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John S. Henley* and George B. Assaf**

Re-Integrating the Central Asian Republics into the World Economy

The dissolution of the former Soviet Union (FSU) and the establishment of the Commonwealth of Independent States (CIS) out of the former Soviet Republics has seen the creation of a number of new independent countries in Central Asia. These six Republics – Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan – are, albeit to different degrees, only at the beginning of the historic process of transformation from a command to a predominantly competitive market-based economic system. This paper¹ will survey the prospects for industrial development and the challenges for enterprise restructuring, privatization and private sector development in four of the republics: Azerbaijan, Kazakhstan, Kyrgyzstan, Uzbekistan.

The Central Asian Republics (CARs) have enormous natural and agricultural resources. With vast resources ranging from petroleum and gas in Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan to abundant mineral and alternative energy and agricultural resources spread throughout the Republics, the region possesses one of the highest concentrations of natural resources in the world. In addition, all the Republics have an industrial base with skilled workers and a relatively well educated population. Few doubt, with their rich human and natural resource base that the Republics have a good foundation for rapid industrial development and therefore should be attractive to international investors.

Yet, four years since the initiation of this transformation process and the beginning of independence, many of the Central Asian Republics are facing a profound crisis in economic, monetary, social, as well as political terms.

The disintegration of the FSU has led to the collapse of Soviet payments mechanisms and inter-republican trade. This, in turn, has led to major disruptions in economic linkages among former member states of the Soviet Union with severe impacts on the Central Asian Republics. The smaller countries, like Kyrgyzstan, have been particularly hard hit as they were dependent on substantial transfers from the FSU and were also highly integrated into the centrally planned economic system. In addition, they were heavily dependent on the FSU for supplies of

raw materials, essential spare parts and industrial inputs, consumer goods of all kinds, grains and energy supplies.

The overall economic situation had already begun to decline in the Republics before 1991. Since the collapse of the Soviet Union, supplies of imported industrial inputs and energy have become extremely erratic, capacity utilisation and real output in industry has declined, inflation has increased sharply (for example, in January 1992, inflation in Azerbaijan soared to 1,500 per cent for the year), unemployment has increased significantly, and acute shortages of essential goods and inputs have emerged. Nascent governments are not only faced with the difficult challenges of political independence, but are also expected to take on the task of designing and implementing radical economic reforms and the initiation of broad structural changes. At the same time, governments have to face the collapse of long-standing political and economic structures while new ones are only beginning to be established – if at all. In the face of these challenges, all governments are pledged to economic reforms and the move towards a competitive market economy. But weak political structures, social tensions and the threat of nationalism, ethnic rivalries, and economic hardship concentrated in key regions have meant that most governments – particularly in Uzbekistan – have adopted a cautious, gradual approach to economic

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reforms. International investors must be keenly aware of this reality, if they are to be successful.

At present, although some progress has been made, economic reforms in terms of macro-economic stabilisation measures have not yet achieved a substantial shift in economic structures or improvements in economic performance. This is particularly the case at the industry and enterprise levels where significant structural rigidities and imbalances remain. Given the rudimentary development of the policy framework, institutions, infrastructure and limited government capabilities to support restructuring of their economies, it is clear that the Republics continue to require international assistance to remove bottlenecks preventing an adequate enterprise level supply response to the incentives that should have been occasioned by macro-economic reforms.

Consequences of the Collapse of the USSR

Output in all of the four countries Azerbaijan, Kazakhstan, Kyrgyzstan and Uzbekistan suffered from the severe disruptions caused by the break-up of the Soviet Union following the failed August 1991 coup attempt in Moscow. All four countries were and remain closely linked by trade with Russia. For example, 56 per cent of Kazakh exports to the countries of the FSU in 1991, valued at 10 billion rubles, and 62 per cent of imports in 1991, valued at 13 billion rubles, were traded with the Russian Federation. By 1993, trade with Russia had changed from a deficit of 14 per cent of the total value of trade between the two countries to a 26 per cent trade surplus. This is probably a short-term aberration in the trade statistics even though the two countries are undoubtedly moving towards a more balanced trade regime. Thus, the situation in the 1980s, when the four republics ran a large interstate trade deficit financed by the central planning authorities in Moscow is gone forever. In Kazakhstan's case the debt amounted to 407 billion rubles or 26 per cent of GDP in 1992. The

disappearance of these transfers from the FSU, according to the IMF, implied the withdrawal of a fiscal stimulus of equivalent to up to 10 per cent of GDP. Uzbekistan received 292 million rubles equivalent to almost 70 per cent of GDP in debt financing from the Central Bank of Russia in the same period.

The vertically integrated, command economy administered from Moscow broke down extremely rapidly after 1991, while new market-oriented institutions have only very slowly emerged. This is not surprising given the very close integration of the economies and enterprises of the region with the Russian Federation and the Ukraine, in some cases dating back to the nineteenth century, but strengthened particularly with the formation of the Soviet Union in 1917 and the introduction of the central planning system.

The industrial structure was (and still is) highly concentrated, and in many cases monopolistic, with enterprises vertically integrated across the frontiers of the constituent republics of the Union. Much of the research and development, particularly supporting the industrial-military complex, was located in the Russian Federation. Heavily subsidized freight charges and administrative decisions in Moscow enabled the final stages of production and assembly to be located in the Central Asian Republics. Indeed, many strategic industries and people were relocated in the region during the Second World War to avoid capture or attack in the German invasion of western Russia. Almost all of these enterprises have remained. It became normal for raw materials and components to be transported vast distances across the Union by rail at prices representing a fraction of the true cost.

