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## Coordinating aid for regional cooperation projects: The experience of Central Asia

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Research Paper No. 2007/48

## **Coordinating Aid for Regional Cooperation Projects**

The Experience of Central Asia

Richard Pomfret\*

August 2007

### **Abstract**

For the Central Asian countries the dissolution of the Soviet Union led to economic disintegration as old coordination mechanisms disappeared and new national borders appeared. This paper analyses why it has been difficult to coordinate aid for regional cooperation projects (e.g., on the Aral Sea or trade facilitation) whose economic benefits appear positive. Bilateral aid flows to Central Asia have been dominated by geopolitical rather than economic considerations, and have been at best narrowly national in focus and at worst regionally divisive. Regional organizations composed of Central Asian countries and various neighbours have also competed rather than cooperated, so that the most plausible source of coordinated aid for regional cooperation projects is the multilateral agencies.

A key role for aid donors is to provide technical assistance in analysing and explaining benefits, and how these affect various interests. Initial advantages which multilateral agencies had as impartial providers of technical advice were undermined in 1992-93 when the IMF's strong position in favour of retaining the ruble turned out to be

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Keywords: aid, Central Asia, trade

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mistaken advice. In the 1990s aid directed to the Aral Sea problem produced few benefits because, despite the magnitude of the gross benefits from reversing the desiccation, littoral countries see differential benefits and costs; pure win-win situations are more likely from regional cooperation in trade facilitation. Subsequently the multilateral agencies have had a better focus, sharing priorities in the destination of aid and agreeing on a functional division of labour, but this has not yet translated into effective assistance for regional cooperation.

## Acronyms

|         |  |
|---------|--|
| ADB     | Asian Development Bank                                     |
| CAREC   | Central Asia Regional Economic Cooperation                 |
| CIS     | Commonwealth of Independent States                         |
| EBRD    | European Bank for Reconstruction and Development           |
| ECE     | United Nations Economic Commission for Europe              |
| ECO     | Economic Cooperation Organization                          |
| ESCAP   | UN Economic and Social Commission for Asia and the Pacific |
| IDA     | International Development Agency                           |
| IFAS    | Interstate Fund for Saving the Aral Sea                    |
| IFIs    | international financial institutes                         |
| IMF     | International Monetary Fund                                |
| PPP     | purchasing power parity                                    |
| RTA     | regional trading arrangement                               |
| SCO     | Shanghai Cooperation Organization                          |
| SPECA   | Special Programme for the Economies of Central Asia        |
| TRACECA | Transport Corridor Europe-Caucasus-Central Asia            |
| UNDP    | United Nations Development Programme                       |
| WTO     | World Trade Organization                                   |

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## 1 Introduction

The five Central Asian countries became independent with the dissolution of the Soviet Union in December 1991. Four of the five countries, together with Azerbaijan, had been the poorest among the Soviet republics (Table 1), and over the next decade they all experienced a severe decline in output and living standards (Table 2).<sup>1</sup> By the end of the century, Tajikistan had become one of the poorest countries in Asia.<sup>2</sup> Development assistance was justified in terms of low and declining income levels and coordination of aid for regional cooperation was especially important to encourage revival and reorientation of trade. This paper analyses the record of delivering and coordinating aid to the Central Asian countries in the first decade and a half after they became independent.

Provision of bilateral aid to the newly independent Central Asian countries was complicated by several factors. While Russia might have liked to retain its regional influence, it was constrained—at least until oil prices started to rise after 1999—by lack of resources. The USA and EU quickly established diplomatic relations with the new countries, but despite talk of a new ‘great game’ for political influence in the region, Central Asia had a low priority when it came to aid funds.<sup>3</sup> As the poorest post-Soviet transition economies and the only Soviet successor states with Islamic majorities, there were concerns that the Central Asian countries and Azerbaijan might turn into extremist regimes if subjected to rapid economic change, but this consideration also had low priority in determining aid flows, at least until after the 2001 terrorist attacks in the USA. The significance of some Central Asian countries as suppliers of minerals and energy has influenced their external relations, and rising oil prices and large new

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<sup>1</sup> Although the World Bank estimates in Table 1 are a reasonable guide to the relative ranking of Soviet republics by living standards, the absolute dollar values for per capita GDP must be treated with caution due to the insoluble problems of the Soviet Union’s artificial relative prices. Since independence, the reliability of data is an issue throughout this region, but, apart from the war years in Tajikistan, the situation is clearly worst in Turkmenistan. It is important to stress that, while data reported by international institutions (such as the figures in Table 2) have been adjusted for definitional consistency, the raw data come from national sources, and international organizations have no way of correcting undisclosed collection or reporting biases.

<sup>2</sup> By 2000, Tajikistan with a national income per capita of US\$180 was poorer than most of Sub-Saharan Africa or the poorest countries of Asia. At purchasing power parity (PPP) the Central Asian countries’ incomes are higher. Tajikistan’s 2000 GNI per capita at PPP was US\$1090 (World Bank 2002a). Corresponding figures for the Kyrgyz Republic were US\$270 and US\$2540 (PPP), for Uzbekistan US\$360 and US\$2360 (PPP), for Turkmenistan US\$750 and US\$3820 (PPP), and for Kazakhstan US\$1260 and US\$5490 (PPP). By Maddison’s PPP estimates, Tajikistan’s 1998 per capita GDP of IUS\$830 was about the same as that of Haiti or Bangladesh; only Afghanistan had lower per capita GDP in Asia, and in Africa only 13 of the 42 countries for which Maddison (2001: 183-5) provides estimates had lower per capita GDP than Tajikistan.

<sup>3</sup> The European Union provided assistance mainly through its Tacis programme of technical assistance, but financial disbursements were small. Germany was expected to show particular interest in Kazakhstan because of the large German minority with right of abode in Germany, but in practice German attention was focused on Eastern Europe. In the early 1940s Stalin shipped ethnic Germans and Koreans from the western and eastern parts of the USSR to Kazakhstan lest they might act as a fifth column for German or Japanese military penetration; despite initial anticipation of German and Korean aid to Kazakhstan, official capital flows were never large and quickly dwindled.

discoveries in the Caspian Basin raised the region's profile after 2000, but the oil-related financial flows came from the private sector.<sup>4</sup>

Table 1  
Income per head, income distribution and poverty  
Republics of the USSR, 1989-90

|            | Population (million)<br>mid-1990 | Per capita GNP <sup>a</sup><br>1990 | Gini coefficient<br>1989 | Poverty (% of<br>population) <sup>b</sup> 1989 |
|------------|----------------------------------|-------------------------------------|--------------------------|--|
| USSR       | 289.3                            | 2,870                               | 0.289                    | 11.1   |
| Kazak      | 16.8                             | 2,600                               | 0.289                    | 15.5   |
| Kyrgyz     | 4.4                              | 1,570                               | 0.287                    | 32.9   |
| Tajik      | 5.3                              | 1,130                               | 0.308                    | 51.2   |
| Turkmen    | 3.7                              | 1,690                               | 0.307                    | 35.0   |
| Uzbek      | 20.5                             | 1,340                               | 0.304                    | 43.6   |
| Armenia    | 3.3                              | 2,380                               | 0.259                    | 14.3   |
| Azerbaijan | 7.2                              | 1,640                               | 0.328                    | 33.6   |
| Georgia    | 5.5                              | 2,120                               | 0.292                    | 14.3   |
| Belarus    | 10.3                             | 3,110                               | 0.238                    | 3.3  |
| Moldova    | 4.4                              | 2,390                               | 0.258                    | 11.8   |
| Russia     | 148.3                            | 3,430                               | 0.278                    | 5.0  |
| Ukraine    | 51.9                             | 2,500                               | 0.235                    | 6.0  |
| Estonia    | 1.6                              | 4,170                               | 0.299                    | 1.9  |
| Latvia     | 2.7                              | 3,590                               | 0.274                    | 2.4  |
| Lithuania  | 3.7                              | 3,110                               | 0.278                    | 2.3  |

Notes: <sup>a</sup> GNP per capita in US dollars computed by the World Bank's synthetic Atlas method;

<sup>b</sup> Poverty = individuals in households with gross per capita income less than 75 rubles.

Sources: World Bank (1992: 3-4) for columns 1-2; Atkinson and Micklewright (1992: Table U13) based on Goskomstat data (HBS) for columns 3-4.

Table 2  
Growth in real GDP 1989-2005, %

|                | Kazakhstan | Kyrgyz Rep | Tajikistan | Turkmenistan | Uzbekistan |
|----------------|------------|------------|------------|--------------|------------|
|                | Part A     |            |            |              |            |
| 1989           | 0          | 8          | -3         | -7           | 4          |
| 1990           | 0          | 3          | -2         | 2            | 2          |
| 1991           | -13        | -5         | -7         | -5           | -1         |
| 1992           | -3         | -19        | -29        | -5           | -11        |
| 1993           | -9         | -16        | -11        | -10          | -2         |
| 1994           | -13        | -20        | -19        | -17          | -4         |
| 1995           | -8         | -5         | -13        | -7           | -1         |
| 1996           | 1          | 7          | -4         | -7           | 2          |
| 1997           | 2          | 10         | 2          | -11          | 3          |
| 1998           | -2         | 2          | 5          | 5            | 4          |
| 1999           | 2          | 4          | 4          | 16           | 4          |
| 1999; 1989=100 | 63         | 63         | 44         | 64           | 94         |

Table 2 continues

<sup>4</sup> The main government intervention has been in influencing decisions about pipeline routes from Central Asia. While Russia has tried to obstruct any new pipelines which would undermine its monopoly, the USA pushed routes to Turkey or through Afghanistan to South Asia and threatened sanctions against any company participating in pipeline projects through Iran. In 2005, China, frustrated by Russia's preference for supplying Japan from its eastern oilfields, began construction of a pipeline to link Kazakhstan's oilfields to the Chinese network.

Table 2 (con't)  
Growth in real GDP 1989-2007, %

|      | Part B |   |    |    |   |
|------|--------|---|----|----|---|
| 1998 | -2     | 2 | 5  | 7  | 4 |
| 1999 | 3      | 4 | 4  | 17 | 4 |
| 2000 | 10     | 5 | 8  | 19 | 4 |
| 2001 | 14     | 5 | 10 | 20 | 4 |
| 2002 | 10     | 0 | 9  | 16 | 4 |
| 2003 | 9      | 7 | 10 | 17 | 4 |
| 2004 | 9      | 7 | 11 | 17 | 8 |
| 2005 | 10     | 0 | 7  | 10 | 7 |
| 2006 | 11     | 3 | 8  | 9  | 7 |
| 2007 | 9      | 6 | 9  | 9  | 8 |

Notes: 2006 = preliminary actual figures from official government sources. Data for 2007 represent EBRD projections.

Source: EBRD (2001: 15) for Part A; EBRD (2007) for Part B.

Absent substantial bilateral aid flows, much of the development assistance to Central Asia has come from multilateral institutions.<sup>5</sup> In 1992 the Central Asian countries joined the United Nations and the International Monetary Fund (IMF) and the World Bank, and over the next decade they joined the Asian Development Bank (ADB) and the European Bank for Reconstruction and Development (EBRD).<sup>6</sup> The contribution of the international financial institutions in the early 1990s was largely technical, focusing on monetary arrangements in 1992-93 (see section 3), although from mid-1993 they became more active in advocating a model of transition and supporting willing pupils with loans and grants (section 4). By the end of the 1990s, the transition from central planning was largely completed in Central Asia, even though most of the economies were not yet well-functioning market economies, and emphasis shifted to developmental issues. Within a wider consensus on the desirability of economic growth and on the positive relationship between trade and growth, there was growing recognition that the main barrier to trade-led growth in Central Asia was high trade costs, many of which could be reduced by regional cooperation. In this context the multilateral institutions declared their intentions of cooperating to assist in facilitating regional cooperation, but the record of multilateral initiatives has been unimpressive.

