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Chapter for JETRO Report on:
“The New Geopolitical Reality of Central Asia and the Caucasus
and Prospects in Economic Dimensions”

Part 3: Keys to the Future Economic Development in Central Asia and the Caucasus

The Prospects for Long-Term Economic and Social Stability in Central Asia and the South Caucasus

Introduction

From 1991 until the terrorist attacks of September 11, 2001 in the United States, the states of Central Asia and the South Caucasus were often considered by U.S. and other international policymakers as a single geographic unit. Along with Russia and Iran, they are part of the broadest extension of the Caspian Sea Basin. They are crossroads for transportation and communication between Europe and Asia, and between Russia and the countries of the Middle East and South Asia. They shared a common political and economic development as part of the Soviet Union for more than seventy years. And, after the dissolution of the USSR, they all emerged as independent, but fragile states, with nascent national identities and a staggering array of challenges in creating new political and economic systems. Although Central Asia and the South Caucasus share a common set of problems, they are also two very sharply distinct regions with their own external and internal dynamics. Even within the shared Soviet space the regions had different histories and cultures and, today, each country must contend with its own particular challenges in its own way.

The transition from the Soviet command economy and authoritarian political system has been much more complex and difficult than anticipated for Central Asia and the South Caucasus. The Central Asian states were the poorest and least developed in the USSR, and both sets of states had to begin almost from scratch in their development in the 1990s. Progress in market reforms, institutional development, and democratic reform has been limited. Attempts at macro-economic reform have led to economic stabilization but have not been matched by local-level developments. Thanks to extensive borrowing from international financial institutions, reforms have saddled regional states with high and unsustainable debt burdens. Governments are weak, poorly committed to economic reform priorities and reluctant to engage in political or sub-regional reform efforts. Instability in Central Asia, the risk of failing to consolidate peace in Afghanistan, and intractable ethnic conflicts in the South Caucasus threaten further progress.

The prospects for long-term economic and social stability in Central Asia and the South Caucasus are, therefore, uncertain. They are dependent on the governments' and the international development community's ability to capitalize upon the inter-linkages and dependencies within and between the two regions while, at the same time, acknowledging the states differences when responding to individual needs and circumstances.

The Challenges of Independence

Before 1991, the states of Central Asia and the South Caucasus were marginal backwaters, republics of the Soviet Union that played no major role in the relationships among the principal regional powers of the USSR, Turkey, Iran, and China. Nor, unlike Ukraine or the Baltic States, were they a factor in the Cold War relationship between the USSR and the United States. But in the 1990s, the collapse of the Soviet Union coincided with the re-discovery of the energy resources of the Caspian Sea, and engendered a series of violent political upheavals. Increasingly over the last decade, the states of Central Asia and the South Caucasus have gained international attention as zones of great power competition and conflict.

The exploitation of Caspian Basin energy resources attracted the attention of a range of international oil companies, including American majors, and eventually became a point of tension in U.S.-Russian relations. Secessionist conflicts in the South Caucasus, civil war in Tajikistan, two wars in Chechnya, and faltering political and economic reforms provided a fertile ground for the germination of radical and militant groups, as well as the infiltration of foreign Islamic networks. As the casualties in conflicts and economic, political and social problems mounted, populations became increasingly disaffected, spawning militant Muslim groups like the Islamic Movement of Uzbekistan (IMU), which first sought to overthrow the government of President Islam Karimov in Uzbekistan and later espoused greater ambitions for the creation of an Islamic caliphate (state) across Central Asia. Russia's brutal assault on Chechnya brought religious fighters from other wars in Afghanistan and Bosnia into the conflict, greatly complicating the prospects for a political solution and sending fighters and refugees south across Russia's borders into Georgia and Azerbaijan.

The fact that the administrative divisions the states inherited as international borders from the USSR in 1991 were all created on the principle of divide and rule from Moscow has shaped many of these conflicts. Without Moscow to play the role of arbiter, these borders became unruly, contested divisions, fracturing ethnic groups, rupturing trade and communication routes, and breaking economic and political interdependencies. Over the last ten years of independence, the political divisions between and among the Central Asian and South Caucasus states have hardened. At the same time, the borders (having previously been lines on a map rather than physical structures) have remained porous to illicit trade (including weapons and drugs smuggling) and the spread of infectious disease.

Independence has not been kind to Central Asia and the South Caucasus. In losing Moscow as the center of gravity, the states also lost crucial Soviet subsidies for budgets, enterprises and households, inputs for regional industries, markets for their products, transportation routes and communications with the outside world (much of which was previously filtered through the Soviet capital). The World Bank estimates that as a result of these disruptions, the Central Asian states alone saw their economies decline between 1990-1996 by 20-60% of GDP. In some states, like Tajikistan and Kyrgyzstan, this led to a government retreat from many aspects of daily life, in particular from the provision of a social safety net. In turn, it resulted in the evident "primitivization" of the states, with the energies of the population becoming focused on household subsistence and shuttle trade instead of mobilizing behind crucial economic and

political reforms. As a result, even the Soviet-era attainments in health, education, infrastructure, and industrial development have gradually eroded.

Despite the limited degree of macro-economic stability and growth that the Central Asian and South Caucasus economies achieved after 1996, they were set back again in 1998 by the Asian and Russian financial crises. The crises led to the devaluation of currencies and the withdrawal of foreign investment. By 2002, there was another modest recovery, especially in states such as energy-rich Kazakhstan and Azerbaijan, which have seen their budget revenues bolstered by a sharp rise in world oil and gas prices between 1999-2001, but landlocked, resource poor countries like Tajikistan, Kyrgyzstan and Armenia have had little success in effecting a turn around. In Tajikistan and Kyrgyzstan, severe regional drought in 2001 put them at risk of a major humanitarian disaster. A staggering 70-80% of their populations have fallen beneath the poverty line according to World Bank estimates, which puts them among the poorest of the developing countries. In fact, all the Central Asian and South Caucasus states have limited potential for development outside the energy sector. Even for the energy self-sufficient states of Kazakhstan, Turkmenistan, Uzbekistan, and Azerbaijan major questions must still be addressed about how to diversify their economies effectively to restore and develop water resources, agriculture, and the manufacturing sector.

