02/04/04

The Economic Outlook for Eurasia: From Transition to Sustained Growth and Integration?[1]

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February 2004

Introduction

15 years have passed since the start of the transition from Communism to democracy and market economics in the countries of the former Soviet Empire. Looking back, it seems like a short time span that has brought many and major changes to the region. One profound change was that as the Soviet Union and its political and economic empire disintegrated the divide which had stretched across Europe and through Turkey into South-Western Asia also disappeared. This permitted an old, long forgotten geographic concept – "Eurasia" – to gain new currency and meaning with profound economic and political significance. The peaceful and prosperous integration of the countries and economies of Eurasia is now a real hope after many decades of forced separation which had followed on many centuries of uneven economic and social development punctured by painful wars spilling across countries and continents.

The purpose of this paper is briefly to take stock of the economic outlook of the Eurasia region, with a special focus on the Former Soviet Union, Turkey, as well as Central and South Eastern Europe. These countries represent the part of Eurasia that was left behind in the spurt to prosperity and democracy which benefited Western Europe, North America and Japan during much of the 20th Century. The isolation and misdirected economic management under Communism and, in the case of Turkey, the legacy of the failed Ottoman Empire and the incomplete modernization and transition of the country under Ataturk and his successors had caused these countries to fall behind their Western neighbors. The question is now whether these countries have firmly embarked on a path towards sustained economic growth after a process of painful transition following the collapse of the Soviet Empire and the reintegration of economic space in Eurasia.

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[1] This paper is based on and updates a presentation made by the author at the "2nd Annual Eurasia Summit on Economic Development, Energy & Regional Security" organized by the Business Council for the United Nations, Eurasia Group and UNDP Grand Hyatt Hotel, New York City, on 24 September 2003

The short answer to this question is that after nearly a decade of economic collapse and social stress, there are now overall good prospects for this region and its population of about 500 million. It recently has been one of the most dynamic regions of the world in terms of economic growth with an average annual per capita income growth rate of about 4-5% over the last four years, even as recession gripped much of the rest of the world. Prospects for continued economic growth in the region remain also strong. At the same time, with a few unfortunate exceptions, there is now peace in the region. And democracy, while still a work in progress in many countries, has perhaps a greater chance to succeed in the long term than ever before. One of the main drivers of this positive development has been the great pull exerted by the European Union, with its prospects of enlargement for many Eurasian countries now much enhanced. And even for those that cannot or do not aspire to membership in the EU, the example of EU institutional and political development and many of the European, transatlantic and global institutions (the OSCE, the Council of Europe, NATO, WTO, the Bretton Woods Institutions, etc.) exert a strong pull on the countries in the Region for economic and institutional modernization, integration and peaceful democratic development.

Of course, there are many challenges and risks which the countries in Eurasia face in bringing about a prosperous, peaceful future. Since the region is highly heterogeneous, and hence since the opportunities and challenges vary significantly across countries, it is best to look briefly at individual countries and sub-regions to get a better sense of what is the outlook one-by-one and then assemble the pieces of the puzzle into one big picture.

Russia

Russia's economic recovery since the financial crisis in 1998 has been buoyed by persistently high oil prices, but also by the cumulative impact of 15 years of economic reforms and recent political stability. Since 1998 the Russian economy has grown by about 30 percent and in 2003 it notched up an excellent 7.3% growth of GDP. High oil prices, the effects of a drastic devaluation in 1998 and the ability to employ underutilized capacity explain much of this dramatic recovery. But business surveys (such as the so-called BEEPS surveys conducted by EBRD and the World Bank) also show a notable improvement in the perception of the investment climate in Russia since 1999, which helps explain the reflow of capital and a recent revival of investment (albeit still heavily concentrated in the natural resource industries). With personal income growth even outstripping sustained high economic growth, per capita consumption is now estimated be exceed its 1990 level by 20% and a new middle income class is emerging rapidly.

Continued economic and institutional reforms are needed, if Russia is to maintain its strong economic performance of recent years. Further improvements in the business climate through civil service reform and improved governance at the federal, provincial and local levels are essential, as are reforms of the banking sector, infrastructure rehabilitation (including IT infrastructure) and modernization of education and health services. Early accession to the WTO is another important factor. President Putin has made it clear that he aims to maintain strong economic growth and can be expected to revive economic reforms by mid-2004, after the current parliamentary and presidential election cycle is completed. Perhaps the biggest challenge for Russia in the longer term is the establishment of firmly democratic institutions, of secure property rights, of effective legal and judicial bodies and of an efficient, honest and impartial civil service at the national and sub-national. Without such changes, economic growth – while sustainable for the near term, especially with continued high oil prices – will likely falter in the longer term.