The first section of the paper describes the Central Asian economies' situation before and after the dissolution of the USSR, and the state of international thinking about aid in the early 1990s. Because the five countries followed diverse strategies towards economic reform, it was possible to discriminate among them according to their good or bad governance as well as according to their needs. The second section examines

<sup>5</sup> Nongovernmental organizations and charities have also provided assistance, notably the Aga Khan's Development Fund which has channelled aid especially to Tajikistan and also to the Kyrgyz Republic and Kazakhstan. Beyond economics, specialized UN agencies such as the High Commission for Refugees have provided valuable humanitarian assistance on the fringes of the conflicts in Afghanistan, Azerbaijan and Tajikistan, and agencies like UNICEF have become more active. Neither NGOs nor these agencies will be covered here.

<sup>6</sup> When the Soviet successor states joined the United Nations in July 1992, the Islamic successor states all opted to be in the Asian region. Membership of the UN Economic and Social Commission for Asia and the Pacific (ESCAP) was a prerequisite for access to the Asian Development Bank. Subsequently, and uniquely in the UN system, they were also permitted to join the UN Economic Commission for Europe which allowed them to join the EBRD.

bilateral aid to national governments, and shows that it has been predominantly driven by geopolitical, rather than development, considerations. The next two sections cover multilateral aid, analysing the technical advice given over the currency issue in 1992-93 in Section 3 and the support for a particular transition model in section 4. The fifth section focuses on regional cooperation projects which were clearly desirable uses of aid but where there were substantial problems of coordinating aid efforts. The final section draws conclusions.

## **1 Background**

### **1.1 The Central Asian countries' economies<sup>7</sup>**

Until the dissolution of the USSR, the Central Asian republics' development strategies were determined in Moscow. The Central Asian republics were open economies, integrated into the Soviet Union's division of labour but isolated from the global economy. Their main role was as producers of primary products, especially cotton, but also energy and minerals, and grain in northern Kazakhstan. Despite some complaints of being exploited by Moscow, there was little open discontent in Central Asia. Most Soviet citizens, but especially those in the isolated Central Asian region, were ill-prepared for exposure in the 1990s to the extent to which their living standards now lagged those in high- or middle-income market economies, or for the emergence of conspicuous consumption and open poverty.

With the dissolution of the USSR in December 1991, the Central Asian countries faced several major shocks. Nation-building started practically from scratch, and initially failed in Tajikistan. Economic disruption, already severe due to the end of central planning, was exacerbated by the cessation of substantial intra-USSR net transfers and by the breakdown of intra-USSR demand and supply links due to non-payment or non-delivery of inputs. The negative impact of the collapse of the integrated Soviet economy was accentuated for the Central Asian countries by their landlocked location and inherited transport networks which made it difficult to reorient their trade. Even if the newly independent governments wished to take time to evaluate the situation, acceleration of economic reform was unavoidable as Russia's price liberalization in January 1992 had to be followed by other countries using the common currency. At the same time the features of the ruble zone contributed to the acceleration of inflation from a triple-digit annual rate in 1991 to four-digit inflation in 1992 and 1993.

Despite the similar economic structures, the national leaders adopted surprisingly diverse economic strategies. The Kyrgyz Republic embraced the advice from western institutions and advocates of rapid change and, within limits, its president fostered the emergence of the most liberal regime in the region. Kazakhstan in the early 1990s appeared to be accompanying the Kyrgyz Republic on a liberal path, but the president became more autocratic as the decade progressed and the economy became dominated by a small group of people who controlled the media and the banks. Uzbekistan retained a tightly controlled political system, but with nothing resembling the personality cult of Turkmenistan, and its economic reforms were modest. In Turkmenistan the president had

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<sup>7</sup> This section is based on Pomfret (1995; 2006) which review the situation in the early years after independence and in the period 1995-2005, respectively.

absolute personal power and minimized economic change. Tajikistan was the only one of the five countries not to evolve peacefully from Soviet republic to independent state under unchanged leadership; the bloody civil war of 1992-97 dominated political developments and delayed implementation of a serious and consistent economic strategy.

The five countries' economic performance since independence has differed (Table 2) to some extent reflecting policy choices although since 2000 the comparative situation has been dominated by the increase in world energy prices. This is especially true for the two largest economies; during the 1990s Kazakhstan's output performance was inferior to Uzbekistan's, but since the turn of the century Kazakhstan, as a significant oil producer which by coincidence also had major new discoveries coming on line, has experienced an economic boom while Uzbekistan's economy appears to stagnate. For Turkmenistan, with its abundant natural gas reserves, the energy boom has alleviated pressures to change the country's poor economic policies, but the opaque statistical situation in Turkmenistan makes any definite judgment hazardous. Both gradual-reforming Uzbekistan and rapid-reforming Kyrgyz Republic have enjoyed less spectacular growth, and have clearly lower living standards than Kazakhstan. Tajikistan is even worse placed, as the economy has recovered but slowly from a very deep trough.

By the turn of the century, the national economies, with the possible exception of Turkmenistan's, had changed substantially from the centrally planned economy of the Soviet era and all were, in one form or another, a market-based economy. Kazakhstan, despite false steps in the 1990s, remains the most likely to succeed. Its new elite, based on an unfair and distorted privatization process, is now keen to establish a rule of law in order to protect its economic gains, and favourable institutional developments are likely. Meanwhile, the hard infrastructure of oil pipelines is starting to improve and provide Kazakhstan with alternative outlets for its dominant exports.<sup>8</sup> At the other extreme, with a regime that is resistant to change, Turkmenistan faces grim economic conditions, and the longer-term prospects depend upon the nature of the political succession after the death in December 2006 of President Niyazov, or Turkmenbashi the Great, as he preferred to be known. Political factors are also critical in Tajikistan, where establishment of effective public administration is a necessary precondition for progress. Even with that condition met, the economic prospects are not good for Tajikistan or for the Kyrgyz Republic, both of which are poor landlocked countries.<sup>9</sup> In the 1990s Uzbekistan was economically the most successful of all Soviet successor states and in day-to-day matters the economy remains fairly well-managed but, if poor economic policies in the key interrelated areas of managed trade, low farmgate prices, reliance on extracting agricultural rents for government revenues and protection of import-substituting industries are not addressed, Uzbekistan's economy could easily slip into the stagnation familiar from many import-substituting countries of the 1950s and 1960s. In Uzbekistan as elsewhere in Central Asia, perhaps more fundamental is the

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<sup>8</sup> The opening of the private CPC pipeline to the Black Sea in 2001 provided the first alternative to the Russian state monopoly, and in 2005 completion of a pipeline from Baku to Ceyhan on Turkey's Mediterranean coast and construction of the first stage of a link from Kazakhstan to China's pipeline network further increased Kazakhstan's options.

<sup>9</sup> The consequences of landlockedness for Central Asian countries are analysed by Raballand (2005). The Kyrgyz Republic and Tajikistan are separated from China by some of the highest mountains in the world, and in any other direction the two countries are double-landlocked, requiring transit through at least two other countries to reach the open sea.



question of whether an autocratic and repressive political regime is consistent with a flourishing market-based economy; China's example says yes, but that has not been easy to replicate. To sum up the situation for Central Asia as a whole, despite much shared background and common initial conditions, the five countries, and especially the two larger economies, Kazakhstan and Uzbekistan, have been moving along differing trajectories and that is likely to continue.

## **1.2 Thinking about aid in 1991**

The 1980s were a decade of rethinking foreign aid, reflected first in stricter conditionality and then in cutbacks, especially by the USA and UK whose governments distrusted the potential of public expenditure to improve living standards. Mosley (1986) highlights the micro-macro paradox that, although ex post evaluation suggested that aid-assisted projects yield net social benefits, at the macro level any positive effects of aid evaporate in cross-country regressions. By 1991 there was neither abundant funding for aid nor much intellectual commitment to directing capital to poor countries' governments, and any claims by the poor new countries of Central Asia for aid would run into opposition from other poor countries which would resist any reduction in their share of the shrinking aid pie.

The conventional wisdom on economic development had moved far away from the focus on capital formation of the development economics pioneers of the 1940s and 1950s. By 1990 the emphasis had shifted to human capital rather than physical capital and to incorporating institutions and political economy. Thus aid to corrupt regimes was money down the drain or, even worse, it would reinforce the hold of the government which was the source of the problem. These ideas were widespread among the young economists assigned to the Central Asia or Mongolia desks in international agencies or working in the field.<sup>10</sup>

The phenomenon of transition from central planning to more market-oriented economies was, of course, not new in 1992 and the 'Washington consensus' on the desirability of rapid economic reform was already in place.<sup>11</sup> On broader questions of transition strategy, the Muslim successor states took backstage to Eastern Europe, the Baltics and Russia and Ukraine which were either more dynamic or more important to the west. Applying the Washington consensus to Central Asia was also complicated by the lack of a suitable model, as the initially more reformist Kazakhstan became more autocratic. Only after the Kyrgyz Republic had established its own currency in May 1993 was this poor and poorly endowed state adopted as the torchbearer of liberalization in the region (section 4).

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<sup>10</sup> One example was Peter Boone, who was based in Mongolia as the USSR was disintegrating and whose paper published in 1996 became a standard reference (or straw-man) on how the effectiveness of aid is nullified when it encourages rent seeking rather than productive behaviour.

<sup>11</sup> The term Washington consensus was coined by John Williamson in 1989 to cover the lowest common denominator of advice being given by the IMF and World Bank to Latin American countries. In its original form the 'consensus' emphasized fiscal discipline with low marginal tax rates and public expenditure focused on human capital formation, trade and interest rate liberalization and a competitive exchange rate, privatization and deregulation, and secure property rights. In the transition context it became identified with rapid price liberalization and macroeconomic stabilization. Williamson (2000) examines the evolution of the term.

## 2 Bilateral aid

Bilateral financial aid for the Muslim successor states to the Soviet Union was minimal during the 1990s. As the USSR dissolved, the southern republics were not high on any western country's priority list. Turkey and Iran briefly filled a vacuum, but neither did much and early identification of their roles as proxies for secularism and militant Islam proved false.

Russia remained engaged in Tajikistan, primarily through military aid, but overall Russia experienced a huge loss of influence in its 'near abroad' during the 1990s. Russia's main diplomatic initiative, the Commonwealth of Independent States (CIS), was ineffectual, and the 1994-96 Chechnya conflict exposed Russia's military weakness. Georgia, Ukraine, Azerbaijan and Moldova gradually became more vigorous in coordinating resistance to Russian plans for military bases in the Caucasus and in October 1997 the four presidents issued a joint communiqué, establishing a formal group (known as GUAM).<sup>12</sup> Uzbekistan shared many of the four GUAM countries' interests and in April 1999 Uzbekistan formally joined the group which then became known as GUUAM. Turkmenistan also moved firmly out of the Russian sphere of interest, and even obtained formal recognition of its neutrality in a 1995 resolution of the UN General Assembly. On the other hand, the government of Tajikistan remained tied to Russia for military support, and Kazakhstan and the Kyrgyz Republic signed a regional trade agreement with Russia and Belarus.<sup>13</sup>

The USA has been the most active western power in the region, and its actions especially since the mid-1990s, have been driven by strategic rather than ideological considerations. US policy shifted from initial indifference to warmer support for allies in containing Russia's southern flank, and the emergence of the GUUAM axis led to growing US support for and friendliness towards Uzbekistan and Azerbaijan. The USA began holding joint military exercises with Uzbekistan in 1998, education opportunities in the USA were increased, and in general US-Uzbekistan relations became warmer, although the détente was associated with technical rather than financial assistance. Turkmenistan and Tajikistan were ignored on both geopolitical and economic grounds, as were to a large extent the more liberal Kyrgyz Republic and Kazakhstan.<sup>14</sup>

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<sup>12</sup> Azerbaijan, Georgia and Moldova had been the most reluctant members of the CIS, joining only under heavy Russian pressure in late 1993 or early 1994, and together with Turkmenistan and Uzbekistan participated least in CIS structures (Sakwa and Webber 1999).