The post-independence economic difficulties for the states have been compounded by the fact that regional conflicts have left hundreds of thousands of people displaced, especially in the South Caucasus. In Azerbaijan alone there are more than 500,000 internal refugees (IDPS) who remain homeless ten years after being expelled from the region around Nagorno-Karabakh, and who are poorly integrated into the rest of Azeri society. The large numbers of IDPs have strained government programs, especially for housing and education. Twenty percent of Azerbaijan's schools, for example, were abandoned as a result of the Nagorno-Karabakh conflict and the students have been placed in the remaining schools, causing severe overcrowding. IDP children manifest serious declines in literacy, which has set back the country's considerable gains in education during the Soviet period. Residents of Azerbaijan's capital, Baku, where a large number of the IDPs have sought refuge, complain of rising crime rates with the influx of displaced people and a change in the city's social profile. Similar phenomena can be observed in Georgia and its capital, Tbilisi, as a result of the refugee crisis from the conflict in Abkhazia.

In recent years, as a result of this economic deprivation and the dislocation of population, there has been a massive exodus of ethnic Russians and highly-skilled members of indigenous ethnic groups from both Central Asia and the South Caucasus. Reports from Kyrgyzstan suggest, for example, that one tenth of the total population has emigrated to Russia over the last decade, while fully one third of Tajikistan's labor force seeks employment abroad in neighboring Uzbekistan and Russia on a regular basis. Expert estimates also suggest that more than one million people may have left Armenia in the same period. Armenia, which was one of the most industrialized and advanced republics in the USSR, has in effect been de-industrialized and depopulated since independence. It is hobbled by dilapidated and obsolete technology and has had no capital investment or modernization in twenty years. Local entrepreneurs have been further driven out by government corruption and other obstacles to pursue business outside the state. Armenia is now dependent on international assistance and the support of its diaspora population in Russia and the West.

Indeed, remittances from diaspora and migrant populations are crucial to all three Caucasus economies. The annual income of Azerbaijani migrants in Russia, for example, ranges between \$700 million and \$1 billion according to different estimates and more than 500,000 Georgian workers in Russia produce about one quarter of the country's GDP. The loss of human resources in the region through out-migration and persistent dependencies on Russia for temporary and migrant employment, and remittances have all skewed development. Russia also serves as the main market for Central Asian and South Caucasus goods, primarily foodstuffs, especially as other international markets remain closed thanks to political instability in the region and a dearth of transit routes, as well as trade tariffs. The presence of large numbers of traders from Central Asia and the South Caucasus in Russian cities has spawned a popular backlash among ethnic Russians, especially in cities such as Moscow where produce markets are seen as dominated by Azeris, Tajiks and other national groups who are perceived to impose high prices on Russian shoppers.

Compounding the devastating effects of out-migration and the general economic failings, the Central Asian and South Caucasus states have not developed effective post-Soviet state institutions. All of the states had to create basic administrative structures and legal systems after independence. Some considerable progress has been made in national institution building over the last decade. Both regions have been integrated into a range of international institutions and a new cadre of technocrats and future young leaders is emerging, many seeking training in the U.S. and Europe. In addition, a range of new non-governmental organizations has sprung up in place of outdated and inadequate government entities. But, the legitimacy of regional governments remains questionable and has not been bolstered by the introduction of parliaments, political parties, and democratic elections. The Central Asian and South Caucasus states are controlled by networks of elites, based on geographical association, common educational background, and on extended family ties. New elites and opposition political parties have experienced difficulties in presenting themselves as viable alternatives to the ruling regime and in creating constituencies for support.

Governments are distinguished by strong executives and weak legislatures. Politics are focused on elections, and on the struggle between presidents and parliaments over respective authorities. Presidents routinely manipulate elections and rule by decree to bypass parliament. The press relies on the patronage of the state or powerful business cliques with their own agenda. As a result, there are few intermediaries between high politics and the people. Governments tend to rely on authoritarian, Soviet-era methods to retain control of the levers of the state—stifling opposition, clamping down on dissent (including harshly cracking down on political manifestations of Islam in Uzbekistan and elsewhere in Central Asia), and frequently violating political freedoms and abusing human rights.

In both regions, power is thinly rooted and largely personified. Crucial decisionmaking is in the hands of aging presidents. Although Russia, Ukraine, Moldova, and other former Soviet states have now undergone changes in executive power since 1991, power has not been fully transferred from the old Soviet to new political leaders in Central Asia and the Caucasus. In Central Asia, former Soviet party leaders have been preserved as “new democratic presidents.” In Georgia and Azerbaijan, Gorbachev-era Politburo members were returned to power after brief

and disastrous flirtations with untested post-Soviet presidents. Armenia has had a regime change, but its political system has been marred by violence, including the assassination of the Prime Minister and key members of parliament in October 1999. In Georgia and Azerbaijan, in particular, political discourse has become focused on what will happen when the respective presidents, men in their late 70s, die, and whether the states will erupt into potentially catastrophic violence immediately upon their demise. These aging presidents and entrenched elites pose a major obstacle to progress. Until succession questions have been resolved and a new generation of leaders have consolidated their positions, it is unlikely that contentious issues such as the status of disputed territories, stamping out corruption or transforming moribund industrial sectors will be tackled.

A Difficult External Environment

The challenges within the states are greatly complicated by the external regional environment. Central Asia in particular is at the center of a number of interlocking regions: Russia and Eurasia, the Middle and Near East, South Asia, and Asia more broadly. In a geopolitical sense, it is the pivotal region for all of these other regions—a fact that has been clearly underscored by developments since September 11, 2001.

Central Asia is simultaneously a buffer zone and a transit area with East/West and North/South axes. It is surrounded by former imperial states (Russia, Iran, China) beset by their own problems of development and with a history of competition in the region, four nuclear powers and other states with nuclear aspirations, and a series of states either emergent economically and politically or in decline. Ethno-linguistic and religious groups are spread across borders, with Russia, Iran, China and Afghanistan all sharing groups with Central Asian states, and Turkey representing the western extension of one of the broader cultural spheres in the region. The South Caucasus states are in a similar position. They are a buffer zone and transit area between Russia, Turkey and Iran on the North/South axis, and the communications route along the East/West axis between the Caspian and Black Sea Basins, and thus Asia and Europe. In looking at the external security, economic and political environment for Central Asia and the South Caucasus, all the regional states have to be factored in as an element in their future (not just Russia as was the tendency in the 1990s).