When the FSU collapsed, demand from the Russian Federation dried up, especially for military equipment. The introduction of increasingly realistic freight charges pushed up prices of final products manufactured in areas remote from inputs and/or final markets. Throughout the FSU aggregate demand

Table 1
Territory and Population (1992)

	Territory (1,000's sq.km)	Density of population (per sq.km)	Total population (1,000's)	Labour force (1,000's)
Russian Federation	17,075.4	8.7	148,625	86,200
Kazakhstan	2,717.3	6.2	17,057	9,300
Uzbekistan	447.4	47.4	21,672	10,390
Azerbaijan	86.6	83.7	7,330	4,000
Kyrgyz Republic	119.9	22.4	4,518	1,730

Table 2
Relative Weight of Countries in CIS (1992)

	GNP	Industrial production	Consumer goods production	Agric. production	Retail trade turnover
Russian Federation	66.3	63.5	60.7	51.5	61.7
Kazakhstan	4.8	4.7	3.8	8.0	3.7
Uzbekistan	3.5	3.4	3.0	6.0	2.4
Azerbaijan	1.4	1.4	1.6	1.4	0.8
Kyrgyz Republic	0.9	0.8	1.0	1.3	0.5

from households contracted as real incomes fell rapidly. The situation was made worse by the breakdown of interrepublic trading relationships primarily caused by the inadequate system for settling payments between the new Republics of the CIS. Attempts to introduce bilateral trade agreements based on state orders as a substitute did not work because state trade organizations generally had insufficient funds to cover payments.

The collapse of the ruble zone and the introduction of national currencies in 1993 made matters worse since there is yet no system for trading regional currency balances held by enterprises. In addition, the state order system often uses controlled prices that provide insufficient incentives for enterprises; payments are slow and not indexed to cover domestic inflation; and governments may retain up to half of foreign exchange earnings.

Enterprises positioned at key points in raw material and component supply chains have started to exploit the situation by withholding payments in order to benefit from inflation. Many so penalized have tried to switch to barter trade in order to maintain their supplies and working capital. Barter, of course, also offers opportunities for avoiding foreign exchange retention requirements, price controls and taxes. Naturally, not all enterprises are able to match their need for inputs with their outputs via a multi-stage barter network. Other producers of raw materials have diverted sales directly to hard currency markets thereby exacerbating shortages for domestic users. Those most adversely affected by disruptions in the flow of raw materials have tended to be the smaller enterprises with limited buying or selling power and no political patrons to secure the necessary allocation of hard currency.

Private traders seeking to take advantage of the many arbitrage situations that now occur as a result of the breakdown of the payment system are, not surprisingly, treated with a good deal of suspicion by

the authorities. Instead of seeking ways and means to regulate and tax barter activities the tendency has been to force them into the "grey" economy. Even more importantly, the authorities and the central banks, in particular, have been very slow in facilitating interrepublic trade through the establishment of a settlement scheme.

Steps are being taken to introduce currency auctions under the auspices of the central banks in the region but it remains to be seen whether heavily indebted state enterprises will wish to reveal the accumulation of liquid assets in a public forum. The tradition of maintaining secrecy in all economic matters in the FSU is unlikely to give way to greater openness in corporate affairs until the fiscal and industrial policy environment becomes more transparent and the benefits to be gained from competitive market operations become clearer.

The interdependence of the energy sector of Kazakhstan, and of the Russian Federation highlights the quite extraordinary extent of linkages between economies of the region. It also puts into sharp focus the very major constraints on any move to internationalize economies which does not have the tacit support of the Russian government. Until an alternative pipeline from the western Caspian oilfield is built, Kazakh oil (about three-quarters of domestic production and rising) can only be routed through a Russian pipeline. At the same time, oil refineries in eastern Kazakhstan can only receive oil from Siberia. However, Siberian producers have other export outlets so they demand a higher price for the feedstock supplied to the refinery in Pavlodar, eastern Kazakhstan, than west Russian importers pay for crude oil from western Kazakhstan. At the end of 1992 the export price of Kazakh crude was reported to be about a quarter of that of imported Siberian crude oil. Azerbaijan and Uzbekistan also have to route their oil and gas exports through Russia. While building

Table 3
Key Macroeconomic Indicators
(Percentage Change January-August 1993 over January-August 1992)

	Industrial production	Producer price index	Consumer price index	Monetary income of population	Retail trade turnover
Russian Federation	-16.8	848	847	1000	5.8
Kazakhstan	-12.3	1383	924	1038	-10.9
Uzbekistan	1.3	1039	597	1068	26.7
Azerbaijan	-9.5	na	na	930	-36.8
Kyrgyz Republic	-28.2	746	1105	693	-21.6

Table 4
Trade Between Russian Federation and Four Countries

	1993 Imports from Russia	1993 Exports to Russia	Finance from Central Bank of Russia, 1992	
	Rubles bn., current prices		% of GDP	
Kazakhstan	1414	2386	407	25.5
Uzbekistan	1026	735	292	69.9
Azerbaijan	181	167	51	25.8
Kyrgyz Republic	112	208	42	22.9

alternative pipelines to the West is clearly a government priority, it has not proved easy to assemble a consortium to build them or agree on the routing or charging regime. The proposed oil swap agreement with Iran for Caspian Sea oil looks like a promising way forward but still has substantial attendant political risks attached.