<sup>13</sup> The Union of Four was joined by Tajikistan in 1999, and in 2000 was rebadged as the Eurasian Economic Community with the formal goal of a customs union. Since the Kyrgyz Republic joined the WTO in 1998, its bound tariff rates are well below levels acceptable to Russia as a common external tariff and it is unlikely that Kazakhstan would raise its tariffs to the Russian level. Tumbarello (2005: Table 4) estimates substantial negative net welfare effects to both Kazakhstan and the Kyrgyz Republic from forming a customs union in which Russia sets the external tariff.

<sup>14</sup> Despite gaining short-term diplomatic benefits from an early decision to relinquish its nuclear weapons, Kazakhstan remained suspect in the west due to the strong Russian connection which includes military bases in Kazakhstan. Kazakhstan's situation is complicated by the presence of a large Russian minority (two-fifths of the republic's population in the 1989 Soviet census), mainly in northern Kazakhstan, with a potential for secession or irredentist claims by Russia. Among the Central Asian countries, Kazakhstan retained the strongest trade links with Russia; reliance on mineral or energy products supplied to manufacturers in Russia by pipelines or rail links made changes in the

A surprising feature of western aid to the region in 1991-2001 is that it was almost totally unaffected by the spectre of Islamic fundamentalism. Early 1990s accounts foresaw proxy competition between Turkey, as the champion of secularism, and Iran, as the champion of Islamic law, but after some early gestures such as the establishment of credit lines or cultural links, the influence of these regional powers has been small. Iran, Pakistan, Turkey, Afghanistan, Azerbaijan and the five Central Asian countries are the members of the Economic Cooperation Organization (ECO) which may have had some influence in turning potential conflict between the first three countries into more cooperative actions, but the influence of ECO has been small (Pomfret 1999). President Karimov has represented Uzbekistan as a pillar of secularism, supporting anti-fundamentalist forces in Tajikistan and northern Afghanistan and, especially in 1995-96, denouncing Iran. Uzbekistan was one of the few countries to back the 1995 US trade embargo of Iran, but this did not lead to much other than the surprising spectacle of Uzbekistan and Israel being the sole supporters of the USA in United Nations voting. Serious US rapprochement towards Uzbekistan in the late 1990s was in the common cause of containing Russia rather than against Islamic fundamentalism; geopolitics appears to dominate ideology in this context.

Western powers stayed out of the Tajik conflict and, more surprisingly, out of the Afghan civil war. The USA in particular was ambivalent until 1997, urging 'engagement' with the Taliban leaders rather than the hardline pursued towards Iran (Starr 1997: 30); Pakistani and Saudi support for the Taliban regime and Iranian support for the opposition tilted the scales towards non-intervention. The Uzbek warlords in northern Afghanistan received no western support, and their stronghold of Mazar-i-Sharif fell to the Taliban in 1997-98. When the US oil company Unocal lobbied for support for a pipeline from Turkmenistan via Afghanistan to Pakistan in 1997, it looked briefly as though US recognition of the Taliban government might be on the cards, but as Taliban atrocities against their opponents and treatment of women received greater publicity, the US government backed away from Unocal's pipeline and all western governments shrank from any show of support for the Taliban. US feelings were heightened by the Taliban's refusal to extradite Osama bin Laden after the 1998 bombing of US embassies in Kenya and Tanzania, but no punitive action was taken against the Taliban until after September 2001.

The events of September 2001 provided the catalyst for US-led military action to overthrow Afghanistan's Taliban government. All of the Central Asian leaders, along with those of Russia and China, gave verbal support to the US-led war on terrorism. Uzbekistan and the Kyrgyz Republic went further by providing material assistance such as making airbases available to the US military, and Tajikistan allowed overflight by US military aircraft. These developments upped the international perceptions of Central Asia's strategic significance. Russia, although officially supporting the USA, attempted to reassert its own influence. President Putin tried to obtain recognition of Russian hegemony over Central Asia and the Caucasus as a *quid pro quo* for his acquiescence in the expansion of NATO in eastern Europe at the November 2002 Prague summit. President Karimov of Uzbekistan, however, had a fairly high profile at Prague, meeting President Jacques Chirac and Secretary of State Colin Powell, who praised 'the practical

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direction of trade difficult, although after experiencing contagion from the 1998 Russian crisis, Kazakhstan has diversified its trade in the twenty-first century—a process helped by the oilboom.

actions of Uzbekistan in the international fight against terrorism'.<sup>15</sup> Although the general perception in 2002 was of a widening of the fissure between those Central Asian countries more and less amenable to Russian influence in the region, this proved short-lived.

After the US-led invasion of Iraq in March 2003 there was a general shift towards closer relations with Russia and to a lesser extent China. This was especially clear in the case of the most authoritarian countries, Turkmenistan and Uzbekistan, which began to have concerns over whether the USA might one day use their own human rights abuses as an excuse for military action. Russia and China were less concerned about human rights issues, and opposed foreign intervention in what they considered domestic matters.<sup>16</sup> Apart from their bilateral links, the main diplomatic lever used by Russia and China was the Shanghai Cooperation Organization (SCO) which has since 2001 included all of the Central Asian countries except Turkmenistan.<sup>17</sup> The SCO is notionally a regional economic arrangement, but there has been no move towards creating preferential trading among SCO members.

The post-2003 Russian and Chinese effort towards Central Asia has been driven more by commercial strategy rather than aid as it is normally defined. This was already apparent in Kazakhstan, where LUKoil has invested US\$3 billion since the turn of the century and the China National Petroleum Corporation has also made substantial investments. After the June 2004 SCO summit, Uzbekistan and Russia signed a strategic partnership agreement and China announced plans to extend US\$900 million in loans and credits to Central Asian countries. In October 2004 Russia wrote off US\$250 million of Tajikistan's official debt in return for military bases and large Russian companies paid cash for shares to gain control over some of the commanding heights of Tajikistan's economy.<sup>18</sup> In March 2006 Gazprom negotiated an oil-for-gas deal to take a controlling stake in developing four gasfields in Tajikistan. UES and Gazprom are completing two power plants and upgrading the energy distribution systems in the

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<sup>15</sup> Quoted at [www.press-service.uz/eng/vizits\\_eng/ve21112002.htm](http://www.press-service.uz/eng/vizits_eng/ve21112002.htm) by the press service of the President of Uzbekistan. President Rahmonov of Tajikistan also publicized improved ties with France and the USA, making visits to the two countries in December 2002 as a signal of displeasure with Russia's deportation of Tajik guestworkers. By contrast, on 18-19 February 2003 President Nazarbayev of Kazakhstan, facing US and EU criticisms of his regime's corruption and human rights record, made an official visit to Russia, where he is not criticized for such things.

<sup>16</sup> Both countries have minorities (notably in Chechnya in Russia, and in Tibet and Xinjiang in China) who may be considered repressed by outsiders, but who are seen as rebels and often as terrorists by the national governments.

<sup>17</sup> The organizations origins were a 1996 meeting of China, Russia, Kazakhstan, the Kyrgyz Republic and Tajikistan intended to demilitarize borders. At a summit in Dushanbe in July 2000, the Five, with Uzbekistan as an observer, took up a number of economic issues, and changed the group's name to the Shanghai Forum. At the June 2001 summit, Uzbekistan became the sixth member and the group was renamed the SCO. At the 2004 summit Mongolia was admitted as an observer.

<sup>18</sup> Rusal undertook to invest US\$600 million in an aluminium smelter and US\$560 in the Rugun hydro dam, and UES committed to invest US\$250 million in the Sangtuda hydroelectric power station with an agreement to invest a further US\$480 million. These numbers should be seen in the context of a country whose GDP at market prices was little over one billion dollars. They can also be contrasted with aid to Tajikistan in 2004 from the main western donors (USA US\$48 million, EU US\$24 million, Switzerland US\$15 million and Japan US\$6 million) or from the multilateral agencies (IDA US\$34 million, IMF US\$20 million and ADB US\$17 million), as reported by the DAC at [www.oecd.org](http://www.oecd.org).

Kyrgyz Republic. Gazprom is also a shareholder in RosUkrEnergo, the company which after the Russia-Ukraine gas war at the start of 2006 ended up becoming the sole supplier of Turkmenistan's natural gas to Ukraine. This dependence pushed Turkmenistan's president to seek alternative partners, including China, with which he signed an agreement in April 2006 to supply 30 billion cubic metres of gas a year from 2009 to 2039 in return for Chinese assistance in constructing a gas pipeline which will tie in with an oil and gas pipeline network from Kazakhstan to China, the first segment of which was built in 2005. All of the companies mentioned in this paragraph, even if notionally joint stock companies, appear to act as agents of national policy.

Central Asia's energy and mineral wealth has attracted western interest. In contrast to official development assistance and military support, western private capital flows have gone overwhelmingly to the energy sector, and hence to Kazakhstan and Turkmenistan, rather than the other three Central Asian countries. Chevron's Tengiz joint venture in western Kazakhstan, negotiated during the Gorbachev era, was the largest foreign investment project in the USSR. Other oil projects have involved most of the North American and European majors. All of these links have, however, led to commercial capital flows rather than to aid.<sup>19</sup>

In sum, bilateral aid to Central Asia has been modest in total, dominated by geopolitical rather than developmental considerations, and driven by competition among donors.<sup>20</sup> It has been targeted to favoured national governments and has been devoid of efforts to promote regional cooperation for economic development. Russia, in particular, has used regional trade agreements to further its political agenda, but these have had little economic impact. There has been little concern for the efficiency of aid delivery, and in many cases military assistance outweighs developmental assistance.<sup>21</sup>

### **3 The ruble zone**

One of the first questions facing the new independent states at the end of 1991 was whether to introduce national currencies.<sup>22</sup> This was a region-wide issue with obvious benefits from coordination; each individual decision to issue a national currency would reduce the ruble's value as a common currency to remaining members of the ruble zone. It was also an issue on which Central Asian policymakers, with almost no knowledge of

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<sup>19</sup> The western companies are driven by profitability and are not instruments of state policy in the same way as the large Russian and Chinese companies appear to be. They have a technical edge, e.g., a reason for the original involvement of Chevron was its technical expertise. It is likely that Russian or Chinese companies may not have the technical capability to exploit the geologically difficult offshore oilfields in the northern Caspian.

<sup>20</sup> The aid data in Table 3 are not very helpful in this context, because (apart from the usual reservations about donor-reported aid data) they report only aid from OECD countries. The two poorest countries, the Kyrgyz Republic and Tajikistan, are the two largest recipients on a per capita basis, but the Table 3 numbers for these countries are dominated by multilateral aid.

<sup>21</sup> In July 2004, citing human rights violations, the US State Department announced a US\$18 million cut in US aid, but in the next month, as Defence Secretary Rumsfeld visited Afghanistan, the chairman of the US Joint Chiefs of Staff, Richard Meyers, visited Tashkent and announced a US\$21 million increase in US military assistance, over the US\$39 million already committed, to Uzbekistan.