The economic, political and military involvement of new states in both regions over the last ten years has also become evident—not least in the establishment, since the beginning of the U.S. campaign in Afghanistan, of American military bases in Central Asia and the introduction of U.S. military trainers into Georgia. In a major shift over the last decade, Northeast Asian countries—China, Japan, Korea—have now also become engaged in Central Asia and in the South Caucasus. In Central Asia, China has put a particular priority on relations with the states to foster the development and stabilization of Xinjiang and its other western provinces. It also sees Central Asia as a potential market, a source of energy and other natural resources and as a communications bridge to Iran and the Middle East. Japan has become the largest donor country to Central Asia and, like China, sees the region—if it is stabilized and developed—as a potential market, source of raw materials and a bridge to the Middle East. And Korea has a more intimate relationship thanks to the distinct Korean populations deported there under Stalin, who have now

become an influential social, political and economic component in independent Kazakhstan and Uzbekistan. Although China, Japan, and Korea, have only just begun to make their presence felt, and their impact on trade and other regional issues has not yet been so substantial, in a sense Central Asia is rapidly becoming the heartland of Asia. In the South Caucasus, both Japan and China have also become active in Caspian and other energy projects, including power generation.

Even before the events of September 2001, there was a growing realization that the accumulation of challenges in Central Asia—especially given the escalating crisis in Afghanistan—and in the South Caucasus demanded attention. The countries of Central Asia and the South Caucasus faced considerable difficulties in ensuring internal stability as well as dealing with threats from their external environment. Military reform from the old Soviet system to forces capable of dealing with new threats from militants and insurgents—including replacing heavy motorized divisions with light border and mountain contingents—was woefully incomplete. Having relied on the Soviet center for security, after the withdrawal of Russian military forces, most states had no functioning border guard units.

But, despite these concerns and ten years of development community involvement and engagement in the region, Central Asia and the South Caucasus were low down the priorities of governments like the United States or those of the European Union. Even for Japan, as the leading bilateral donor in Central Asia, its preeminence was largely the result of the disinterest of others rather than a major priority on the part of the government in Tokyo. In the 1990s, there was no real vision for the regions in world capitals, and no sense of their interaction with issues of global consequence. This changed with the terrorist attacks on the United States and the realization that civil war and acute state failure in Afghanistan had facilitated them. With the U.S. pursuit of the war on terrorism branching out from Afghanistan, Central Asia's linkages with Afghanistan and the spread of instability from Afghanistan into Turkmenistan, Tajikistan and Uzbekistan, and from there into Kyrgyzstan, Kazakhstan and north into Russia—as well as into Georgia with the reported spread of Islamic militants into the Pankisi Gorge area on the Georgian border with Chechnya and Russia—have been acknowledged and underscored.

Facing the Challenges and Creating Opportunity

Now with international attention on the two regions and the promise of new assistance, especially to the “frontline states” of Uzbekistan, Tajikistan, Kyrgyzstan and Georgia in the U.S. war on terrorism, the primary issue for all the states remains, given the challenges they face, can they harness the full range of their resources for economic development, and thus for political and social consolidation? And can international engagement make a difference? Natural resource development, commitment to reform and overall economic development within individual states, regional cooperation on key issues such as water management, trade and transit, and combating disease and drug-trafficking will all be important components, as will the ability of donors, both bilateral and multilateral, to coordinate and develop new methods of delivering long-term assistance to Central Asia and the South Caucasus.

Natural Resource Development

The energy potential of the Caspian Basin is seen as the key to the development of the two regions. But there are major constraints on energy development, not least export dependence on Russia. Energy reserves are primarily located in Azerbaijan, and in three of the Central Asian states: Kazakhstan, Turkmenistan, and Uzbekistan. Kazakhstan and Azerbaijan have the most significant oil reserves, while all four countries have substantial natural gas resources that have yet to be fully developed, with Turkmenistan accounting for the largest reserves. All the states face challenges in optimizing energy production and in securing market access for exports. Outside the extensive Soviet-era pipeline system running through Russia, the Caspian Basin faces a major shortage of transportation infrastructure. Although new pipelines have been built for oil exports from Azerbaijan and Kazakhstan since the 1990s, there has been little significant progress in the construction of regional gas pipelines.

Since independence, Azerbaijan, Kazakhstan, Uzbekistan, and especially Turkmenistan, have nurtured aspirations for export production and tried to find ways of bypassing Russia in oil and gas exports to penetrate the same energy markets in Europe and Asia that Russia also wants to expand in. In the 1990s, the growing interest and investment of U.S. and international energy companies in the rich Caspian oil and gas deposits led to sharp differences between Russia and the United States, as well as to struggles between Russia and regional countries over the demarcation of the Caspian Sea, title to oil fields, and the direction of export pipelines. These struggles subsided as Russia discovered more reserves of its own in the northern Caspian and as Russian oil companies began to engage in new production opportunities in the region, becoming members of international consortia exploring and exploiting Caspian fields. Over the last two years, Russian companies have steadily consolidated their positions in the region, including in Azerbaijan and Kazakhstan.

Russia's ability to dominate regional gas production and exports is much more significant and extensive than its hold over Caspian oil. Central Asian gas fields are poorly situated for European markets and equally distant from new energy markets in Northeast Asia. All existing gas export pipeline routes run through Russia, and international energy companies have failed to make the same inroads into Central Asian gas production as they have in Caspian oil. As a result, Russian gas is exported at high-cost to markets in Western Europe, while Central Asian producers like Turkmenistan have been forced to supply gas at low-cost to former Soviet states such as Ukraine, which have fallen behind in their energy payments to Russia (and which frequently fail to pay Turkmenistan). Uzbekistan's gas is exported to the local Central Asian market to supply energy-poor Tajikistan and Kyrgyzstan (which, even more than Ukraine, can barely maintain their payments), and the population centers of southern Kazakhstan. Some Uzbek gas also flows to Russia through the Central Asia-Central Russia pipeline system. Although Kazakhstan has the potential to become a major gas exporter, its vast gas reserves are under-utilized even for the domestic market as the major fields have yet to be connected to the existing gas pipeline network. Kazakhstan is thus dependent on both Uzbekistan and Russia for gas imports.