Sharp increases in input prices including energy and freight costs to nearer world levels are threatening the competitiveness of large sections of manufacturing industry in the region designed to operate under a very different price regime. Even where production is exportable, support from the export promotion programme is still very weak. Numerous barriers still exist. For example, export licensing is still subject to administrative procedures, many exports are subject to duties and part of foreign exchange earnings are retained by the central bank. Sometimes mineral exports are subject to arbitrary bans for national "security" reasons. Moreover, the division of responsibility between state holding companies and enterprises does not encourage active marketing or product development by producers.

For governments, the challenge is to manage the transition of the industrial sector so that it becomes able to compete with imports and develop new export markets. In the short term, government capacity is severely restricted by budgetary constraints while, in the medium term, rising resource export receipts may fuel an import boom if not managed effectively. There is therefore an urgent need to strengthen the government's capacity to identify bankable projects and supervise completion of ongoing investments and rehabilitation of existing assets that show promise.

The government's role in investment ought to decline over the next five to ten years. However, this is wholly dependent on the emergence of a strong and independent banking sector with investment appraisal capacity and the development of a managerial cadre at enterprise level able to operate effectively in a competitive market environment. The latter conditions were noticeably absent from the enterprises visited and banking sector reform has only just begun.

Lack of a Clear Vision for Industry

All the Republics have promulgated various decrees aimed at market-driven reforms, privatization, industrial restructuring, investment promotion both domestic and foreign, small and medium scale enterprise and entrepreneurship development and broad-based private sector development. But none of

the Republics appears to have developed a clear "vision" for industry in the form of a comprehensive industrial development programme. There is also a lack of basic statistical data and other information on the industrial sector in the Republics upon which to base a comprehensive development programme. Not surprisingly, there is a very real lack of a coherent focus for industrial development in the Republics. But, without a clear focus, direction or prioritization to guide the privatization and restructuring processes is not possible.

All the Republics have stated their intention to develop or launch an industrial development programme in the near future. There are, however, limited capabilities within the government machineries to do this effectively. The implication of the current situation is that there is very little guidance or consistent information that can be gleaned explicitly from policy documents and government statements about industrial policies and priorities for industrial development.

To add to the difficulties facing reformers, the region has limited capacity to absorb external assistance. Prior to 1991, the region had very limited experience of external assistance. Not only was experience and information limited as to what external assistance might be available, there was virtually no infrastructure in place to co-ordinate or handle requests or offers of assistance. There are also severe short-to-medium term constraints in the Republics' ability to absorb investments. These constraints give rise to a lack of "bankable" projects reflecting deep structural problems in the region and are likely to persist for some time as administrative capacity, financial engineering experience, the legal framework and marketing and distribution channels are developed. Although particular Republics may appear to be inundated with offers of assistance from the international agencies, bilaterals, and private sector consultancy and law firms, much of the assistance, though usually well-conceived, is not co-ordinated. There is a particular need to help local and regional authorities articulate their needs so that requests from national governments reflect local needs as well.

Private Sector Development

Private sector development and privatization are inextricably linked with industrial restructuring. The reason is simple: in an economy almost totally dominated by state-owned enterprises, the policy environment and markets for raw materials, intermediates and credit, and the market for

manufactured goods are still largely determined by state enterprises. The creation of a level playing field for both state-owned and privately-owned enterprises is vital for the effective restructuring of industry and commerce and the development of international standards of efficiency and competitiveness.

At the present time, macroeconomic stability has not yet been attained. (Price inflation in Azerbaijan, Kazakhstan, Kyrgyzstan and Uzbekistan in mid 1994 was averaging between 30 and 50 per cent per month.) Macroeconomic instability biases private sector development towards trading activity where money can be turned over very quickly and little is tied up in illiquid fixed assets. Other factors inhibiting private sector development are numerous. Distorted markets and prices make competition unfair and not based on the true scarcity value of inputs. The state still controls the distribution system in Kazakhstan, Azerbaijan and Uzbekistan.

The burden of non-business related activity of state-owned enterprises (social services functions such as nurseries, schools, hospitals and sanatoriums) and labour retention constraints, does not give state-owned enterprises the freedom to compete on the same basis as private sector enterprises. This social welfare function is often used to justify preferential allocation of credit to state-owned enterprises. Uncertainty about potential environmental liabilities from past activities needs to be removed from enterprises. Of course, all future pollution damage should be explicitly the enterprises' responsibility.

Working capital is always in short supply when inflation and interest rates are high. Efficiency in the allocation of credit is vital to prevent crowding out of the private sector by the state's budgetary requirements. However, the development of efficient financial markets is dependent on the transformation of existing state-owned banks. They need to operate to international standards and acquire the capacity and capability to evaluate commercial risk and enforce compliance with loan requirements in a manner supportive of business development, regardless of owner. Long-term investment capital is not currently available to the private sector. The best available credit is revolved over 90 days. By contrast, state-owned enterprises receive heavily subsidised credit and may roll over bad debts.