<sup>22</sup> This section draws on Pomfret (1996: 118-29; 2002).

macroeconomic policymaking, turned to external sources for technical assistance. Coordination of technical assistance was not a problem, as the IMF had obvious expertise on monetary arrangements and other multilateral institutions had not yet established a significant presence in Central Asia.

Already in 1991 intra-USSR trade had been severely disrupted and the drift to barter accelerated in 1992. The Baltic countries were clearly heading along a path towards breaking Soviet political links at all costs, but the remaining Soviet successor states which had formed the CIS, were concerned with bolstering existing economic relations and preservation of a common currency was seen as a bulwark against adverse economic tendencies. Thus, the issue was associated with the desire for economic stability within the CIS. The desire for stability may have been shared by western policymakers, but western input into the debate over the currency issue in 1992 was on a technical rather than an ideological or geo-political basis. Although there may have been some attempts to coordinate technical assistance, the lead, given the nature of the issue, was taken by the IMF.

Western advice on monetary and exchange rate arrangements within the CIS was initially couched in terms of the theory of optimum currency areas. Because there were no obvious breaks in factor mobility within the CIS and internal trade far outweighed trade with outsiders, the CIS appeared to be an optimum currency area, and conventional wisdom was strongly in favour of retaining the ruble zone after the dissolution of the USSR. Max Corden's report for the UNDP/World Bank Trade Expansion Programme, with some caveats, recommended creation of a ruble zone and specifically pointed to the Central Asian countries as the ones for which the argument was likely to be strongest:

If a republic is small, if the argument for fixing the exchange rate to the ruble is strong because trade with Russia is expected to dominate the country's trade for a long time, and if Russia is expected to succeed in stabilizing its economy, then the case for going all the way into a monetary union with Russia becomes strong. Perhaps these conditions apply for the central Asian republics. If the intention is to maintain a fixed exchange rate indefinitely, it is better to lock it in through an institutional arrangement and thus avoid any foreign exchange speculation (Corden 1992a: 14-5).<sup>23</sup>

The first *Economic Reviews* of CIS countries published by the IMF in spring 1992 repeated the policy recommendation that the Central Asian countries should remain within the ruble zone.<sup>24</sup> The Central Asian countries followed this advice in 1992.

The advice was flawed because the ruble zone's institutional arrangements encouraged an inflationary monetary policy. Russia controlled the currency issue, but, because all

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<sup>23</sup> Max Corden's influence was large because of his academic stature as one of the leaders in international economics over the last four decades and because in 1991-2 he was working for the Johns Hopkins University in Washington DC and had connections with both the IMF and World Bank. His May 1992 World Bank working paper contains essentially the same quotation (Corden 1992b: 27).

<sup>24</sup> The argument was set out in IMF (1992a), where introduction of new currencies was discouraged on the grounds that (i) macroeconomic stability should be achieved first and (ii) intra-CIS trade would be disrupted.

the Soviet successor states retained control over domestic credit creation and because there was no balancing mechanism for inter-country trade, no institution could exert effective monetary control. During the first half of 1992 the increase in the money supply was less pronounced because the Russian government pursued a reform programme supported by fairly restrictive monetary policy. The tight monetary policy encouraged Russian enterprises to sell to other ruble-zone members, and the growth of Russia's trade surplus drew rubles away from the deficit countries. Some ruble-zone members issued parallel currencies to alleviate the cash shortage, and the proliferation of parallel currencies with varying degrees of inconvertibility plus the increasing trade imbalances eroded the trade-facilitating benefit of having a common currency. Trade between ruble-zone countries was disrupted by delays in payments, and more generally there was a shortage of cash which affected both domestic and intra-zone trade. The situation deteriorated after June 1992 when growing opposition in the Russian parliament forced the replacement of the Central Bank chairman by a chairman committed to supporting state enterprises through a looser credit policy. Inflation accelerated as enterprises and governments throughout the ruble zone faced soft budget constraints. Each country individually had little incentive to restrict money creation, because they would reap the benefit from issuing money but only bear a fraction of the cost (in higher zone-wide inflation).

Between June and November 1992, the Baltic countries and Ukraine abandoned the ruble in favour of national currencies. At the October 1992 Bishkek summit of the CIS, Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan and Uzbekistan signed an agreement to establish a single monetary system and coordinate macroeconomic policies. Turkmenistan did not sign the agreement, but continued to use the ruble. However, the Bishkek agreement failed to create effective mechanisms for money creation, and it did not exclude the emission of parallel currencies.<sup>25</sup> Renegotiating the ruble zone's institutional framework could not be solved quickly enough, and the IMF's plan of establishing a fund to support new currencies after macroeconomic stabilization had been achieved was unrealistically slow.<sup>26</sup> Although the Central Asian countries were the firmest advocates of retaining a common currency with Russia, even they found that membership in an inherently inflationary ruble zone was undesirable. The Central Asian countries began to make physical preparation for issuing national currencies; by spring 1993, the banknotes had been printed and were in their vaults. The printing of ruble notes with the Russian flag instead of Lenin's head created the impression that Russia itself was introducing a national currency and might declare the old ruble notes worthless, and the heightened political uncertainty in Russia after March added to nervousness about Russia's intentions.<sup>27</sup>

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<sup>25</sup> Armenia, Belarus and Moldova had all introduced parallel currencies earlier in 1992 (as had the then non-CIS members, Azerbaijan and Georgia), leaving the Central Asian countries as the only non-Russian CIS members not to have issued some form of parallel currency by the end of 1992

<sup>26</sup> The IMF was reconsidering its position by October 1992 in light of Russia's lack of monetary discipline. See IMF (1992b: 363). Odling-Smee and Pastor (2002) provide a more sympathetic account of the IMF's role.

<sup>27</sup> Russia's role was crucial because it controlled two inducements for other countries to remain in the ruble zone despite the hyperinflation: favourable ruble-denominated raw material prices and credit. Although officials from the Central Asian countries complained about paying the one per cent service charge on ruble notes levied by the Russian central bank plus 20 per cent interest on banknotes provided on credit, the interest rate was negative in real terms. During the first five months of 1993, it

Physical problems of shipping banknotes which tended to arrive in large quantities at irregular intervals, added to the uncertainty over what the Russian central bank was doing. After a lengthy period of non-delivery, the Kyrgyz Republic received a shipment of 21 billion rubles at the beginning of April 1993. When these notes were released over the next five weeks, they roughly doubled the currency supply in the republic. The monetary uncertainty was exacerbated in the Kyrgyz Republic when Russia started to exert pressure for settlement of inter-enterprise debts and threatened not to provide any more credit. This appears to have been the catalyst for the Kyrgyz Republic to issue its national currency on 10 May 1993.<sup>28</sup>

The Kyrgyz Republic received immediate support from the multilateral institutions. On May 12 the IMF's Executive Board approved a SDR 16.125 million (US\$23 million) loan under the Systemic Transformation Facility which had been set up less than three weeks earlier, and a SDR 27.09 million (US\$39 million) stand-by credit. The next day the World Bank announced its first credit to the Kyrgyz Republic of US\$60 million through its soft loan arm, the International Development Agency (IDA). Co-financing of US\$70 million was promised by Japan, the Netherlands and Switzerland. These were the first substantial amounts of western aid to an Islamic Soviet successor state, and were also connected to the emergence of the Kyrgyz Republic as the regional showcase for economic liberalism analysed in the next section.

In June 1993 Russia adopted a tougher line on credit towards ruble-zone countries. Negotiations with Kazakhstan broke down because Russia wanted settlement of intergovernmental debts (where it was the creditor), but would not link this to inter-enterprise debts (where Russian enterprises were debtors to Kazakhstan). The Kazakhstan government talked of opening direct negotiations with Asian republics of the Russian Federation, and the Russian central bank cut off the ruble supply, causing

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became increasingly obvious that Russia was using credit access for political ends. Fears that Russia might use its creditor status for political leverage were highlighted by Azerbaijan's experience (Pomfret 1996: 103-17). Although the manat was introduced as a parallel currency in August 1992, it represented only a small proportion of the currency in circulation by year's end. As the military conflict over Nagorno-Karabakh escalated, culminating in the Armenian invasion in April, the Russian central bank ceased granting credits to Azerbaijan and the emission of rubles practically ceased after March. Emissions of manat increased to finance the war, the ruble began to trade at a premium to the official exchange rate, and rubles effectively disappeared from circulation; during the first five months of 1993 about three-fifths of the rubles issued in Azerbaijan left the country, mostly converted into goods from other ruble-zone countries. The manat had *de facto* left the ruble zone by June 1993, as hyperinflation peaked and the government was overthrown in a coup which led to the return to power of a Brezhnev-era leader.

<sup>28</sup> The failure of education about the impact of issuing national currencies was not restricted to policymakers in Central Asia. The western press reaction was surprisingly negative, and as with the introduction of other new currencies (e.g., *The Financial Times*, London, 15 May 1992, had described the introduction of the Latvian currency as 'a suicidal step' which would precipitate further collapse of trade with Russia) the som's introduction was predicted to lead to trade disruption ('Out of Steppe' was the headline in the *Far Eastern Economic Review*). The *Wall Street Journal* ran a story on resistance to internal acceptability of the new currency, but this difficulty had disappeared within a week. *The Economist* also took a negative track with its headline 'Battle of the Som'. In fact, there was no major disruption of intra-CIS trade; Uzbekistan closed its border with the Kyrgyz Republic and stopped bank transfers between the two countries on the day the som was issued, while Kazakhstan kept trade flowing by granting credit to its neighbour, but these differing reactions by the Kyrgyz Republic's two larger neighbours are explained by political rather than by economic considerations.



currency shortages in Kazakhstan in early July. On July 26 the IMF announced a US\$86 million credit to Kazakhstan under the Systemic Transformation Facility, obviously in the knowledge that the country was likely to be adopting its own currency soon.

On July 24 the fears of Russian invalidation of pre-1993 ruble notes were realized. No other ruble-zone members were informed of the decision, nor was the IMF which had a mission in Moscow earlier in the week. Apart from the financial losses suffered by those who could not convert their old notes into new notes at the one-for-one rate, this episode destroyed trust in the Russian central bank. Between August and November the ruble zone unravelled in a more or less chaotic fashion. On August 19 President Niyazov announced that Turkmenistan would introduce the manat on November 1st. At a September 1993 summit in Moscow, Russia, Belarus, Armenia, Tajikistan, Uzbekistan and Kazakhstan once again reaffirmed their commitment to a renewed ruble zone, but the monetary institutions were not specified. In October suppression of the parliamentary opposition to President Yeltsin gave reformers the upper hand in Russia (the complete freeing of bread prices was a symbolic step which underlined the renewed price liberalization), and at the same time Russia was moving towards a more federative budget which would reduce the central government's ability to grant technical credits to CIS partners. These developments made the ruble zone less attractive to Uzbekistan, whose government was reluctant to reform prices, and to Kazakhstan, for whom reduction in Russian credits would remove the main carrot for staying in the ruble zone. On October 31 President Nazarbayev announced that Kazakhstan would introduce its own currency within the next two to three months. Following Nazarbayev's announcement, the currency markets of Kazakhstan and Uzbekistan went into total confusion.<sup>29</sup>

The ruble zone collapsed in November 1993. On November 5 President Nazarbayev issued a decree freezing most bank accounts immediately, and a week later he announced that the national currency would be introduced on November 15. Uzbekistan issued the sum coupon also on November 15. After Armenia introduced the dram on November 22 and Moldova the leu on November 29, Tajikistan, where the main medium of exchange was still the old Soviet rubles which were no longer accepted anywhere else, was effectively in its own currency area.