In short, lack of pipeline infrastructure is the main impediment to increased gas production and exports from Central Asia, constraining Turkmenistan's and its other neighbors' efforts to

become independent suppliers to regional consumers. Unlike oil, Central Asian gas cannot be shipped by tanker and rail across alternative routes until new pipelines are built. In the late 1990s, China briefly flirted with an idea to construct a gas pipeline from Turkmenistan through Uzbekistan and Kazakhstan to Beijing, and ultimately Korea and Japan. This project was shelved when China resolved to concentrate on pipelines from its own fields and from Russian fields in Siberia. U.S.-backed plans in the 1990s for a Trans-Caspian gas pipeline from Turkmenistan to Azerbaijan and then to Turkey also stalled in 2001. Turkmenistan has made some small progress in expanding its export options south by opening a gas pipeline to Iran. But Iran itself is a major competitor to Turkmenistan in regional gas markets, especially in potential South Asian markets.

In spite of past offers to act as a transit country for Turkmenistan's gas, Iran has engaged in intensive negotiations with both Pakistan and India to export its own gas to these two South Asian states. Likewise Russia has ambitions to penetrate these markets. The Russian government has stressed the importance of developing a north-south trade and communications axis between Russia, Iran and India, linking Asia and Europe in what they present as a cheaper, more cost-effective transport corridor to other sea and overland routes. In January 2002, in meetings in Azerbaijan and Turkmenistan, Russian President Putin also proposed the creation of an Eurasian Gas Alliance between Russia, Uzbekistan, Kazakhstan and Turkmenistan. Headed by Moscow, the Alliance would coordinate Caspian Basin gas production. It would ensure Central Asian access to Russian export pipelines, and guarantee long-term Russian purchases of Central Asian gas for the Russian domestic market. The thrust of the proposal would address concerns about falling production by Russia's giant gas monopoly, Gazprom, by feeding Central Asian gas into the Russian domestic and European export system. But it would also ensure the Russian energy industry a major role in the construction of any gas pipelines south to Pakistan and India, as well as east to China from Central Asia. Indeed, Russian energy experts speculate that, in the next decade, Russia will try to direct Central Asian gas through the Russian pipeline system and then into future gas pipelines from Russia to China rather than let Kazakhstan or Turkmenistan construct their own export pipelines to China.

Thus, natural resource development—especially gas development in Central Asia—will depend on the full participation of Russia and perhaps Iran in regional ventures. While oil and gas from Azerbaijan can and will flow through Turkey (especially with the completion of the new Baku-Tbilisi-Ceyhan oil pipeline and a parallel gas pipeline along the same route), for Central Asian states, markets in Europe and those in East Asia are hard to reach without traversing Russia. For South Asian gas markets, both Russia and Iran will inevitably play the major roles, especially if one considers the fact that, between them, Russia and Iran control almost one half of world proven gas reserves.

Sustainability of overall economic development

Energy development has begun to boost the economies of Azerbaijan and Kazakhstan. But, even with increased market penetration and revenues, questions must be resolved about how to harness these energy revenues to transform the moribund sectors of the industrial economy, revitalize agriculture, and rebuild the public sector. The over-development of the energy sector and the divergence of revenues to elites has already distorted Azerbaijan's and Kazakhstan's

societal and economic development. Throughout Central Asia and the South Caucasus, the absence of a developed free market system, and a focus on raw materials export and general commodities trading have resulted in the considerable enrichment of elites with ties to the state, who have secured control over energy and other strategic reserves. Corporatism is a notable feature of all regional economies. The elite networks that have dominated politics since independence also dominate the economy. In Azerbaijan and Kazakhstan, these elites have reaped the benefits of limited economic growth and global increases in commodity prices.

In response to international pressure to address the role that energy will play in their long-term economic development, both Azerbaijan and Kazakhstan have set up oil funds for existing and future revenues generated by the sale and transportation of natural resources. These funds are intended to ensure that a portion of revenue funds will be invested and expended outside the energy sector to tackle poverty reduction, education, public health and other critical public sector issues. However, it has yet to be determined how these funds will be managed and overseen. Management issues are crucial given the fact that cronyism and corruption are rife (in a 1998 report by the European Bank for Reconstruction and Development, Azerbaijan, Kazakhstan and Uzbekistan scored the highest ratings for corruption among public officials for any region of the world). Corruption is endemic beyond government reaching down to the lowest levels of society where there is considerable tolerance for and emulation of the corrupt practices of public officials. In regional states, corrupt bureaucrats have become more of a problem than traditionally perceived “mafia” groups. Indeed, for the citizens of many states, “the government is the mafia.” Corrupt elites controlling strategic resources have moved wealth generated from these assets into offshore bank accounts and investments. Those with close linkages to regional presidents have used their wealth to encourage policies that bolster their financial positions and prevent new elites and social groups from challenging their ownership of formerly state assets. As the same elite groups are behind the creation of the oil funds, it is difficult to imagine that they will be managed in a transparent manner. To address this issue, in 2001, the New York-based Open Society Institute (Soros Foundations) initiated a “Caspian Revenue Watch” program to promote the transparent use of the funds by encouraging public oversight and demanding government accountability for expenditures.

Beyond the natural resource sector, corruption has had pernicious effects throughout the region. It has stunted the development of small and medium-sized businesses (SMEs) that could spur market development and economic growth. SME development has been further hindered by the misconception of business as small-scale trade linked to basic subsistence, a lack of entrepreneurial skills, the scarcity of investment capital for new ventures, crushing tax burdens, and inadequate legal protections.

Entrepreneurial skills are critical given high unemployment and the dramatic increases in poverty. Post-Soviet populations have been moved through economic restructuring from non-productive or minimally productive activity, but they have not been moved into new and more productive activities. There is no established culture of new business creation. Governments do not have funds for large-scale employment creation and maintenance programs, nor do they have the funds to maintain the social safety net. There are few sources of capital to seed and support new businesses. The economic reforms of the 1990s and early bouts of hyperinflation eroded domestic savings. Capital flight has removed domestic wealth, and regional banks have not

developed small-scale lending programs. Foreign investors focus on large investments in extractive industries and strategic infrastructure, or their own “greenfield” ventures, rather than small-scale capital investments in indigenous ventures. Functioning banking systems also still need to be established. Communist and post-Communist states, including Russia, have never had banking systems in the internationally understood sense of the word. Regional banks have yet to offer a full range of products and services such as market-rate loans, credit cards, and mortgages to stimulate investment and to encourage regional populations to deposit their money in savings accounts. Legislation to regulate the activities of banks and make them viable has also yet to be put in place in most of the states.