Given Russia's size and centrality for many of its neighbors, a buoyant, stable and democratic Russia will be essential for the economic and political integration of Eurasia. The recent efforts to create a common economic area between Russia, Ukraine, Belarus and Kazakhstan can be seen as an initiative to promote regional cooperation and integration. Past efforts of this kind (including the Commonwealth of Independent States) have not been successful in creating a common economic space. Much will depend on whether Russia can convince its neighbors that its intentions are non-hegemonic and that it is not aiming to set up a regional trading block which will prevent its members to seek closer cooperation with the EU and integration with the world economy.

Ukraine

In many ways Ukraine's good economic performance over the last four years has presented the greatest surprise to those following developments in the region. Ukraine's sustained annual economic growth of 5% or more, in the absence of large energy resources and despite still low ratings on most comparative indicators of good governance, shows a surprising turn-around in economic fortunes. Among the reasons for this unexpectedly good performance are the strong Russian economic growth, the cumulative impact of domestic economic reforms, increasing political stability and predictability in economic management (even as the domestic political situation remains often murky for the outsider) and Ukraine's increasingly solid orientation towards the EU. One much under-appreciated fact about Ukraine is that Kiev has become one of the most attractive cities in Europe!

The economic prospects for Ukraine are good, if continued reforms (including WTO accession, improvements in governance and continued orientation towards the EU) are combined with political stability in the run-up to and following the presidential elections in 2004. As for Russia, there are, however, downside risks for the longer term. Continuing internal divisions between east and west of the country, tensions between democratic and non-democratic forces, and the pervasive corruption which still hampers the business climate and life of the average citizen, are all factors that can still derail Ukraine's progress with political and economic reforms. The outcome of the current constitutional debate and of the next presidential election will be the weather vane that will tell whether democratic and economic progress will continue or whether serious detours and set backs must be considered likely.

Other CIS Countries

Many of the smaller CIS countries were especially hard hit by the disintegration of the Soviet Union and by the collapse of the Russian economy in the wake of the financial crisis of 1998. But most have also shared in the economic recovery of the Eurasia region over the last four years, partly because of Russia's revival, but also because of their domestic economic reforms and their gradual integration with the world economy. However, future prospects for these countries are mixed.

Among the positive surprises are Armenia, Azerbaijan, Kazakhstan and Tajikistan, where economic reforms and political stability have combined with improved regional economic conditions to produce significant economic turn-around and reasonable prospects. Among the more disappointing performers for varying reasons are Georgia, Moldova, Uzbekistan and, of course, the continuing outliers and non-reformers, Belarus and Turkmenistan.

A number of cross-cutting factors will determine the medium term outlook of these countries:

- Settlement of regional conflicts: Central Asia's prospects would be much enhanced by peace in Afghanistan and Iraq and by normalization of the international relations of Iran, as well as by improved cooperation among the Central Asian countries themselves. Settlement of the Armenia-Azerbaijan conflict over Ngorno-Karabakh and of the division of Georgia with Abkhazia would help regional development in the South Caucasus. Settlement of the Trans-Dnistria conflict would help Moldova's development and regional integration with Urkaine. International political support for the settlement of these conflicts will be essential.

- Economic and governance reforms: Continued improvements in economic management and especially improvements in governance (including transparency in the management of natural resources) are critical. The recent peaceful political change in Georgia holds out some hope that the internal divisions and corrupt management of the country can now be turned around, but the economic and political challenges facing the new President and his government are severe. The oil and gas wealth of Azerbaijan and Kazakhstan and the recent introduction of oil funds in Azerbaijan and Kazakhstan bode well for continued sound economic management and prospects in both countries, but the long-term outlook for democracy and good governance and hence for political and economic stability remain uncertain.. For Central Asia, economic reforms in Uzbekistan are essential, given the size and central location of Uzbekistan, and the fact that its current restrictive economic policies severely inhibit regional trade and cooperation.