The currency issue dominated the first two years of the Central Asian countries' independent existence. With hindsight, there was a clear feeling that mistakes had been made and that the suffering due to the hyperinflation of 1992-94 had been exacerbated because no serious attempt to control inflation could be undertaken until after national currencies had been established. Even at the time, the monetary confusion and its negative impact on economic activity were palpable. Some of this was exacerbated by

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<sup>29</sup> Old (pre-1993) rubles, no longer valid in Russia or in Turkmenistan after 1 November, flooded into Uzbekistan and Kazakhstan as holders saw the conversion to new national currencies as their last opportunity to get rid of potentially worthless banknotes. Traders were unwilling to accept old notes, despite their continuing official status and market exchange rates (against new rubles or against dollars) dropped rapidly. Uzbekistan announced that it would form a monetary union with Kazakhstan, confirming suspicions that Kazakhstan and Uzbekistan had a secret agreement that if they left the ruble zone they would do so in unison, although Kazakhstan denied that a monetary union would be formed. When the two countries introduced their national currencies, the differing par values were a clear signal that monetary coordination, if it was ever intended, had not carried through to implementation.

the national governments' indecision, reflected in the futile attempt to maintain the ruble zone as late as September 1993, and the lack of reasonable preparation by the governments of Uzbekistan which issued miserable temporary coupons in November 1993 and only brought out a credible national currency in July 1994, or Tajikistan which introduced the Tajik ruble in May 1995 and then replaced it by a new currency, the somoni, in 2000 but in this setting, it was easy to pass the blame to bad IMF advice.

Both Russia and the IMF, and other multilateral institutions by association, suffered from the episode. In Central Asia, where Kazakhstan had been a solid supporter of continued union and where Uzbekistan and Tajikistan still looked to Russia, the currency-related events of the summer and autumn of 1993 generated frustration with and loss of trust in Russia. Western influence was still far behind Russia's in 1993, but a potential vacuum was emerging. Although its position had been largely driven by impartial economic theory, there was a suspicion that institutions like the IMF had been supporting Russian hegemony and inhibiting national development of the new states.<sup>30</sup> More importantly, the outcome undermined the reputation of western economics, especially on macroeconomic issues.

The IMF and the World Bank have difficulty reconciling the pressures for a single 'company line' on key policy issues, with the inherent imprecision of answers to major economic questions. In January 1992 it was not obvious whether the ruble zone should be maintained and, if so, by which countries and for how long, and the analytical problem was exacerbated by the IMF's lack of regional expertise.<sup>31</sup> In the first half of 1992, it would have been better to air pros and cons of a common currency rather than trying to present a unified front, and to indicate to national policymakers that in a novel and highly unstable setting the best course of action was uncertain. Of course, it is difficult to be a two-handed economist when policymakers want definite answers, but the IMF did not try, and the representatives on the spot often did nothing to discourage an impression that they were the experts in this area.<sup>32</sup> The IMF had reversed its position on the common currency by the end of 1992 and supported the new Kyrgyz currency in spring 1993, but the reversal of position was difficult to reconcile with the technical advice of the previous year—especially as there was never any admission of

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<sup>30</sup> Apart from their paying relatively little attention to the region, there has been little political influence over the IFIs' activities in Central Asia. The USA may have encouraged the IFIs' rapprochement with Uzbekistan in 1998-99, but this was nothing like the degree to which the IFIs became explicit tools of western, especially US, foreign policy in Mexico in 1994 or in Russia throughout the decade.

<sup>31</sup> Both the IMF and the World Bank were going through a learning phase in 1990-92. From having few staff familiar with the transition from central planning and almost none with knowledge of Central Asia, they soon had some.

<sup>32</sup> Although the IMF sent occasional missions from Washington, day-to-day technical assistance was being provided through resident representatives and consultants. The unified position may have been related to a desire to monitor these IMF employees, many of whom were new or temporary, but it also appears to have been driven by a paternalistic desire not to confuse local policymakers. The IMF's influence was especially strong in Central Asia because there were few opportunities for national policymaker to obtain well-informed second opinions, and few people within national administrations with a good understanding of how market-based economies functioned at the macroeconomic level. The IMF and World Bank provided training programmes, especially at the Joint Vienna Center, which were important in creating a group of mid-level officials with economic knowledge, but senior politicians and officials could not take time off running their country in order to study economics and had to learn on the job.

error or explanation of why the position had changed. For many people in Central Asia, the policy reversal only served to confirm prejudices about the arbitrariness of policy conclusions based on western economics.

The faulty advice on the ruble zone, given with apparent certainty for most of 1992, damaged the IMF's credibility as a technical adviser in macroeconomic matters, with lasting consequences in Central Asia—and by extension the episode jaundiced views in the region about the technical competence of outside advisers. The most unfortunate consequence was Uzbekistan's imposition of tight exchange controls in the second half of 1996 which all western economists would have criticized. Uzbekistan's policymakers paid no attention to IMF advice, even though it was much more firmly based than the more debatable 1992 analysis of the ruble zone, and felt vindicated when Malaysia, seen by many in Central Asia as the model of successful economic development in an Islamic country, introduced capital controls after the 1997 Asian crisis. The fact that the Malaysian controls were much lighter and fairly quickly eased was ignored, and Uzbekistan was condemned to learn the costs of draconian exchange controls by experience over the next half-decade. This episode was important for regional economic cooperation, because the absence of a convertible currency in Uzbekistan, the country at the geographical heart of Central Asia, has been a fundamental obstacle to regional trade and transit. More generally, all multilateral agencies found that the process of convincing policymakers of the gains from trade was undermined by suspicion that the advice was driven by considerations other than technical analysis.

#### **4 Multilateral aid for national governments**

The IMF and World Bank were associated with a particular position on the transition from central planning. The Washington consensus of the early and mid-1990s was not shared equally by all staff, but it remained the company line until a new position was adopted in the later 1990s (articulated most forcefully by the World Bank's new chief economist in, for example, Stiglitz 1998). Although the choice of a transition and development strategy was an important issue, the desire to maintain a common front was less harmful than on the currency issue. First, other multilateral institutions could offer alternative perspectives and domestic policymakers felt better placed to judge the arguments than on the monetary issue.<sup>33</sup> Second, despite heated debates over shock therapy versus gradualism in the early transition period, these fizzled out by the end of the 1990s. The appropriate speed of reform could be debated, but there was substantial agreement about content (price liberalization and macroeconomic stabilization are critical elements of transition and the other parts of the consensus were sensible components of a development strategy), and the speed issue was passé by the end of the century.

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<sup>33</sup> The UNDP distanced itself from the Washington consensus, often advocating a more gradual approach to the transition from central planning and focussing on social sectors rather than macropolicy. There has, however, been convergence since the World Bank and IMF in 1999 introduced a new approach to their relations with low-income countries, centred on preparation of poverty reduction strategies by national governments, and after the ADB made poverty alleviation an overarching policy for all loan proposals.

The Kyrgyz Republic quickly became established as the model country in Central Asia and, starting with the May 1993 assistance for the establishment of the new national currency, it was the leading recipient of multilateral aid.<sup>34</sup> In 1992 Kazakhstan rather than the Kyrgyz Republic was the reforming leader in Central Asia (Pomfret 1995: 53-7), but the initial reforming impetus became dissipated in struggles over natural resource rents and the spread of corruption, so that outside observers increasingly worried about a crisis of governance.<sup>35</sup> Meanwhile, the resource-poor Kyrgyz Republic had little room for manoeuvre. The dissolution of the USSR and early stages of transition had been highly disruptive to the Kyrgyz economy; average incomes fell from already low levels and inequality increased, leading to the highest poverty rates in all of the former USSR and eastern Europe in 1993 (Milanovic 1998).

Starting in mid-1993 the Kyrgyz Republic embraced the philosophy of the Washington Consensus in return for generous financial assistance and technical support. Macroeconomic control was established after the introduction of the national currency, and annual inflation was brought below 50 per cent in 1995 (compared to 1996 in Kazakhstan, and 1997 or later elsewhere in Central Asia). Financial reform was pursued energetically as banks were restructured (with support from an IDA Financial Sector Adjustment Credit) and credible prudential regulation enforced after 1995. Privatization of housing and small enterprises was completed quickly. Agricultural reform was more thorough than in neighbouring countries, although the impact varied significantly from region to region. Trade policy was liberalized, and current account convertibility established; in 1998 the Kyrgyz Republic became the first Soviet successor state to accede to the World Trade Organization. The Kyrgyz Republic's progress and status as the region's leading economic reformer was lauded in public documents such as the World Bank report (1996), but the country's economic performance was disappointing.<sup>36</sup> The drop in real output in the first half of the 1990s was larger than in most non-war-torn Soviet successor states and the increase in poverty was traumatic, especially in the poor rural areas of the south.

The Kyrgyz Republic's success in generating foreign aid is reflected in World Bank commitments up to the end of 1996 of US\$70 per capita, compared to US\$49 in Kazakhstan, US\$11 in Uzbekistan, US\$6 in Turkmenistan and US\$1 in Tajikistan. During the second half of the decade, annual aid flows to the Kyrgyz Republic averaged about US\$50-60 per head of population which is high by international standards

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<sup>34</sup> After the dissolution of the USSR, the IFIs' focus was on supporting 'reformist' elements in the ongoing political struggles in Russia and, although the Washington institutions established resident representatives in many of the southern republics and provided training services in-country and abroad, these transition economies in 1992 were not high priorities.

<sup>35</sup> See Kalyuzhnova (1998) and Olcott (2002)—the latter had circulated widely in draft since at least 1998—and references in Pomfret (2005). Dissolution of parliament and President Nazarbayev's manipulation of the March 1994 election also cast doubt on Kazakhstan's democratic credentials.

<sup>36</sup> The Kyrgyz Republic was also lauded as an island of democracy and an open society in a region of autocracies and intolerance, but the 'island of democracy' image is an oversimplified perspective. President Akayev ruled by decree when he considered it necessary to push through desirable legislation (especially in 1994-96), and his western supporters generally turned a blind eye (Kubicek 1998). He was as unwilling as other Central Asian presidents to allow establishment of a political process that could lead to changes in power. Nevertheless, under Akayev the media flourished more in the Kyrgyz Republic than elsewhere in Central Asia and the feeling of oppression was less than in other countries.

(Table 3). From 1992 to 2000 international aid to the Kyrgyz Republic amounted to US\$1.7 billion, over half of which came from the major multilateral agencies: the World Bank provided 23 per cent, the ADB 15 per cent, IMF 15 per cent, and EBRD 5 per cent.<sup>37</sup>

The financial assistance enabled the government to reduce inflation without balancing domestically generated revenue and expenditure. As tax revenue fell during the early stages of transition, expenditures were not cut commensurately and the budget deficit peaked at 17 per cent of GDP in 1995. The deficit was reduced after 1995, with less draconian expenditure cuts than would have been required in the absence of foreign aid. The Kyrgyz Republic's budget required practically no inflationary financing by the central bank in 1997 or 1998, due to huge external support rather than balancing the domestic books (Pomfret 2004). Success in reducing inflation could then be used as evidence that the country had been deserving of support because its economic reform strategy and economic policies were sound, although it was really the foreign aid which had underpinned the success in reducing inflation.