Beyond the banking system, tax codes must be simplified for both business and personal taxes. Tax codes are unwieldy, contradictory, and confiscatory. They stifle attempts at conducting business and do not encourage citizens to contribute personal income to taxes. In addition to streamlining taxes (which was carried out in Russia in 2001), legal and judicial capacities still need to be developed in Central Asia and the South Caucasus—to support property systems, regulate economic interactions, resolve disputes, enforce contracts, and bolster citizens faith in due process. These are all essential elements in economic and political development.

The most significant hurdle for regional businesses, as well as for the general population, remains the constantly changing “rules of the game”—inconsistent and randomly enforced laws and regulations, unfavorable and fluctuating tax policies, and excessive government control. Increasing numbers of controlling government agencies has exacerbated the corruption among local bureaucrats. Although legislative reform is proceeding in both regions to some degree, the establishment of an independent and just judiciary remains a major problem. Governments continue to control courts. In addition to their potential for government bias, courts are widely viewed as corrupt and susceptible to bribes, which undermines public confidence. Regional populations do not believe that the law will be upheld, or that their rights will be protected.

In sum, the governments of Central Asia and the South Caucasus face a daunting set of challenges, including how to achieve a sustainable rate of growth, improve the overall business climate and create new jobs; how to raise general living standards and tackle growing inequalities in wealth; how to improve legislation, enforce existing laws, and increase the effectiveness of government; how to control and limit the activities of corrupt oligarchies; and how to expand opportunities for citizen participation in political and economic decisionmaking. In particular, states must nurture and sustain organizational capital for political development. Local governments in regions and municipalities are ill equipped for self-governance. They tend to resort to crisis management rather than long-term strategic planning. Local government cadres are poorly trained and lack management and budgetary skills, and mechanisms for evaluating government performance are almost entirely lacking.

Individual Country Prospects

In looking at and extrapolating from these challenges on a region-by-region and country-by-country basis, the following general picture emerges:

In Central Asia, Kazakhstan has the brightest economic prospects and has already moved onto a development trajectory that is roughly comparable to that of Russia and Ukraine. The development of the country's substantial oil and gas reserves will bring the state closer to the world market and generate resources for developing the private sector. Private sector development has also begun to drive political reform in Kazakhstan with the gradual emergence of a more active middle class, and property-owning interest groups with a stake in broader progress. The major risks for the longer term lie in the inappropriate use of the state's energy resources, which has plagued many other resource-rich developing countries such as Nigeria and Venezuela, and the failure to open up politics and bring new elites into the policymaking process. Over the last several years, there have been numerous expulsions of political opposition figures from Kazakhstan and, in January 2002, a major political struggle took place between the incumbent government of President Nazarbayev and a group of young, "technocratic" politicians and business people, who have designated themselves "Democratic Choice." These "technocrats" were once endorsed and promoted by Nazarbayev, but have now begun to seek real power and influence. Although the political conflict was defused through a government reshuffle, repression of political dissent also followed and some of the young leaders were placed under house arrest on charges of abuse of political power. The incident was a harbinger of more conflicts ahead if political reform in Kazakhstan continues to fail to keep pace with the country's economic development.

Unlike Kazakhstan, Uzbekistan faces serious challenges in most dimensions and has very uncertain prospects. It is the most strategically located of the Central Asian states, with the largest population and the most significant military capabilities and resources, but it has also been a source of regional tension and a logjam for regional development. In the 1990s, a clamp-down on Islamic groups in response to acts of terrorism and militant activities led to the closure of mosques, a ban on political opposition movements, and arrests of practicing Muslims, which forced groups underground and increased support for insurgencies and extremists. Uzbekistan has had water and territorial disputes with all of its neighbors, and periodically used energy exports to Tajikistan and Kyrgyzstan as a lever to pressure these governments to make concessions in some of the disputes. It has begun to mine its borders to guard against militant incursions without consulting its neighbors, rupturing communication routes from Tajikistan and Kyrgyzstan. And, it has been in perpetual domestic economic crisis. Indeed, crisis has become the status quo. Through a mixture of currency and exchange rate controls, state orders for its two main export commodities, cotton and wheat, and the good fortune of being self-sufficient in energy, Uzbekistan has muddled along for several years, defying expectations of collapse and refusing to open up and deregulate its economy.

However, thanks to pressure from the U.S. and other international donors in 2002, it seems that Uzbekistan is now contemplating renewed IMF and World Bank programs and a new phase of the macro-economic reforms. Progress in economic reforms, an improvement in its economic performance, the removal of currency controls, and increased readiness to deal with regional issues in a cooperative manner would have major benefits not only for Uzbekistan itself, but for all the Central Asian states. However, there is also a serious risk of economic and political stagnation, as well as increased social dislocation and deprivation and destabilization in Uzbekistan from these new reforms, which could also have disastrous implications for its immediate neighbors.

Turkmenistan, on Uzbekistan's southwestern border, is an outlier even within Central Asia in the Soviet-style personality cult centered around its leader, Sapamurat Niyazov (the self-styled *Turkmenbashi* or Father of the Turkmen), its near-total political isolation, and its lack of reform. There is no real indication that this will change in the immediate future—although there are signs of growing political dissent within Turkmenistan in the increasing defections of senior officials. In its current situation, in spite of its energy resources and the revenues it has generated from regional gas sales, Turkmenistan represents a significant obstacle to any effort to increase cooperation in Central Asia in all key areas, including in the energy sector and in water resource management.