The legal and business environment leaves the security of property and contractual rights vague and does not prevent arbitrary administrative abuse of power and rent seeking. Financial governance of

state-owned enterprises is weak, reflecting the persistence of the old system of government-directed credits which did not require banks to take responsibility for lending to state enterprises. As the banks move to accept responsibility for and evolve bad debt workout regimes, the authorities will need to establish a defensible approach for writing off debts of state enterprises.

The problem areas that have so far emerged are predictable from Central and Eastern European experience. In the Central Asian Republics, they tend to be of a more extreme form as a result of the debilitating effects of seventy years of dependence on the central planning mechanism of the FSU. Problems include:

- ☐ A very weak banking and financial services industry with very few bankers with knowledge of commercial risk appraisal and financial intermediation.
- ☐ Lack of bad debt sanitization and workout provisions by ministries of finance and central banks; persistence of soft budgetary constraints and subsidised credits for state enterprises.
- ☐ No clear source of venture capital for funding restructuring and reinvestment in privatised or private enterprises. Current lending is short-term and trade related or state-directed to state enterprises and/or inter-firm credits.
- ☐ Legal and regulatory infrastructure to support the private sector has been developed rapidly with technical assistance from the World Bank and the EBRD (especially in Kazakhstan and Kyrgyzstan). It is on the statute book but is generally not operational because of the lack of trained professionals in the Government administration to make it work. There is also evidence of extortion by state officials from private entrepreneurs.

Privatization

The extent of state ownership in Central Asia in 1991 (up to 90 per cent of fixed assets) was much greater than in any of the countries of Central and Eastern Europe. In the absence of any experience of successful privatization of an economy with no recent history of private enterprise nor even an embryonic entrepreneurial class, it is not surprising that progress has been patchy. There have also been some false starts and, in the case of Azerbaijan, no start at all beyond passing some untried enabling legislation.

Programmes adopted in the region all start with so-called small privatization: retail shops, trade, and consumer services. The second "phase" aims to

privatise "medium-sized" enterprises. In the case of Kazakhstan, these may employ up to 5,000 people.

The third "phase" which may overlap with the second phase, involves case-by-case disposal of very large or "special" enterprises, that is, those with major political and strategic implications, often enterprises that are fragments of the industrial-military complex of the FSU.

There are many unresolved issues that have arisen so far from privatization. Competition policy does not work because of lack of resources and personnel, but more importantly, the continuing fragility of all enterprises makes it very difficult to introduce stringent controls that may precipitate enterprise collapse. None of the four countries has begun to deal with the social or potential environmental liabilities of state-owned enterprise. Each case needs to be negotiated individually as part of the privatization process. Legislation is required to sanitise environmental liabilities and a framework must be developed for dealing with individual cases. Corporatization is an essential first phase of privatization, but bad debts have not been defined clearly and sanitised in the new joint stock companies.

Policy implementation is incremental so that mistakes accumulate as well as successes. Early preferences for ownership transfer to employee collectives has created new problems in terms of constraints on effective corporate governance and the adoption of management-driven business strategies. The Uzbek government is trying to correct earlier mistakes by presidential decree. This may not be so easy in Kazakhstan and Kyrgyzstan, though the Kyrgyz authorities have promulgated a new programme to redress what they consider to be "low quality" privatization.

Early Kazakh legislation favoured privatization via

ownership transfer to employees (worker collectives) but later was modified to restrict employee holdings to no more than 25 per cent (2,037 enterprises are nevertheless owned by collectives). A similar process occurred in Uzbekistan, where 1,286 enterprises were transferred to collectives. However, in the Presidential Decree of January 1994, it was announced that "closed" joint stock companies will be reorganised to permit non-employees, including foreigners, to buy shares. In Kyrgyzstan, "closed" privatization has also occurred to such an extent that the government has promulgated a new programme in 1994, auctioning shares remaining in state hands to outsiders (non-employees).

Kazakhstan has advanced most towards mass privatization, the second phase, with the suspension of the 1991 procedures and adoption of a new voucher scheme. Vouchers were issued to adults in November 1993 and the first auctions took place in mid-1994. The vouchers are non-redeemable and have to be "invested" in an investment promotion fund (IPF). The management of the IPF is then able to use the vouchers that have been invested to bid for enterprises offered for sale. However, it is by no means clear how the IPF's will actually mobilise new capital to finance necessary enterprise restructuring and rehabilitation, nor whether they have the expertise to introduce proper corporate governance into newly privatised enterprises.

An underlying assumption behind privatization is that the efficiency of hitherto state-owned enterprises will improve as a result, strengthening the incentives for managers to accept personal responsibility for their actions and accept the consequences of inadequate performance. Without a massive investment in restructuring assistance and training for management in cost accounting and marketing, progress is likely to be slow because managers do not

Bernhard Fischer (ed.)

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have the means with which to function effectively. Kyrgyzstan has produced the most elaborate and detailed plan for privatization (with quarterly targets), but is already running behind schedule, only one year into the programme.

Industrial Restructuring

The issue of privatization in the CARs is intricately linked to that of industrial restructuring. With the slow pace of privatization in the Republics and the absence of a well-developed private sector, many state-owned enterprises (SOEs) will remain in the public sector for some time to come. It is therefore essential that in this interim period governments try to greatly improve the efficiency, productivity and competitiveness of existing SOEs. In this context, industrial restructuring has become the major challenge for the industrial sector in the Republics. However, existing industry in the region is currently facing severe difficulties.