Macroeconomic stabilization is an important achievement, but in the Kyrgyz Republic it came at a high price in terms of external debt. International aid in the 1990s was provided about one-fifth in grants and four-fifths in loans. Even if World Bank, ADB, IMF and EBRD loans were provided on better than commercial terms, they still had to be serviced and eventually repaid. By mid-1998 external debt exceeded US\$1 billion, over half of which was on concessional terms from multilateral institutions; the main

Table 3  
Aid to Central Asia Countries, various years

|                 | ODA, US\$ m.<br>(OECD/DAC definition) |          | World Bank lending,<br>US\$ m. |     | ABD<br>US\$ m. | IMF<br>SDRs m. | EBRD<br>US\$ m. |
|-----------------|---------------------------------------|----------|--------------------------------|-----|----------------|----------------|-----------------|
|                 | 1998                                  | 2003     | IBRD                           | IDA |                |                |                 |
| Kazakhstan      | 223 (14)                              | 268 (18) | 1,983                          | 0   | 502            | 539            | 1,400           |
| Kyrgyz Republic | 240 (50)                              | 198 (36) | 0                              | 718 | 57             | 252            | 174             |
| Tajikistan      | 161 (26)                              | 144 (23) | 0                              | 361 | 2              | 165            | 49              |
| Turkmenistan    | 24 (5)                                | 27 (6)   | 90                             | 0   | 0              | 0              | 133             |
| Uzbekistan      | 158 (7)                               | 194 (8)  | 554                            | 85  | 860            | 165            | 599             |

Notes: DAC data are annual aid flows from OECD members and multilateral agencies, as reported by donors (numbers in parentheses are dollars per capita).

All other data are cumulative totals since the Central Asian countries began borrowing:

World Bank data are for cumulative lending up to 30 June 2005;

IDA loans are soft loans;

ADB data are for cumulative lending up to 31 December 2003;

IMF disbursements are in million SDRs, cumulative to 30 April 2006;

EBRD data are cumulative totals up to 31 December 2005 of funds committed to financing private sector projects, usually as a joint sponsor with a larger contribution from other sources.

Sources: Official websites (accessed 22 May 2006).

<sup>37</sup> The major bilateral donors were Japan (15 per cent of the total), and Germany, Switzerland and the EU (each 4 per cent).

items were US\$267 million owed to the World Bank's concessional arm (the IDA) and US\$127 million under the IMF's Extended Structural Adjustment Facility (ESAF), while others included concessional loans from the ADB and the EBRD.<sup>38</sup> Until the late 1990s, the government acted as though the foreign aid could be used to smooth out the consumption shock from transition and the dissolution of the USSR, without worrying about investing the funds in order to generate the foreign exchange earnings necessary to service or repay the loans.<sup>39</sup> In 2002, when the debt/GDP ratio was over 100 per cent, the Kyrgyz Republic was forced to turn to the Paris Club for rescheduling.

The Kyrgyz Republic's debt problem, now the worst in the CIS, arose because both the IFIs and the Kyrgyz government underestimated the depth and length of the transitional recession, and hence failed to recognize how much consumption smoothing could be achieved by loans without creating an unrepayable debt (Helbling, Mody and Sahay 2003). One problem with this analysis is that in the dire situation of 1992-96, it would have been difficult for the government to reduce consumption by any more than actually happened (the Kyrgyz Republic had the highest poverty rate of any transition economy in 1993; only Tajikistan suffered more in the later 1990s, and that was due to civil war). The Washington consensus policy package exacerbated the short-run costs of transition, and if the IFIs really wanted the Kyrgyz Republic to adopt this policy package, then it should have been supported with an aid package containing more grants and fewer loans. As with any delinquent debtor, the Kyrgyz government could be criticized for failing to borrow within its means, but blame also lay with the IFIs which lent without due diligence in assessing ability to repay or full explanation of the need to repay.

The other four Central Asian countries have all received less aid per capita than the Kyrgyz Republic (Table 3). Kazakhstan received the largest aggregate aid from the IFIs, led by a US\$700 million commitment in 1994 for support for the national currency. Subsequently, the IFIs' enthusiasm for Kazakhstan waned, perhaps in response to concerns about internal political or economic developments or to external political conditions.<sup>40</sup> Relations remained cordial and technical cooperation continued, but financial aid was small, and little needed after the oilboom began.

Uzbekistan after independence was cold-shouldered by the west as an undemocratic and unreforming regime. Relations with the IFIs were formal but not cordial; Uzbekistan did not receive the same assistance as the Kyrgyz Republic or Kazakhstan for the establishment of its national currency, and relations deteriorated even further in 1996. The stand-off was not uncongenial to President Karimov who emphasised his country's

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<sup>38</sup> See IMF (1999: 125). The external debt for all Soviet successor states except Russia had been zero at the start of 1992 when Russia assumed the USSR's external assets and liabilities.

<sup>39</sup> In the Soviet era, the Kyrgyz Republic had become used to external assistance in the form of net flows from the rest of the USSR, but these paper debts were never repaid. A big difference in the post-1991 situation was that the assistance led to accumulated debt which was intended to be serviced.

<sup>40</sup> Kazakhstan's slide into authoritarianism could be seen as a necessary response to the delicate ethnic balance but once President Nazarbayev embarked on this path, concern for state stability transformed into concern for his own political longevity, and 'a solid undemocratic foundation' was laid (Bremmer and Welt 1996). At the same time, privatization of large enterprises, especially in the natural resource sector, at giveaway prices created a new rich class and an aura of corruption (Pomfret 2005). As mentioned earlier, the ethnic situation and strong economic links kept Kazakhstan closely aligned to Russia.

independence and outperforming the good pupils. The IFIs were somewhat embarrassed by Uzbekistan's economic success, with the smallest 1989-96 decline in real output of any Soviet successor state. Whether the performance was due to favourable initial conditions or good policies remains contentious, but Uzbekistan was helped by buoyant cotton prices in the early and mid-1990s.<sup>41</sup> Reversal of these price trends in 1996 set in motion the reimposition of exchange controls in the second half of the year, despite commitments to the contrary to the IMF, and the rupture of relations between Uzbekistan and the IFIs.<sup>42</sup> In the late 1990s both sides sought a rapprochement, as the increasingly obvious costs of the exchange controls stimulated rethinking of Uzbekistan's gradual reform strategy, at the same time as rethinking of the Washington consensus made the IFIs more amenable to a heterodox strategy. The warmth was increased as Uzbekistan assumed a pivotal role in the fight against terrorism during the Afghanistan invasion, but it cooled even more rapidly as the regime's brutality received wider coverage, and especially after the deaths of demonstrators in Andijan in May 2005.

Turkmenistan's gradualism has been a synonym for non-reform, and its relations with the IFIs have been minimal. The government has been autocratic, with an extreme personality cult. Without exception the international agencies and western governments have held back from close contact with Turkmenistan.<sup>43</sup>

In Tajikistan the intermittent civil war was not resolved until the June 1997 peace agreement. During the war the central government was heavily dependent on Russia—and to a lesser extent Uzbekistan—for military and other financial support, and by 1996 had the highest debt/GDP ratio in the CIS, 84 per cent (Kapur and van der Mensbrugghe 1997: 24). Serious economic reforms were pursued in a sustained manner only after 1997; before that, relations with the IFIs were limited.<sup>44</sup> Although some signs are emerging of economic liberalism on the Kyrgyz model, driven by similar resource scarcity and widespread poverty, there is a gap between declared policies and implementation. Given the extent of poverty, Tajikistan's need for assistance is the highest in the region, but aid disbursements are limited by concerns about domestic absorption capacity and corruption.

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<sup>41</sup> Some of the good performance may reflect optimistic data, but Taube and Zettelmeyer (1998) conclude that only a small part of Uzbekistan's performance can be explained away as a statistical artefact.

<sup>42</sup> Uzbekistan's disbursements from the IMF (Table 3) amounted to 106 million SDRs in 1995 and 59 million in 1996, but nothing since then. Initially the frostiness was on the side of the IMF, but after the magnitude of the Kyrgyz Republic's debt burden to the IFIs became apparent, Uzbekistan appeared to have no desire to borrow even when relations with the IMF warmed in the early 2000s.

<sup>43</sup> The World Bank committed US\$25 million in 1995 and US\$64 million in 1997, but only US\$5 million had been disbursed by the end of 1997. A similar pattern of small disbursements applies to EBRD loans. The IMF has limited itself to technical assistance. Turkmenistan did not join the ADB until 2001, perhaps seeing the Asian agency as a counter-weight to the Washington-based institutions which were providing negative publicity about the country's economic policies.

<sup>44</sup> The first financial assistance from the IMF and World Bank was in 1996, but after the resumption of violence in December 1996 and kidnapping of UN and Red Cross personnel in early 1997, the IMF and World Bank resident representatives were evacuated in February (they returned in May). IMF staff were involved in developing the new economic reform programme after October 1997. The main source of western assistance to Tajikistan until then was humanitarian aid mainly from the USA, the EU and its member states, and UN agencies (UNDP 1997: 103-4).

Despite differences in institutional philosophy and incentives to distinguish their programme, aid to Central Asia from the multilateral agencies has followed a common pattern of favouring the Kyrgyz Republic, preferring Kazakhstan over Uzbekistan, and ignoring Turkmenistan. Whether this is driven by need or economic strategy or political liberalism is difficult to determine, because all point to the same ranking of aid recipients. Ideology might explain the relative generosity of aid to the Kyrgyz Republic, but it is simply a more congenial counterpart than authoritarian Uzbekistan, pathological Turkmenistan or dysfunctional Tajikistan.<sup>45</sup>

The general record and reputation of the international agencies have probably improved as the national governments have learned, to varying degrees, to work with them. The mixed performance of the Kyrgyz Republic has not obviously strengthened the credibility of the IFIs' advice; by accepting the whole Washington consensus package, the Kyrgyz Republic has entered the ranks of the highly indebted poor countries. Nevertheless, many micro projects supported by technical assistance and loans from the IFIs have been beneficial. The outcome has been that governments have learned to be more wary of taking on loans and discriminating in their relations with the IFIs.<sup>46</sup>

The major multilateral economic institutions have pursued similar country priorities in Central Asia, but there has been some institutional differentiation by functional area. The IMF remains the principal provider of advice and assistance on macroeconomic problems, but the demand for such advice and assistance has diminished. The World Bank has been lead advisor on structural adjustment, public finances and financial sector reform.<sup>47</sup> The ADB was rather slow to become involved in Central Asia but, together with ESCAP, it has focussed on transport and other infrastructure projects. The EBRD is distinguished by its orientation towards the private sector, and much of its lending has gone to promote small and medium enterprises in the region, but it still has to deal with national governments and it made a disastrous decision when it held its 2003 annual meetings in Uzbekistan.<sup>48</sup> Although the common country priorities and the

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<sup>45</sup> Praise of democratic tendencies followed identification of the Kyrgyz Republic as a model of economic reform in Central Asia rather than being the reason for aid, and in the mid-1990s President Akayev governed autocratically without loss of his preferred status among western leaders. Elsewhere in the region, the IFIs' aid has shown little relation to the degree of democracy, with no assistance going to relatively democratic Azerbaijan in 1992 and 1993. The limited aid to Uzbekistan and to Turkmenistan is explained by these countries' failure to embrace the Washington consensus economic policies as well as by their undemocratic regimes. Increased aid to Azerbaijan from 1995 onwards followed unilateral adoption of economic stabilization by an undemocratic regime; neither the policies nor the nature of the regime were much affected by the provision of western aid.

