)	2.0 (162)	Not free (7/7)
Uzbekistan	2.66	2.11	3.68 (111)	1.7 (175)	Not free (7/7)
Russia	3.77	2.89	5.94 (59)	2.3 (143)	Not free (6/5)
Hungary	4.33	4.00	9.18 (5)	5.3 (39)	Free (1/1)
Range/ Total #	(from 1 to 4+)	(from 1 to 4+)	(125)	(180)	(193)

Sources: EBRD, Bertelsmann Foundation, Transparency International, Freedom House

Central Asian countries 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 can help, as does establishment of natural resource funds. Some of the Central Asian countries, 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? Is it as bad as its reputation?
- What are the best ways to improve Central Asia's 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?
- 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, 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 faces other important issues. Many of them were explored in the UNDP's Central Asia Human Development Report (UNDP 2005). They include the following:

1. <u>Capital market and financial integration</u>: 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. <u>Agricultural development and link to food security</u>: 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 scare water resources, especially in irrigated agriculture, and adequate food security for their populations are important tasks for the region's policy makers.
3. <u>Central Asia's human development challenge</u>: Central Asian republics 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. <u>Central Asia's environmental, climate change and natural disaster threats</u>: Central Asia faces 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 Central Asia 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, Central Asia faces major natural disaster risks, especially from possibly major earthquakes. These issues require greater domestic policy focus and stronger institutional capacity, as well as more attention at the regional level.

5. Political and geopolitical aspects of Central Asia's development: Central Asia's political systems are characterized by autocratic governments with strong presidencies, weak parliaments and an absence of independent parties who could compete for political power in a democratic contest. China and Russia support the stability of the existing political systems, while the European Union and the US would like to see a transition to more democratic forms of governance, not least because of fears that continued autocratic systems would in the long run lead to instability and conflict. How a process of political transition could be achieved without destabilizing the countries in Central Asia is however unclear. Moreover, the EU and US would like to see improved access for their military engagement in Afghanistan through Central Asia, while China and Russia have an interest in keeping EU and US military presence in a region to a minimum. Finally, there is competition for access to and control over the natural resources of the region. Therefore, while all international partners have a shared long-term interest in a stable and prosperous Central Asia region, in the short to medium term the interests of the various partners diverge and have to be managed in a way that doesn't exacerbate the potential for instability and conflict in the region.

Conclusion

Central Asia is an important region of the world, which deserves more attention and understanding than is often given by the diplomatic and development communities around the globe. A stable and prosperous Central Asian 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 paper identified some key issues facing Central Asia that represent both opportunities and challenges. It is critical that Central Asian countries work individually and together to make the most of these opportunities. Given the many interdependencies between Central Asian countries in water, energy, transport and private sector development, among others, a cooperative approach holds many opportunities for win-win outcomes. The international community can assist the countries in the region in many ways to find a suitable development path that will put them on a sustainable path of development through cooperation, despite the immediate challenges of the global financial crisis and at times competing interests within the region and among the international partners.

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Annex Table: Selected Social Indicators for Central Asia, 2005

	GNI 2007 $ bil.	Popul-ation 2007 (mil.)	Human Development Index	Life Expectancy (years)	Gross Enrolment Ratio (%)	GDP per capita $ PPP
Azerbaijan	21.9	8.6	0.746 (98)	67.1	67.1	5,016
Kazakhstan	78.3	15.5	0.794 (73)	65.9	93.8	7,857
Kyrgyz Rep.	3.1	5.2	0.696 (116)	65.6	77.7	1,927
Tajikistan	3.1	6.7	0.673 (122)	66.3	70.8	1,356
Turkmenistan	n.a.	5.0	0.713 (109)	62.6	N/A	3,838
Uzbekistan	19.7	26.9	0.702 (113)	66.8	73.8	2.063
Russia			0.802 (67)	65.0	88.9	10,845
Hungary			0.874 (36)	72.9	89.3	17,887
Total #		67.9	(177)			

Source: World Bank World Development Indicators 2009 and UNDP Human Development Report 2007/8