In all the countries of the region, the transition from a command to a competitive market economy and regulated FSU trade to liberalized trade and prices has resulted in many industries being cut off from traditional sources of raw materials and supplies, a loss of markets and sharply declining domestic demand. Above all, the reduction or suspension of government subsidies coupled with competition from imports has revealed an extremely low level of product competitiveness and shortcomings in production processes, capacity utilization and enterprise structures. Industrial subsectors which were primarily supplying goods to the FSU markets have been particularly badly affected. The efforts to pave the way for industrial restructuring and recovery will require policy reforms and interventions in a myriad of ways from sub-sector restructuring programmes, privatization, FDI, modernization of enterprises, technology through to skill upgrading, retraining in technical skills and management practices.

Whereas the choice of speed and sequence of required policy reforms has been the subject of great debate, there has been little disagreement about the need to support the restructuring process with specific measures and assistance. Without restructuring, many enterprises in the region will not be viable and none of the countries in the region is in a position to absorb high levels of unemployment. Political stability in the region is too fragile to withstand the heightened social pressure that would result. Restructuring needs to avoid re-establishing previous conditions for inefficient production, establishing

instead a new basis for viable production and overall growth.

Declining performance and eventual bankruptcy of some industrial enterprises are inherent features of a dynamic industrial development process. However, this also can be an indication of inadequate economic/industrial policies and other shortcomings in the economic environment or the result of abrupt changes in key parameters – such as the abrupt loss of input and output markets and increases in the price of previously subsidized energy inputs. Introducing new industrial policy measures, drawing up special structural adjustment programmes at the sectoral and sub-sectoral levels and building up greater resilience in industry are among the major problems that many of the CARs are addressing. In all the four Republics most enterprises are in need of restructuring.

The Regional Dimension

In the context of industrial restructuring and because of the past distribution of economic growth and investment which was driven by the priorities of Moscow, many regions within individual Republics were neglected. Other regions became dominated by “one-enterprise” towns. The threat of closure of these enterprises spells economic and social disaster for the communities that have grown up around a single enterprise. The situation is particularly acute in Kazakhstan because of its vast size and the geographical isolation of many of its mining complexes. Structural change in a regional context should be seen not as a general problem of the national economy, but as a set of specific problems characteristic of the different regions of a country and particular enterprises. The extensive social and welfare responsibilities of large state-owned enterprises further accentuate the consequences of a closure for the local community.

Governments in Central Asia will need to build up active regional development policies to support industrial restructuring within their individual countries. Indeed, the administrations of major cities in the regions such as Karaganda, Pavlodar and Chimkent in Kazakhstan, Osh in Kyrgyzstan, Samarkand in Uzbekistan and Gendje in Azerbaijan, among others, are powerful political entities in their own right. Any plan to significantly alter the size of enterprises in disadvantaged regions may result in the widespread outbreak of social unrest and in particular instances may pit regional power centres against the central government. Regional development initiatives are thus vital for maintaining internal political stability during the transition process.

Two key problem areas arise in the fallout from enterprise restructuring at regional level. The first is to provide a forum in which local interest groups can be made aware of the issues involved in restructuring and be helped to work constructively on ways of ameliorating the situation. Local politicians, officials and interest groups need to have access to professionals and resources with the capacity to contribute to local initiatives.

The second problem area is how to deal with unemployment and employment generation. Policies to promote private initiative and enterprise through the development of small and medium-sized enterprises (SMEs) are obviously important. In this regard, new key actors may have to be created at the regional level, in the form of a "regional development agency", to channel local efforts and provide help with the preparation of project proposals for regional assistance, either from the national government or the donor community. Such agencies are also valuable for collecting information about a region and organizing its promotion at a national and international level.

Internationalization of business activity and intensification of competition amongst regions for increasingly "footloose" investment capital means the task of attracting both domestic and foreign investment has to be tackled in a professional manner. Moreover, regions compete substantially on the basis of the producer services they can offer to investors such as efficient marketing and transportation services, consultancy and financial services, and of course, the availability of a well-educated and productive labour force. In the Central Asian countries, there is no long history of producer services development. These services need developing at a regional level, just as much as at a national level if the benefits of economic growth, when it comes, are to be spread to the region.

Pre-privatization Intervention

A word should be said about the relationship between restructuring and privatization. Should privatization precede restructuring or vice versa? There is no universally applicable answer to this question. The answer will depend on the country, its stage of development and subsector or industry concerned, and most importantly, the individual enterprise in question. Nonetheless, many enterprises in the CARs require assistance in devising plans for restructuring before privatization. Indeed, given the slow pace of privatization, there appears to be a definite preference for restructuring prior to

privatization in the region – where it is understood that in many cases large-scale privatization may be some way off in the future. In many cases, such pre-privatization intervention will be necessary, if only to keep them going long enough to find a private investor. The conversion of the branch plants of the former Soviet Union's industrial-military complex in the region to independent civilian production poses particularly acute problems.