<sup>46</sup> The generalization is also complicated by the concessional component of aid, e.g., for Uzbekistan almost all IFI assistance has been on non-concessional terms (Lane 2003: 17) which presumably reinforces awareness of the repayment issues. There is also greater comprehension that the IFIs are not simply pawns of the western powers and that they may have their own motives, including pressures on desk officers to make loans.

<sup>47</sup> Since the introduction of the poverty reduction and strategy paper (PRSP) process in 1999 the IMF and World Bank have explicitly aimed to coordinate their advice and assistance in conjunction with national stakeholders. There are, however, concerns over 'mission creep', and some commentators (e.g., the Meltzer Commission in the USA) have criticized the IMF's involvement in poverty reduction.

<sup>48</sup> Holding the 2003 meetings in Tashkent was intended as a signal of EBRD's increased attention to Central Asia as its eastern European and Baltic clients were about to join the European Union, but the EBRD set targets on human rights issues such as the elimination of torture which the Uzbekistan



agreed functional differentiation sound as though they would provide a solid basis for promoting regional cooperation where that is needed in Central Asia, the record on regional cooperation has been disappointing. The next section analyses why the multilateral agencies (and bilateral aid donors) have been so ineffective in promoting regional cooperation even when the benefits appear to be obvious and large

## **5 Regional cooperation and multilateral aid**

There are several reasons for regional cooperation in Central Asia.<sup>49</sup> External assistance can help to realize the benefits from regional cooperation by creating supranational institutions, fostering trust, and providing expertise and finance. Where agreement is needed on sharing regional public goods such as water resources, an external ‘honest broker’ can help to establish the higher authority which will settle disputes over the distribution of costs and benefits or facilitate renegotiation of arrangements as circumstances change.

Water resource management (including the desiccation of the Aral Sea and related energy supply issues) is the most critical area for regional cooperation in Central Asia, but also one of the least tractable. The failure to take any common action on the desiccation of the Aral Sea is symptomatic of the inability of Central Asia’s leaders to cooperate on a pressing regional issue, and the record of aid to deal with the Aral Sea disaster is poor. Security matters have been dominant since 1999, and have entered the international spotlight since September 2001 but they are not likely to provide an arena for cooperation among aid donors.<sup>50</sup> Trade facilitation, while more mundane, is an area in which stepwise progress could be made to reduce foregone opportunities for mutually beneficial trade due to impediments such as unnecessary delays or bureaucracy at border crossings or in transit, and official or unofficial taxes on traders.

### **5.1 The Aral Sea**

The Aral Sea poses an environmentally serious but also intractable problem because the states involved can only see short-term economic costs from addressing the environmental disaster. The problem is straightforward. Ever increasing demands on the water of the two river systems, the Amudarya and Syrdarya rivers, have so far reduced the amount of water reaching the Aral Sea, the world’s fourth-biggest lake (after the Caspian, Lake Superior and Lake Victoria) as recently as 1960. Between 1960 and 2000, the Aral Sea’s area fell by half, its volume by 80 per cent and the shoreline receded by 60-80 km as it subdivided into two small lakes. The fisheries and other sea-based activities were destroyed by the end of the 1980s. The shrinking of the Aral Sea has changed climate patterns, increasing extremes of heat and cold, shrinking growing seasons and reducing crop yields. Exposure of the seabed has been accompanied by dust

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government was not prepared to meet; EBRD involvement in Uzbekistan was substantially reduced in 2004, and the only multilateral institution left with an active programme in Uzbekistan was the ADB.

<sup>49</sup> UNDP (2005) provides a general assessment of regional cooperation in Central Asia.

<sup>50</sup> Some indirect assistance may be given by programmes run by the UN, for example, to improve border management and restrict the trade in narcotics.

storms carrying toxic chemicals (a legacy of the fertilizer-intensive nature of Soviet cotton-farming) for thousands of kilometres. Morbidity rates have risen in the affected areas, especially in Karakalpakstan and Dashkoguz, where high levels of anaemia contribute to underweight babies and high infant mortality rates; respiratory diseases, dysentery, hepatitis, typhoid and tuberculosis, associated with poor water supply and sanitation, are also prevalent.<sup>51</sup>

The solution is straightforward in principle: reduce the quantity of water being taken out of the river systems. Before 1992 water was allocated by the central authorities in Moscow using formula-driven methods which the Central Asian republics had little power to dispute, but which clearly needed to be revised in order to reverse the desiccation of the Aral Sea. After independence, the Central Asian leadership looked for technical fixes, and Weinthal (2002: 195) argues that it was the (mistaken) prospect of funding for such schemes that led them to welcome international financial institutions' involvement in the Aral Sea after the dissolution of the Soviet Union. In fact, no institution was prepared to provide anything like the amount of funds needed to finance the grand technical schemes.<sup>52</sup> When instead all they could offer was advice to reduce water-usage, this fell on deaf ears and attempts to foster regional cooperation were doomed to failure.

The World Bank, which played the lead role in negotiations in the mid-1990s, tried to streamline the post-Soviet institutional arrangements and to focus narrowly on water. In 1993 the five Central Asian countries established the Interstate Fund for Saving the Aral Sea (IFAS), and under the IFAS, the Interstate Commission for Water Coordination (ICWC), with a secretariat in Khujand, Tajikistan, is the implementing body responsible for managing the seasonal allocation of water. Lack of funds from the national governments limited the effectiveness of these bodies, and in 1994 the IFAS and external donors came together in the Aral Sea Basin Programme, administered through a special office of the World Bank with US\$60 million funding.<sup>53</sup> More fundamental to the ineffectiveness of the IFAS, however, was the rotating chairmanship and its lack of authority. The technical management institutions for the two river systems are both headquartered in Uzbekistan and mainly staffed by Uzbek nationals, which inhibits other countries' confidence in their activities even though they report to the ICWC. Actual control over water flows is dependent on the agreement of national entities such as power companies, e.g., the headgates of the Toktogul Reservoir are under the control

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<sup>51</sup> The most directly affected regions—the autonomous republic of Karakalpakstan and Khorezm in northwest Uzbekistan, Kyzylorda and South Kazakhstan, and Dashkoguz in northern Turkmenistan—are among the poorest areas of the respective countries. The full extent of the health problem is difficult to assess because few outsiders travel to Karakalpakstan and Dashkoguz, and the authorities conceal much of what happens there. In Kazakhstan, where the authorities are more open, mutations are reported.

<sup>52</sup> A Soviet-era scheme to divert waters from the River Ob in Siberia to Central Asia is sometimes revived, usually by Russian politicians considering the geopolitical benefits of increasing Central Asian dependence on Russia. Yuri Luzhkov, mayor of Moscow and an influential Russian politician, for example, has campaigned for the Ob-diversion project, arguing that Russia has plenty of water to sell and the US\$34 billion project is necessary to forestall a huge wave of Central Asian immigrants pushed into Russia by water-related economic failure in Central Asia.

<sup>53</sup> UNEP, which had been involved in a technical capacity since 1989, was also engaged in promoting regional cooperation on the Aral Sea, but due to its limited financial resources, it was perceived as secondary to the World Bank during 1992-97.

of the Kyrgyz Ministry of Energy over whom the ICWC had no authority (Weinthal 2002: 1845). In 1997 the World Bank closed its office due to lack of effective progress in coordinating actions with respect to the Aral Sea.

The World Bank's narrow focus on water failed, but other approaches fared no better, e.g., the attempts by USAid to create new structures linking water and energy issues were naïve considering the entrenched power of the existing bureaucracies. For international organizations and foreign economists, the least confrontational solution would be to use the price mechanism to allocate a reduced amount of water to competing demands. However, apart from the Kyrgyz Republic, which adopted legislation in July 2001 making water a tradable commodity, and some quarters in Kazakhstan, most Central Asian policymaking elites have a deep antipathy to the concept for cultural reasons associated with the role of water in this arid region, and also because of concerns about fairness and opportunities for corruption, technical monitoring problems, and the inability of the poorest farmers to afford any but negligibly low prices for irrigation water. Despite the downstream countries' reservations about using prices in international trade in water, where they are importers and hence satisfied with a zero price, water pricing is likely to come eventually to the downstream countries because it is the most efficient way to allocate water domestically—but it will not be forced on them by external agencies.<sup>54</sup>

A major component of any solution to the Aral Sea problem should be to increase the efficiency with which water is used in Central Asia, where profligate practices were encouraged in the Soviet era, but national governments refuse to accept externally imposed agrarian reform. In the absence of improved water-use efficiency, however, reduction in the amount of water available for irrigation will make any agriculture denied of water infeasible in the arid conditions of Central Asia. This would be especially disastrous for Turkmenistan, most of whose agriculture draws on water carried by the Karakum Canal, a 1,300 km open channel westwards from the Amudarya River which has been the single main contributor to the shrinking of the Aral Sea.<sup>55</sup> Apart from unequal sharing of costs and benefits across countries, there would also be intra-country conflicts of interest. Much of the irrigated area of Tajikistan is marginal agricultural land with poor farmers who would be hard hit by reduced availability of water, while in Uzbekistan the areas where irrigated agriculture should be discontinued rather than reformed are concentrated in Kashkadarya province (World Bank 2002b: vii). In international negotiations on how to deal with the Aral Sea crisis, agricultural change has been kept off the agenda.

Given the huge obstacles to negotiating an international solution, existing intrastate agreements, administered by the ICWC, have essentially maintained the pre-1992 status

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<sup>54</sup> Water is implicitly priced in the energy-for-water barter agreements because there is no exogenously determined price for the energy component of the swaps.

<sup>55</sup> President Niyazov seemed, if anything, intent on enhancing the irrigated agricultural area in Turkmenistan, and some observers have speculated that if Turkmenistan proceeds with plans to build a huge artificial lake in the country's desert, it could trigger war with Uzbekistan. Water conflicts between Turkmenistan and Uzbekistan already existed as a result of Turkmenistan's construction of a canal to (inefficiently) bypass Uzbekistan and secure its own water, and accusations by Uzbekistan that Turkmenistan has been failing to maintain the pumping stations at Karshi and Amu-Bukhara which serve Uzbekistan or to clean drains through which water passes from Turkmenistan to Uzbekistan.

quo under which Kazakhstan, Turkmenistan and Uzbekistan are allocated over 70 per cent of the water in the Amudarya and Syrdarya river systems, while the upstream countries—the Kyrgyz Republic (source of 25 per cent of the water) and Tajikistan (source of 55 per cent)—are allocated 0.4 per cent and 11 per cent, respectively; 16 per cent is allocated to the Aral Sea and a small proportion to northern Afghanistan. The upstream countries agree to release water for the irrigation needs of the downstream countries in return for guaranteed deliveries of other energy sources in winter although these agreements are regularly breached and the specific terms, which are largely barter arrangements, have been frequently revised. Despite their flaws these agreements have been critical in preventing interstate armed conflict over water resources, and international nongovernmental organizations or multilateral agencies (such as the World Bank or UNEP) have been facilitators of agreement, often providing or identifying side-payments which lubricate a deal (Weinthal 2002).

The conflicts are becoming more severe over time because the annual releases from the reservoirs exceed the average inflow, a situation which was exacerbated by dry conditions in 2000 and 2001. Prior to 1991, annual releases from the Toktogul reservoir on the Syrdarya River system averaged  $2.7 \text{ km}^3$  in winter and  $8.0 \text{ km}^3$  in summer which was below the long-term average inflow of  $12.3 \text{ km}^3$ , but between 1995 and 2000 the annual release was  $13.5 \text{ km}^3$  (Biddison 2002: 4). The Kyrgyz agreements with Kazakhstan have been reasonably stable, with Kazakhstan supplying coal and oil for water, but agreements with Uzbekistan have been more volatile, leading the Kyrgyz and Tajik governments to threaten (or actually) to produce more hydropower in winter and hence have less water available for release during the cotton-growing season. So far there have been fewer disputes over Amudarya water, because the sole major upstream power station on the Nurek reservoir in Tajikistan has operated below capacity and also because Afghanistan has not fully used its water entitlement. In the future, economic stability and growth in Afghanistan could lead in short order to increased use for irrigation because the left-bank of the Amudarya is suited to gravity irrigation without the need for investment in pumping facilities.