- Access to world markets: Most of the smaller CIS countries are still isolated from world markets by a combination of land-locked and remote location, poor domestic policies, lack of transport infrastructure and regional cooperation, and lack of access to industrial country markets, esp. the EU. EU trade policies remain unfavorable towards these countries, esp. as regards agricultural trade. The future of these small countries will to a large extent depend on peaceful and effective integration of their economies with each other and with the rest of the world.

Turkey

During the last 12 months Turkey has been able to overcome many of the symptoms of its economic and financial crisis that have plagued the country in recent years. Economic growth has revived, inflation and real interest rates have dramatically declined, and the prospects of peace in Iraq, improved relations with Syria and enhanced domestic political stability since the national elections in late 2002 have improved the outlook for continued financial stabilization and economic growth. However, the country still faces major challenges that, if not addressed, may yet derail the recovery and improved prospects.

- Iraq: As long as the security and economic situation in Iraq remains unsettled, Turkey will not be able to normalize its trade with this important neighbor, and there will remain the perceptions and the reality of security risks, as well as risks of continued confrontations over the issue of the Kurdish minority and of possible frictions with the US and the EU.

- Economic and financial risks: Turkey has a long history of stop-go reforms and of recurrent economic and financial crises. Only persistent fiscal, structural, social and governance reforms will address the underlying causes of this instability. The program of the current government is generally pointing in the right direction, and with its clear majority in parliament it has the political clout to implement reforms quickly and effectively. But progress with key structural and social reforms has so far been uneven, possibly because of diverging interests within the governing AK party and because of the lack of a strong cohesive leadership in the economic sphere.

- EU accession: The prospects of eventual EU accession have been much enhanced by the decisions taken at the EU Summit in Copenhagen late in 2002, by the government’s fast pace of domestic political reforms and by a recently improved outlook for a timely settlement of the Cyprus issue. However, the risk of failure to reach a settlement in Cyprus, uneven progress in the economic domain, an unfinished political reform agenda, and continuing deep divisions within the current EU about the prospects of Turkish accession, all imply that the prospects for a positive decision about the start of membership negotiations in late 2004 remain uncertain for now.

- FDI: Turkey has an extraordinarily poor track record in attracting FDI, considering its favorable location relative to European markets and its well developed private sector. This has many causes, not least the investor perception of regional security risks, of poor governance and high corruption, and of an inhospitable local business community. The current government has vowed to change the reality underlying these perceptions and open up the country to foreign investors. Progress in this area will be a major indicator of progress with economic reforms and EU integration.

The Balkans

Compared to 3-4 years ago, and even more so, compared to 8-10 years ago, the political and economic outlook in the Balkans has greatly improved. The political changes and ensuing economic reforms in Serbia and in Croatia in 2001 in particular have led to a quantum leap in the prospects of the region, reinforced by the salutary effects of the South East Europe Stability Pact. The decision of the EU to offer the Balkan countries a long-term perspective of eventual EU membership provides an essential umbrella of political stability and an incentive for economic and governance reforms that will, as elsewhere in Central Europe in the last decade, help propel governments in the right direction of regional cooperation and improving the business climate.

There are, however, still substantial risks in the short to medium term: The unsettled territorial and political status of Kosovo, the continuing domestic political uncertainties in Serbia (and the as yet uncertain prospects of the union of Serbia and Montenegro), and the legacy of the Bosnia conflict and of the Dayton Agreement which have burdened Bosnia and Herzegovina with a huge liability of unresolved governance problems – these are key issues yet to be addressed by each country and by the international community, the sooner the better! Additional challenges arise out of the unfinished economic and governance reform agenda in the region and the continuing difficulties of the region to access EU markets, especially for agricultural products. As long as these risks and challenges hang over the region, regional economic prospects, security and integration with European markets will remain uncertain.

The EU Accession Countries of Central Europe

Although by now taken largely for granted, it is an extraordinary historical development that eight Central European countries, including three former republics of the Soviet Union, will joint the European Union in May 2004. If one further considers that Bulgaria and Romania probably, and Croatia possibly, will accede to the EU by 2007, and this within less than 20 years after the Iron Curtain fell, one can only be amazed by the extraordinary progress and success of the transition from command to market economy, and from dictatorship to democracy in Central Europe.

Even before EU accession, foreign investors already grasped the opportunities which this transition has offered them, with FDI rates in recent years in this region exceeding those in most other emerging markets. It was only natural for investors to take advantage of the rapid improvements in these countries' business climate and in their financial institutions, of their highly educated, but still relatively cheap labor force, and of the ease of access to Western markets with the prospects of early integration into the unified EU markets.