In contrast to Turkmenistan, the two poorest of the Central Asian states, Kyrgyzstan and Tajikistan have both made some progress with economic reform and have taken some steps toward building an active civil society. However, lack of market access, serious institutional weakness, pervasive poverty, and an unsustainable level of debt provide tremendous challenges and risks. For Tajikistan, these risks are multiplied by the legacy of the 1992-1997 civil war and the lingering memory of violent internal conflict. This being said, Tajikistan is seen by international donors as the most receptive of the regional states to outside assistance and also serves as a potential model for dealing with Islamic and political opposition elsewhere in the region. The Tajik government ended the five-year civil war by bringing its opposition into a dialogue process and ultimately agreeing on a series of power-sharing arrangements. However, in spite of this very positive development and the relative openness of their societies, both the Tajikistan and the Kyrgyzstan governments, like their neighbors, have engaged in political repression. In Kyrgyzstan, the government has begun to clamp down harshly on social protest (which is increasing in line with the population's descent into poverty). Most recently, in March 2002, Kyrgyz authorities shot and killed several demonstrators during a protest in the country's impoverished southern Jalalabad region.

In the South Caucasus, all three countries find themselves in a state of "no peace, no war" that has crippled regional development and shows no immediate prospect of resolution. Conflicts are frozen and in constant danger of re-ignition in Abkhazia and Nagorno-Karabakh in spite of repeated international efforts at mediation. Georgia is teetering on the verge of collapse, overwhelmed by internal difficulties and burdened by the inability to combat corruption and tackle economic reform. The dual secessions of South Ossetia and Abkhazia have amputated the country and spillover from Chechnya has soured already poor relations with Russia. In 2002, reports of the incursion of fighters from Afghanistan into Georgia's Pankisi Gorge region, as well as persistent reports of Chechen forces in the Gorge, resulted in an American decision to deploy U.S. military trainers into the country to assist the Georgian military in tackling its security problems. While this move has in fact bolstered Georgian morale and perhaps given a stimulus to renewed efforts at reform, executive succession still remains a critical issue (as in Azerbaijan). No provisions have been made for a presidential transition, and this will be the major political challenge in the near future.

Like Kazakhstan, Azerbaijan has relatively good prospects for long-term economic development, if its energy resources and the resulting revenues are properly utilized. Oil and gas development will increasingly pull it into the world economy and provide leverage points for encouraging

political reform as well as financial resources to tackle poverty. Azerbaijan's major challenges remain its presidential succession issue, its ongoing conflict with Armenia, and managing its entrenched refugee crisis. Unlike in Armenia, where refugees from the war over Nagorno-Karabakh have often left the Caucasus for Russia, in Azerbaijan the refugee population has been stuck in place for a decade and not integrated into Azeri society. Refugees form a disaffected political force that is also an obstacle to improved relations with Armenia, especially as Armenia continues to occupy Azeri territory outside Nagorno-Karabakh.

For its part, Armenia has been largely de-populated and stripped of the human resources vital to its economic recovery. Not only does the country lack a natural resource base, but it has seen the collapse of its once significant manufacturing sector, and has been bypassed in regional transportation and pipeline projects as a result of the conflict with Azerbaijan. While Armenia maintains tenuous lines of communication with Iran to the south and through Georgia to Russia in the north, its southern border with Turkey is closed. However, Armenia still has a well-educated population with close ties to a huge and increasingly prosperous diaspora in Russia, as well as in the U.S. and Europe, and has made some progress in recent years in the development of a high-tech industrial sector, capitalizing on diaspora resources. If the Nagorno-Karabakh conflict is resolved, Armenia's communications with Turkey will be restored, providing additional links to the West as well as the Middle East. For all three South Caucasus countries, the resolution of regional conflicts will open the way for increased development, including promising prospects in regional tourism and freight forwarding from Central Asia and the Caspian to the Black Sea and Europe, as well as from Russia south to Turkey and Iran.

Regional Cooperation

In spite of the promising prospects from sub-regional cooperation in both Central Asia and the South Caucasus, this remains the most difficult and complex development priority. Little progress has been made over a decade. In fact, in areas such as the Ferghana Valley in Central Asia, which was formerly integrated economically, but has now been divided among Uzbekistan, Kyrgyzstan and Tajikistan, regional cooperation has deteriorated steadily during the post-independence decade with a devastating impact on population livelihoods. Trade, water, energy development, and the environment have all been negatively affected by the failure of sub-regional cooperation, and ethnic tensions in the South Caucasus and drug trafficking in Central Asia have both intensified.

In the 1990s, Central Asia became the primary conduit for heroin trafficking from Afghanistan to Russia and from there to Eastern and Western Europe. This spawned a huge intravenous drug use problem in Russia and Ukraine, and a public health disaster that is now approaching catastrophic proportions with the rapid transmission of HIV infection and AIDS, extending back along the drug routes themselves into Central Asia. In addition, in Central Asia, man-made droughts and major economic, social and environmental problems have developed as governments have failed to cooperate in intra-regional water allocations. Individual states plan large, wasteful water storage and distribution projects at the country, rather than regional, level. In both regions, tariff and quantitative controls, and conflicts, have closed borders and disrupted trade and transit for goods and people.

The importance of regional cooperation on key issues is recognized by all the governments, and the prospects are ultimately better for cooperation in Central Asia than in the South Caucasus, given the fact that the political tensions there have led to less acute conflicts. But there is also a paucity of regional organizations to promote cooperation even though sub-regional entities like GUUAM (Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova) and international initiatives like TRACECA (the European Union-sponsored Transport Corridor Europe Caucasus Asia) have emerged to promote trade, communications, and economic cooperation from the Caspian to the Black Sea. Regional organizations often overlap in their goals and yet contain only a subset of regional states. In Central Asia, there has been much focus on the Shanghai Cooperation Organization (SCO), which includes China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. This was initially formed in 1996 to deal with border security and confidence-building issues along the former Chinese-Soviet border, where there are still outstanding border disputes between China and its Central Asian neighbors. The organization has since moved increasingly toward economic cooperation and in 1999, in light of increasing militant activity in the region, the Shanghai group expanded its mandate to focus on drug-trafficking and combating extremism and terrorism.