These pre-privatization interventions generally include legal restructuring (the transformation of SOEs into limited liability or joint stock companies), and creating viable core business units by breaking up combines and spinning off non-core activities or social services. In some cases, financial restructuring will be required in order to make an otherwise viable enterprise attractive to private investment. In the CARs, particularly Kazakhstan where industries are highly vertically integrated, large monopolistic enterprises often will need to be split up, and horizontal specialization pursued prior to privatization. It is considerably more difficult to de-monopolize or split up large enterprises and introduce the required structural changes after privatization than before it. Anti-monopoly legislation is on the statute books or in preparation in all the four countries surveyed, but none of this legislation has been implemented successfully so far.

At the enterprise level where the key actors are managers, restructuring needs are extensive and will include the development of new products and product mixes, acquisition of new technologies and production processes and application of modern managerial, accounting, management information and marketing practices. Such restructuring needs to win the commitment of the management team who have to decide whether certain auxiliary activities should be spun off leaving core production processes to be continued and turned into profit centres.

State Holding Companies as Key Factors

Many of the state-owned enterprises visited were formally subsidiaries of state holding companies or associations. Sometimes the holding company was simply the old functional ministry dating back to the administrative structure of the FSU transformed into a corporate entity. For example, the former ministry of light industry in Kazakhstan and Uzbekistan became LEGPROM, the state holding company responsible for a group of light industries, which usually included textiles, clothing, leather and shoe manufacturing. The precise nature of the relationship between the holding company and its subsidiary enterprises was

difficult to ascertain. The principal functions of the holding company cover overseeing the annual budget preparation process and managing marketing, sales and purchasing on behalf of enterprises. The main source of power of the holding companies seemed to be derived from their routine control over trading operations and any foreign exchange earnings or credit allocations from central government.

As regards capital allocation within the state budget and between enterprises, this appeared to be determined through a complex system of formal and informal bargaining, not that dissimilar to the processes that go on within large corporations in mature capitalist economies. While direct subsidies had mostly been abolished, credit at negative interest rates was often provided. More importantly, penalties for failing to repay loans were unclear. Since company and property laws were underdeveloped and the legal status of state enterprises and their holding companies was ill-defined, enforcement depended on administrative action by the ministry responsible.

Privatization and corporatization is gradually strengthening the position of the Director-General of individual state enterprises. This appeared to be most advanced in Kyrgyzstan where privatization has transferred majority ownership to employees. Even so, chronic shortages of essential inputs, foreign exchange and working capital still left most enterprises substantially dependent on the state budget. In Kazakhstan, the introduction of a voucher scheme of privatization in 1994 will in time permit the creation of investment funds, but it is unclear how fund managers can exercise significant influence without access to new capital with which to invest in efficient enterprises. In Uzbekistan and Azerbaijan, state-holding companies continue to dominate external relationships between enterprises and their suppliers and markets.

In all four countries joint ventures with foreign partners were based on contracts with the government rather than on company law. Examples of joint ventures encountered were either for the supply of equipment and technology or for the production of manufactured goods under contract. There were no examples of foreigners participating in enterprise management.

Implications for Enterprise Restructuring

The prevalence of state holding companies operating at an intermediate level between the state planning and budgeting system and the enterprise creates additional complexity for restructuring

exercises in the region. While they may have been introduced as interim institutions following the collapse of the central planning system of the FSU, the basis of their legislative and financial support is obscure, yet many officially control important functions of enterprises, particularly capital budgeting, marketing and sales.

None seemed to have strong decision making functions. If anything, they had rather less power than when they were simply functional ministries of state. Holding companies also suffered from many of the vices of the old central planning mechanism. In particular, by concentrating trade operations in the holding company, enterprises were effectively cut off from the market place and their customers. To make matters worse, none encountered were inclined to demand market-oriented business plans from their subsidiaries. Indeed, no example was found of a holding company introducing a system of control based on identifiable strategic business units and modern cost centre-based management accounting. Instead, the main functions of holding companies appeared to be administrative, namely, passive processing of cash flows and sales orders.

The policy question arises as to whether enterprise restructuring exercises should be conducted through holding companies or directly at the enterprise level. Evidence from Central European economies in transition demonstrates clearly that it is the impact of government policies on the economy as a whole which is more important than organizational structures in determining whether restructured enterprises become more competitive and profitable. Without a market-oriented policy environment and structure of incentives, it is unlikely that any holding company or enterprise can somehow lift itself outside the dominant economic framework on its own or with technical assistance.

Having said that the necessary policy pre-requisites for the development of a market-oriented economy must be in place, the question still remains, should holding companies be abolished, avoided, or restructured? Obviously, there can be no categorical answer to the question, since it depends on a thorough business audit of the remit and personnel of particular holding companies. However, given the immensity of the task facing economic reformers in Central Asia and the shortages of competent personnel to manage the long and protracted restructuring process in the thousands of state enterprises of the region, it would seem sensible to work through holding companies.