Looking forward, however, Central European countries face big challenges, each of which also represents an opportunity. Depending on whether or not Central European countries, their governments and their people can respond effectively to these challenges and opportunities over the next ten years or so, they will be able to replicate the extraordinary successes of Finland and Ireland – relatively recent members of the EU that have been able to convert their rather backward economies into highly dynamic and successful modern knowledge economies. Alternatively, if Central European countries fail to respond, they will stagnate, at least in relative terms, and stay behind the pack, as have Greece and East Germany in the recent past.

Briefly, the challenges – and opportunities – are the following:

- <u>EU constitutional reform</u>: The new member countries have an opportunity to influence the expected new constitution of the EU and to ensure that the decision making processes and institutions of the new, enlarged EU function effectively and credibly. The disappointing outcome of the Brussels Summit in December 2003 attests to the difficulties which the enlarged EU will face with consensus formation and decision making.

- <u>EU economic performance</u>: The new member countries will be much affected by the overall economic performance of the EU. To a significant extent this will be determined by the ability of the larger members of the EU, esp. Germany, to carry out much-needed structural reforms and to maintain a prudent fiscal and monetary policy mix that limits undue indebtedness and keeps interest rates low.

- <u>Continued economic transformation in the new member countries</u>: Many of the new member countries, esp. the larger ones, are burdened by old industries and relatively large rural sectors, by high unemployment and inflexible labor markets, by high and rising social spending requirements for an aging population, by significant infrastructure investment requirements and by potentially huge environmental liabilities. Making the structural, social and environmental reforms and investments, while also maintaining a prudent fiscal stance, will be difficult and politically challenging. The influx of large financial transfers from the rest of the EU to the new and poorer members will help in making the needed investments, but this also requires the creation of the institutional capacity needed to absorb these funds effectively, a capacity which so far remains underdeveloped. Finally, managing the fiscal stresses which especially the larger accession countries, Hungary and Poland are under, with record budget deficits and rising debts, will be a major challenge.

- <u>EU external economic policies</u>: The new member countries have an important opportunity to influence the approach of the EU towards "Wider Europe" – as the neighbors to the East and South of the enlarged EU are now increasingly referred to – and towards important global economic issues, such as the WTO negotiations (and especially the EU's agricultural policy), the international debate on the global financial architecture, and international support for the economic and social transformation of the developing world with a view to reducing global poverty and disparities.

Concluding observations

Looking back over the last 10-15 years of political, economic and social transformation in Eurasia, one can only marvel at the overall progress and success that are now becoming apparent, after the painful and difficult political disintegration and transition recession which gripped the entire region during the early years – and for some during much of the 1990s. The countries themselves and the international community can take some justified pride in the achievements of the transition process in Eurasia. The prospects for continued progress of peaceful integration and continued economic growth are good for now, especially as the largest countries of the region – Russia, Turkey and Ukraine – are set to continue their recent recoveries and as the Central Europeans are set to join the European Union.

Of course, progress and prospects are not uniform across the region, as the preceding detailed discussion has shown. In particular, at a time when the world now understandably focuses on Afghanistan, Iran and Iraq, it is important to remember that the belt of countries from the Balkans through the South Caucasus and Central Asia still represents major challenges, as a number of temporarily "frozen" regional conflicts and a number of potential failed states could turn into major sources of regional and global instability very quickly.

Moreover, many challenges remain for the countries of the region and for the international community. Among these challenges three stand out:

- First, the need for each country to ensure the appropriate fundamentals of economic policy and democratic governance and to foster regional economic cooperation, so as to create a favorable business environment for foreign and domestic investors alike.

- Second, the need to continue the process of integration of the Eurasian economy after the collapse of the Soviet economic empire and the disappearance of the divide between East and West. This requires efforts on the part of the enlarged EU not to let a new divide grow on its eastern border, and efforts of cooperation among all the countries with their neighbors, whether in Central Asia, the South Caucasus, and in the Balkans. Above all it will require the existence of a peaceful, prosperous, stable and democratic Russia which acts as a good neighbor across the two continents.

- Third, the need for the international community to provide continued support, especially to the smaller, and economically weaker countries, to help ensure an early settlement of still potent regional conflicts and to support the economic and social recovery of these countries, many of which are still among the poorest of the world, especially in the Balkans, the South Caucasus and Central Asia.