However, tensions among the Central Asian member states of the SCO, squabbles over budgetary issues, and a shortage of funds for group commitments, have constrained the development of the organization as a new multilateral mechanism for regional cooperation (a Central Asian version of ASEAN or APEC, or potentially a Central Asian "OSCE" as the Russians and Kazakhs have occasionally suggested). The entry of the United States and other international players into Central Asia in October 2001, coinciding with the beginning of the military campaign in Afghanistan, has also changed the SCO's internal dynamic. The individual member countries have reacted in their own way to the war in Afghanistan and established independent roles in the U.S. coalition in Afghanistan rather than acting as a group. China, in particular, has taken a back seat, while the Central Asian states have forged ahead of Russia in seeking to deepen their relations with the U.S., openly speaking of the benefits of a potentially long-term American military presence in the region, and inviting and hosting U.S. and other foreign troops on their soil. Underscoring this fact, the SCO was barely mentioned as a factor for consideration as a significant regional entity at the APEC summit in October 2001 in Shanghai, in spite of the conspicuous presence of its two primary motivators, China and Russia, at this meeting.

Looking ahead, the Shanghai Cooperation Organization may find itself subsumed by new international bodies that will also become focused on counter-terrorism activities, regional security and regional development, and will likely include new players with considerable resources such as Japan and the European Union. Regional states such as Pakistan, which was denied membership in the SCO by Moscow, and Afghanistan may also seek entry into these regional organizations as reconstruction efforts after the conclusion of the Afghan war proceed, and as Central and South Asia come increasingly to be seen as one contiguous region in the Asian heartland. Clearly the SCO and other existing sub-regional organizations only address some of the needs and relationships in Central Asia and the South Caucasus.

The Role of Afghanistan in Central Asia

For Central Asia, beyond the individual and regional dilemmas, there is another critical issue that will have an impact on long-term development: Afghanistan. Without stability in Afghanistan, there is little likelihood of significant positive change in Central Asia. Afghanistan has played a major role in regional dynamics over the last decade—not least because of the historical spread of Central Asian ethnic groups into northern Afghanistan. During the 1992-1997 Tajikistan Civil War, refugees from the fighting and opposition forces frequently sought sanctuary among their ethnic kin in Afghanistan. After the 1996 Taliban takeover of Afghanistan, Uzbekistan, Tajikistan, and Kyrgyzstan experienced raids and attacks by forces of the Islamic Movement of Uzbekistan, which became closely tied to the Taliban. Uzbekistan and Tajikistan both lent support to factions of the Northern Alliance in their struggle against the Taliban. Tajikistan, in particular, frequently served as a base for the forces of the assassinated Northern Alliance leader and ethnic Tajik, Ahmed Shah Masoud, and funneled supplies and weapons from Russia and other backers of the Alliance through its territory. Uzbekistan, Tajikistan, and Turkmenistan, as immediate neighbors of Afghanistan, played an active role in the United Nations-sponsored “6+2” process to find a negotiated settlement for the Afghan civil war. Kazakhstan initiated parallel efforts to find a solution to the conflict, pushing the UN, the U.S. and other major international actors to maintain their focus on Afghanistan, and offering its territory and good auspices for peace talks among the various Afghan factions.

Renewed interest in the region as a result of the U.S. campaign in Afghanistan and the international commitment to reconstruct Afghanistan opens new opportunities in the region and calls for a new approach to Central Asia. Afghanistan was the missing link in the development and regional chain for Central Asia, and the Central Asian states themselves have shown a keen interest in participating in its reconstruction. Beyond ethnic ties, they have historical trade links to Afghanistan and are part of Afghanistan’s North-South communications axis stretching from Europe and Russia to the Indian subcontinent. In the Soviet period, this axis was dominated by flows of armaments and economic assistance from Moscow to Afghanistan. In the 1990s, the axis was dominated by weapons flows south to the Northern Alliance and by drugs and armed militants flowing north into Central Asia.

Efforts by regional governments to tackle drug trafficking were stymied by the civil war in Afghanistan and direct linkages between regional militias and the drug trade. Now, there is an opportunity to transform this North-South axis into a route for licit rather than illicit trade. In this regard, Central Asia’s energy resources may eventually come to play a role. Projects for transporting gas from Turkmenistan and the broader Caspian Basin across Afghanistan to South Asia, which were precluded by the instability in Afghanistan, could one day be revived in the context of a broader effort to restore and improve road, rail and other transportation and communication links (although they would face competition with Iranian and Russian energy projects as discussed in the preceding section). The restoration of Central Asia’s links with India and Pakistan, which were ruptured through war in Afghanistan, also opens up the possibility of access to Pakistani and Indian ports, as well as markets, for Central Asian goods.

The Prospects for International Engagement

Further progress in Central Asia and the South Caucasus will now depend on the political posture of the United States, other key donor states like Japan, and on international organizations and their ability to coordinate in delivering assistance to regional states. It will also greatly depend on the attitudes of the states themselves, and their governments' commitment to and capacity for domestic reform and development, as well as for regional integration.

In the 1990s, apart from the forays of international business into Kazakhstan, Central Asia was a remote netherworld. With the beginning of the U.S. campaign in Afghanistan, the region shot to the forefront of international attention. In the first few months of 2002, the region had more high-level delegations paying visits from the United States, Europe, and international financial institutions than in the entire last ten years. The significance of these connections and this attention, no matter how superficial, cannot be underestimated. Although the U.S. and Central Asian states had already developed military ties in the 1990s, the physical presence of U.S. and other international armed forces in the states in 2002 has had an important symbolic effect in emphasizing Central Asia's links to the outside world after a decade of obscurity and tenuous contacts. Central Asian countries are only now, for the first time, beginning to interact at various levels with the international community, creating new opportunities for development.

The South Caucasus, in contrast, had more engagement with the United States, Europe, and other international players in the 1990s, thanks to the activities of the Armenian diaspora and the interest of energy companies in Caspian oil. But, in spite of foreign investment in Azerbaijan's energy resources and the construction of the Baku-Tbilisi-Ceyhan pipeline—which both Azerbaijan and Georgia have come to see as a lifeline (rather than simply a pipeline) to Turkey and Europe—like Central Asia, the South Caucasus states had little prospect of close economic, political and security relations with the West. Although, in the same decade, the Baltic States moved toward the possibility of NATO as well as eventual EU membership, and even Russia and Ukraine moved closer to Europe, the location and under-development of the South Caucasus states precluded these possibilities. In 2002, with U.S. military trainers descending on Georgia and the EU and individual European states formulating plans for more multilateral and bilateral cooperation, the situation may have changed.