Management and Entrepreneurship Development

Management training and development is widely recognised as a priority for technical assistance in the donor community. The total volume of management training taking place in the four countries is difficult, or even impossible, to estimate since many programmes have implicit training objectives built into otherwise technical objectives. So far the impact of the training is limited. Not one of the enterprises visited in any of the four countries had a business plan, neither did the management give the impression that they knew what a market-oriented business strategy should consist of. Specifically, enterprise managements

- ☐ were externally oriented to the extent that their strategic thinking focused on the intricacies and dynamics of the state planning and budgeting system, regardless of whether the enterprise was formerly a joint-stock company;
- ☐ made decisions according to administrative or bureaucratic criteria rather than primarily economic or entrepreneurial factors;
- ☐ were very interested in, even fascinated by Western technology and were eager to close the perceived gap between existing plant and technology frontiers;
- ☐ had no modern management information systems available to them. Accounts were still kept to the standards of the FSU, that is, they were records of expenditures. Cash flow forecasting, cost- or profit-centred budgeting and active financial management was unknown even in kombinats contemplating spending hundreds of millions of dollars;
- ☐ were unable to produce a marketing plan or demonstrate market research activity. Enterprises passively waited for buying orders from their holding company or the appropriate foreign trade organization;
- ☐ conceived of product design and development as an autonomous activity divorced from any systematic assessment of what consumers wanted. Even fabric design was some kind of theoretical aesthetic exercise divorced from marketing considerations;
- ☐ were unable to control product quality as a trade-off between the cost of quality control and target market price sensitivity. Quality was set by the available mix of raw materials and machinery. Often materials and spare parts were in short supply; and
- ☐ had no control over wages, conditions of employment and social obligations of the enterprise. These were set by the state authorities.

Effective management training needs to be supported by the culture of the enterprise in which it is occurring. Without enterprise restructuring and the

intervention of change agents such as external consultants, training in modern management techniques is unlikely to have a major impact. Systematic change in the policy environment, in particular the interface between the state apparatus and the enterprise, is also necessary to reinforce change in organizational cultures and behaviour. A mass programme of management training is required, designed to be carried out over a given time period, say five years.

Present efforts are too elitist, too western-oriented, taught off-the-job, on too small a scale and are too expensive. As a consequence, none of the countries of the region is even remotely approaching developing a critical mass of trained managers. Clearly, as enterprise restructuring gradually acquires momentum in the region, the demand for management training will increase at the enterprise level. This increase in demand and need has to be planned for.

Catching up with Global Technology Frontiers

Industrialization in all four countries has been driven by the requirements and objectives of the central planning system in Moscow for over seventy years. This system was designed to maintain the central authorities' control over industrial development in the Republics of the former Soviet Union. While universities and academies of science were established in the Republics, scientific research was mostly concentrated in the Russian Federation and in the Ukraine. The more advanced manufacturing facilities of Central Asia were primarily concerned with final assembly of products designed and engineered in Russia. This was particularly so in the case of the military-industrial complex. Thus, although the Dastan Torpedo Factory in Kyrgyzstan, for example, has a highly sophisticated machine shop for making the casings for torpedoes, all the research and development work on the electronic guidance system is carried out in Russia.

As a consequence of the collapse of the Soviet Union, not only are enterprises cut off from their trade links and supply lines, those in high technology industries are now excluded from product and process research and development is centred in the Russian Federation. Personnel no longer retain regular contacts with all Union research institutes or attend scientific conferences in Russia. Foreign exchange shortages and budgetary constraints also cut universities, research institutes and enterprises off from western scientific journals, conferences and normal networks for scientific discourse.

On the more positive side, western capital equipment salesmen are now beginning to explore the markets of Central Asia and are making project proposals to state enterprises and Government ministries. While these contacts raise awareness of decision makers in the region of developments in modern process and product technology, they are inevitably partial and do not necessarily lead to the selection of the appropriate technology, the efficient transfer of know-how or the enhancement of indigenous technological capability.

The closing off of scientific networks to Russia and the opening up of access to global technology networks raises specific problems for Government with respect to technology policy, licensing and intellectual property legislation. For enterprises, the need is for assistance with evaluating technology proposals and, in the long term, creating their own in-house research and development capacity. Scientific research institutes and universities require assistance with reorienting their activities towards the needs of restructured market-oriented enterprises. To achieve this adjustment, research institutes need technical assistance and grants with which to buy modern equipment for laboratories and library grants to buy western scientific journals and books. They also need advice on linking their research activities to enterprise needs. Past performance has been particularly poor.

The Governments of the four Republics are aware of the need to integrate science and technology policies into the overall development process. In Uzbekistan, a special office under the President of the Republic has been set up to advise on technology policy and in Azerbaijan, the Chairman of the Committee on Science and Technology serves as an adviser to the President of the Republic. Both governments in Kazakhstan and Kyrgyzstan have adopted new science and technology policies. The problems are more at the operational level in terms of the quality of laboratories and other research facilities and the wide communication gap that exists between the research institutes and productive enterprises.

Conclusion

For the transformation to a market economy in the CARs, industrial reform, enterprise restructuring, rehabilitation and privatization are not simply technical matters of rearranging the factors of production into a more efficient configuration, they also involve creating a social system in which, in net terms, ordinary people can achieve a substantially better lifestyle than was possible before. It also means

change and disruption to the working lives of many people, some of whom will end up significantly worse off than they would have done under the old system. If the radical economic transformation of the newly independent states of Central Asia is to be successful, policy-makers must be sensitive to the very real costs as well as the benefits of the changes. The distribution of the costs and the benefits is of as much concern as the aggregate effects. Unfortunately, many of the policy prescriptions given by international advisors have never been tested on economies or societies with the particular features of the Republics of Central Asia. It is wise, therefore, to proceed cautiously in order to arrive safely rather than to attempt heroic leaps in the dark in the vain hope of finding quick solutions to what are undoubtedly deep-rooted structural problems.