In high-level donor meetings in London, Berlin and other capitals in 2002, international donors undertook to work together with the countries of Central Asia and the South Caucasus on sustainable development, and particularly on debt and poverty reduction. New initiatives on debt reduction, combined with improved growth performance over the past two years, have now created some breathing space for the regions' economies. A range of other issues have also been identified for donor coordination, including: small business and micro-finance promotion; improving the general investment climate; bolstering the activity of non-governmental institutions and strengthening civil societies; helping states to build capacity for government institutions; and supporting public investment and social service improvement. On a regional level, in Central Asia, donors have agreed to coordinate on water resource management; trade and transportation; energy development; rural development in crucial areas such as the Ferghana Valley; tackling HIV/AIDS, tuberculosis and other public health issues; and combating drug-trafficking.

This coordination is crucial and will have to be continued and intensified over the long-term if any significant development success is to be achieved. Although increased attention to the regions has already brought additional resources for assistance, international aid to both Central Asia and the South Caucasus will still be limited. It is unlikely to be sufficient to cover all pressing development needs. Multilateral donors, such as the World Bank and the UNDP, for example, will not provide huge new infusions of cash. World Bank loans for projects eventually have to be repaid, and regional governments are cash-starved and already heavily indebted. And while the UNDP can tackle poverty alleviation, this cannot be achieved through large financial outlays, but only through structural changes within the states themselves, multilevel projects in conjunction with other donors, and through gradual, incremental steps over a long period of time. The United States, other bilateral donors such as Japan, and the European Union and its individual member countries, can provide far more significant funding for Central Asia and the South Caucasus. But, here too, there are serious limitations.

All the states have a low absorptive capacity for assistance. There are few actors outside the central governments for donors to partner with. Local governments lack the skills and budget revenues for self-governance. Non-governmental organizations are largely absent in states like Turkmenistan and Uzbekistan, or closely tied to the government where they exist. They are squeezed politically and starved of funds elsewhere in both regions and dependent on foreign donors. The private sector and business community can act as a partner and has a vested interest in progress on reform, but it requires additional resources in the short-term to organize and enhance its capacity. In the South Caucasus in particular, and in Kazakhstan, as noted earlier, the private sector has already begun to attract some of the most competent and progressive individuals away from government to create an alternative potential power base.

In Central Asia, some notable successes have already been achieved through international donor assistance to private sector and business association development, and through the creation of micro-finance programs for small businesses by the EBRD, USAID and the U.S.-based Eurasia Foundation in Kazakhstan and Kyrgyzstan. However, these can not be replicated easily in the closed economy of Uzbekistan or in isolated Turkmenistan. Private donors such as the Eurasia Foundation have also been able to work with the business community and NGOs to develop very active small grantmaking programs in the South Caucasus that have improved cooperation between business and civil society groups across borders. However, in spite of their potential, these programs have not yet been translated into larger initiatives because of mounting political tensions around the frozen regional conflicts. In Central Asia, similar efforts by the Eurasia Foundation and the Open Society Institute to promote cross-border business cooperation and NGO activity in the Ferghana Valley have faltered through the persistent resistance of the Uzbek government.

If sub-regional projects are to make any headway on a large-scale and over the long-term, they will require the backing of the largest multilateral and bilateral donors and a systematic, coordinated, and equally persistent approach to Central Asian and South Caucasus governments. Donors will have to focus on promoting dialogue within and among Central Asian and South Caucasus countries on critical issues related to reform and increased sub-regional cooperation; on encouraging them to increase popular participation in economic and political decisionmaking;

and on exploring new approaches to development, such as tapping more into local resources for increasing economic activity. Initially, regional cooperation will have to be depoliticized to move ahead by giving states national “ownership” of specific projects, and also by promoting regional pilot projects on non-contentious issues, such as tackling child malnutrition, to serve as confidence-building measures. To encourage states to bring actors outside governments into the economic and political process, donors themselves will have to be willing to open their programs to public scrutiny and to carefully assess the impact of their programs on society—perhaps through the use of “social impact assessments,” and by bringing in regional and local expertise to inform sectoral programs.

In Central Asia, in particular, donors focusing on economic development may also have to join forces with the OSCE, and with advocacy groups such as the Open Society Institute and activists like Human Rights Watch and Amnesty International to pressure governments to cease the blatant abuses of human rights that have become increasingly common in states like Uzbekistan, to push for the restoration of press and other political freedoms, and to combat the most egregious authoritarian tendencies. Donors will have to find a common voice, and use strength in numbers to move against government resistance, especially on issues of democratization where the importance of political reform accompanying economic reform must be stressed. Donors need to create responsive structures with enforcement mechanisms at a time when regional governments are resisting strategies for political reform and regional cooperation that are essential to their development.

In addition, in Central Asia, all donors will have to use high-level dialogue to press the leadership of the five countries to work together on regional water management. This is essential given repeated droughts, the catastrophic depletion of the Aral Sea, and widespread pollution and degradation of water resources. In the immediate future, however, it is more likely that pragmatic support will have to focus on bi- and trilateral cooperation among selected Central Asian countries, and on country-specific reform and investments for improved water management and use. Attention will also now need to be paid to the role of Afghanistan as a potentially significant player in the regional water situation.

In both Central Asia and the South Caucasus, support for investment and institution building in trade and transit facilitation and infrastructure are of high priority. In Central Asia, individual countries such as China, Japan and Korea can play a particularly important role in bringing the landlocked Central Asian countries into the global marketplace by helping to reconstruct ancient trading routes to both East and South Asia. Russia and Turkey, as well as the European Union, can play equally important roles in the South Caucasus. Ultimately, the most important role that all donors can play is to plug Central Asia and the South Caucasus into global communications networks and to help the states develop new human capital. The experience of the Baltic States and of Russia over the last decade demonstrates that countries that were once part of the Soviet command economy and authoritarian political system can “learn” and develop relatively quickly as long as they have access to new networks—including horizontal linkages with Western and Central/Eastern Europe—through which contacts can be developed and information and skills transmitted. Central Asia and the South Caucasus have a long way to go, but with serious, long-term international engagement they can still have real prospects for economic and political development.