The first major challenge for enterprise reform is providing a coherent "vision" for industrial development. As the electoral reverses of liberal political parties and their replacement by post-communist parties in all the countries of Central and Eastern Europe (except the Czech Republic) have demonstrated, economic reform has to take account of popular opinion. Specifically with respect to enterprise reform, successful achievement of global competitiveness depends ultimately on human resources as much as on capital. This means enterprise managements have to be sufficiently convinced of the benefits of reform to drive through the necessary changes at enterprise level.

At a national level, there is currently a very real lack of a coherent focus for industrial development. The remnants of the structure of the old communist economy, sometimes remarkably resilient, continue to compete with elements supporting reform. Though all countries of the region are making some progress in developing an appropriate macroeconomic framework, more detailed consideration of enterprise reform within a clear industrial development strategy has hardly begun. Kazakhstan and Kyrgyzstan have made more progress than Uzbekistan or Azerbaijan, but even in Kyrgyzstan, which has publicly espoused a "fast-track" approach, industrial policy and the programme for enterprise restructuring has had little visible impact. In Azerbaijan, policy development has been stalled by the human tragedy of invasion and warfare with Armenia. In Uzbekistan, the government also seems more preoccupied with maintaining political stability than introducing necessary industrial reforms, understandably, given the presence of refugees from civil wars in neighbouring Tajikistan and

Afghanistan on its territory. At least in the three natural resources-rich countries of Azerbaijan, Kazakhstan and Uzbekistan, the window of opportunity for industrial reform will not remain open indefinitely. As new oil, gas and gold mining concessions come on stream over the next five to ten years, there is a real danger of a severe attack of "Dutch disease" as rising revenues stimulate an import-led boom. Unreformed state enterprises will be unable to compete in a competitive domestic market. At the present time, domestic demand is still substantially repressed by the structural adjustment-induced recession in the economies of the region. Even so, "suitcase" importing of consumer products is visibly growing as disposable incomes begin to recover.

At national level, then, industrial reform has hardly begun. Firstly, the structure of the government departments responsible for industrial policy development and implementation needs reorganisation. The old communist division of labour between the Ministry of Economics, State Planning and the Ministry of External Economic Relations and the new, between agencies, such as for privatization and competition policy, the central bank and the Ministry of Finance has led to fragmentation of responsibilities. The donor community has also contributed to the confusion, as different donors have competed for the attention of different departments of government, sometimes encouraging separatist tendencies in particular agencies.

Relatively easy, legislative "paper" reforms are generally well-advanced but, all too often, inadequate attention has been paid to the practical and longer term problems of implementation. The increasingly urgent task is to build up the capability of a government department or agency to assume responsibility for overall co-ordination of industrial restructuring and enterprise reform, including improving the quality of statistical data available on the industrial sector for decision makers; and liaison over key policy initiatives such as privatization, competition policy, as well as with the Ministry of Finance over credit and fiscal policy, particularly debt restructuring and workouts for state-owned enterprises.

A second national priority is to create a fully professional agency responsible for powering up reform and restructuring of state-owned enterprises prior to privatization. For the foreseeable future, a major portion of the enterprises of the region will remain effectively under state ownership. It is vital to preserve those that are potentially viable or are currently viable in as efficient a form as possible. The

current tendency to let them all drift without support or assistance is to store up disasters for the future and unnecessarily waste valuable assets. The restructuring agency should be the major operational division of the government actively responsible for the governance of state enterprises and liaison with the state property committee and anti-monopoly agency. It would have responsibilities for corporate governance of SOEs, commissioning diagnostic studies and technical assistance to SOEs to be restructured, including energy audits, social and environmental liabilities assessment, technology licensing to SOEs, spin-offs and SME support during and after restructuring, training, and public relations campaigns to facilitate enterprise transformation. Another key function is working with the Ministry of Finance and the commercial banks, to impose proper credit controls on SOEs and design debt workout regimes to sanitize their balance sheets and enforce a hard, profit-driven budget constraint.

Evidence from Central and Eastern Europe suggests that it is unwise to assume privatization is the end of state assistance to enterprises. Post-privatization support to newly private enterprises, including small enterprises that are spun off from large enterprises as part of the restructuring and privatization process, is likely to be necessary as the legal and regulatory infrastructure and financial services sector are developed to support market-oriented and competitive enterprise. This remains a mammoth undertaking and inevitably there will be many mistakes. Failure to be seen to be facilitating the transformation process with state assistance will provoke an unpredictable political backlash.

An irony, then, of the kinds of reform programmes envisaged in this paper is that reintegrating the Central Asian Republics into the world economic system requires active state intervention supported by substantial technical assistance from the international community over a considerable period of time. Of course, this intervention is not comparable to the stultifying influence of the central planning mechanism of the former Soviet Union, but there are very real political dangers implicit in any overbearing role for the state in economic activity. Fortunately, East and South East Asia provide many examples of high growth economies where, despite occasional setbacks, a successful dynamic balance has been struck between state and enterprise. Moreover, as these economies have matured and prospered, state intervention in economic activity has declined and political democracy has strengthened.