In sum, efforts to resolve the Aral Sea problem have been ineffective beyond the short-term achievement of avoiding water wars, and the situation will get worse. The fundamental problem is that all parties, but especially the downstream (and more conservative) countries—Uzbekistan and Turkmenistan—are defensive about their perceived national interests, unwilling to countenance the necessary domestic changes in agriculture, and suspicious of any change in the current interstate arrangements (Horsman 2001). All attempts at multilateral solutions have been doomed due to a lack of political will on the part of the national governments to accept the costs needed to realize the obvious (global) benefits.

## **5.2 Trade facilitation**

Regional cooperation on trade facilitation is a more promising area than the Aral Sea for multilateral assistance because the national interests in resisting change are less strong and win-win situations amenable to piecemeal improvement are more easily identifiable. The dissolution of the Soviet Union was associated with economic disintegration as old coordination mechanisms disappeared and new national borders appeared. Since 1991, the Central Asian countries' generally disappointing trade

performance, with only energy exports flourishing, has contributed to a poor economic performance with substantial increases in inequality and poverty.

External advice has been important in making the intellectual case for openness and, more influentially, providing the empirical evidence for the relationship between trade and growth. Trade policies (tariffs, quotas and related non-tariff barriers) have not been major barriers to intra-Central Asian trade although the unpredictability of such measures (e.g., temporary duties or other restrictions on trade) has been a problem on occasion. Both trade within the region and external trade are constrained by poor infrastructure. Improving the hard infrastructure of the transport and communications systems (roads, bridges, ports, etc.) is primarily a matter for national action and, although there are benefits from regional cooperation, they will not be addressed in this paper.<sup>56</sup> Especially important has been lack of cooperation on soft infrastructure which would facilitate cross-border and transit trade for these landlocked countries (ADB 2006).

Trade facilitation and soft infrastructure are impediments to trade not included under trade policy or the hard infrastructure. Customs policies and practices are a major problem because, apart from uncoordinated opening times and other physical problems, the customs services still have a philosophy of control rather than facilitation. All countries in the region undertake inspection of all vehicles at which the trader or trader's representative must be physically present, increasing border dwell times and providing opportunities for abuse as officials on the spot enjoy discretion in interpreting complicated rules and schedules. Other examples of poor soft infrastructure include internal breakdowns of law and order which undermine the security of traders, arbitrary levies on traders, changes in trade or trade-related regulations, taxation systems which discriminate against traders by being imposed on traded goods both as exports and as imports, rudimentary communications networks which make it difficult to obtain information about current conditions in the foreign market and en route, and poorly developed banking and insurance services which are exacerbated in some countries by poor payment mechanisms due to inconvertibility or lack of confidence in national currencies. Predictability in areas such as customs duties, fees and so forth is itself a positive factor in facilitating trade, but one feature of Central Asia's post-independence economic history has been volatility.<sup>57</sup>

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<sup>56</sup> The inherited networks of the former Soviet republics emphasized links to Russia at the expense of links to the east or south. Since independence, national infrastructure spending has often focussed on improving internal communications within each new state, rather than strengthening the regional network or coordinating access to southern or eastern neighbours.

<sup>57</sup> Uzbekistan suddenly re-introduced tight foreign exchange controls in response to a balance of payments problem triggered by falling cotton prices. Similarly draconian controls were imposed by Turkmenistan in December 1998. After the August 1998 Russian crisis which hit Kazakhstan hardest among the Central Asian countries, Kazakhstan imposed special tariffs as high as 200 per cent on a number of goods imported from the Kyrgyz Republic and Uzbekistan and in April 1999 the Kazakh tenge was floated which led to an effective 50 per cent devaluation. Border enforcement has at times been lax and at other times rigorous, with occasional total closure, e.g., for several months in 1999 Uzbekistan unilaterally closed all but one of the posts along its border with Kazakhstan. Such actions are often unpredictable and may be only discovered upon arrival at the border. In July 2000 Kazakhstan increased the bond required from customs agents from US\$5,000 to US\$20,000, a measure justified by government officials in terms of concerns about the financial stability of smaller

The trade situation in Central Asia in the 1990s represented a tragedy of the anti-commons, where excessive ability of official and unofficial regulators to tap the gains from trade forestalled potential win-win situations.<sup>58</sup> A practical example (and just one of thousands) occurred in 1999 when the high shipment costs across Kazakhstan made Kyrgyz vegetable exports to Russia unprofitable. When Kyrgyz onions were not exported, Russian consumers missed their onions, Kyrgyz producers swamped the domestic market driving down prices, and Kazakhstan received no transit charges. Thus both Kazakhstan and Russia were absolute losers. The only gainers were Kyrgyz consumers but even for the Kyrgyz Republic, the net loss was undoubtedly substantial, because the Kyrgyz-Russian onion trade was so clearly a case of efficient specialization and the onions could be more valuable earning foreign currency to pay for imports than adding to the amount of domestically consumed onions. Because the numerous individual fee-leviers across Kazakhstan each tried to maximize their own 'tax' on the transit trade, the trade was choked off, to almost everybody's disadvantage. Moreover if the trade is cut off for some time, it will not be a simple matter to restart it because connections will have been lost and new channels to Russian wholesalers will have to be established.

Why do these lose-lose situations arise? Each individual with the power to levy a fee along the road from the farm in the Kyrgyz Republic to the onion market in Russia thinks only of maximizing their own returns. Given that the trader has started out on the enterprise, he or she will be willing to pay the extra cost as long as the shipment retains value, but at some stage the trader will look at the total costs and decide it is not worth trying to make a new shipment. There is a coordination problem because each levier of fees will not consider this possible effect of their combined actions. Such impediments to trade tend to be very specific and often individually minor, but it is important to see the big picture of their overall effect. If impediments to trade are sufficiently large, trade will be choked off with no prospect of realizing the potential gains from trade.

How large are the social costs of impediments to trade within the region? Without trade, it is not always clear how much has been lost because the alternative with-trade situation is not observed. Measurement of something that does not happen is always difficult, and even rough estimates are hard to make when we have little idea of potential areas of comparative advantage or of the relevant demand and supply curves. The burdens of trade impediments are likely to be heaviest in markets where supply is elastic. If demand is also elastic, then relatively small impediments will cut trade volumes far below potential. This is likely to best describe household or labour-intensive activities, like the Kyrgyz onion farmers, underlining the regressive impact of trade impediments which are likely to hit the poor hardest. Beyond basic necessities, the demand for non-luxury consumption goods is likely to be more price elastic so that the

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brokerage firms and expected to reduce the number of customs agents from 75 to 15, but exporters to Kazakhstan were concerned about the anti-competitive impact of the reduced number of agents.

<sup>58</sup> The tragedy of the commons arises from too many people having access to a common resource, such as fisheries; each fisher has an incentive to catch as much as possible because any individual conservation strategy will be ineffective as fish left in the water will be caught by other fishers. The tragedy of the anti-commons arises when too many people have the potential to hold-up an activity by levying taxes or imposing other costs. As in the tragedy of the commons, each hold-up agent will ignore potential externalities of their actions and try to maximize current benefits, in this case leading to too little rather than too much of the activity actually taking place.

non-rich members of the community will be hit as consumers. A useful role for external agencies is to provide estimates of the net benefits from removing trade impediments and to publicize who bears the costs, and perhaps assist financially with the adjustment costs.<sup>59</sup>

The internal levies are an example of the cost to traders from the failure to establish the authority of the central government or even from a breakdown of law and order. The solution in more established areas of flourishing intra-regional trade is for the government to exert its influence to prevent a tragedy of the anti-commons. In the new states of Central Asia, it is necessary to convince governments that they should play this role. Enforceability of contracts is critical to the smooth operation of a market economy, and so is protection from arbitrary intrusion into property rights; in Central Asia these are inadequately addressed by the national governments although with the ongoing process of nation-building, things may be improving.<sup>60</sup> Since the early 1990s, contracts have been especially difficult to enforce when the dispute is between people in different jurisdictions, and an obstacle to international cooperation to promote the enforceability of contracts is the mutual mistrust between the political entities.<sup>61</sup>

Transit is an area where regional cooperation is clearly desirable, especially given the landlocked status of the Central Asian countries and their long pre-independence history of free transit within the region. Since 1991 transit rights have varied, and it is difficult even to establish transit rates which are often levied irregularly by local police. An often cited figure from the late 1990s is of lorries travelling through Kazakhstan from the Kyrgyz Republic to Russia paying on average ten such levies, amounting to an average of US\$1,700. Uzbekistan's complaints about transit charges in Kazakhstan include unofficial and local levies, as well as national measures.<sup>62</sup> When tensions between the

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<sup>59</sup> Schiff and Winters (2002: 10-11) include this in their list of ways in which international organizations can promote regional cooperation. They also emphasize the potential for international organizations to act as honest brokers in determining a fair allocation of costs and benefits and they provide several interesting case studies, although surprisingly they claim the Aral Sea as an example of successful regional cooperation fostered by the World Bank and UNEP.

<sup>60</sup> The beneficiaries from internal levies and other sources of corruption may be protected by the government. Allocation of remunerative jobs in the customs service is a way for politicians to keep their clients happy and in some cases the point of complex regulations seems to be to increase the potential unofficial earnings of such clients. The solution is to convince the central government that it is better served by an efficient public service in which employees will need to be paid attractive salaries.

<sup>61</sup> When fees are levied or regulations imposed in differing countries, there is a tendency to see the benefits as accruing to the country levying the fees and the costs being born by foreigners, especially with transit trade where there is no impact on domestic consumers. The problem is complicated because there are genuine reasons to charge fees for road and rail use or to regulate axle size of lorries and so forth but if the sum of the fees or the heterogeneity of the rules chokes off trade, then nobody benefits.

<sup>62</sup> Kazakhstan's regulations impose additional fees if the truck's weight or size exceeds certain limits and if the truck deviates from its previously specified route. The maximum weight of trucks allowed to enter Kazakhstan is 36 tons which is less than international standards (normally between 38 and 54 tons) and Uzbekistan's 40 ton limit. Lack of agreement on the limit makes it likely that an Uzbek truck entering Kazakhstan will have to pay US\$100-150 for exceeding the Kazakhstani limit. Agreements on the use of refrigerated railcars also broke down and were not renewed in 1999, leading Uzbekistan to find alternative routes for shipping perishable goods. Any railcars passing through Kazakhstan are subject to a US\$14 per railcar fee which Uzbekistan claims is contrary to agreements.

two countries have risen, the Kazakh authorities have closed part of the Tashkent-Samarkand main road which passes through Kazakhstan territory, imposing a long detour along minor roads for travellers between the two largest cities of Uzbekistan. Using these practices as justification, Uzbekistan has introduced its own restrictive measures which is especially important, given the crossroads location of Uzbekistan. Turkmenistan—which has the only railway south from Central Asia and the main port on the east coast of the Caspian Sea—could be a significant route for other Central Asian countries' international trade but levies high transit fees. This hard line, although short-sighted, is not surprising given the extent to which Turkmenistan has suffered from transit fees charged by Russia on gas exports to Ukraine and the Caucasus. Nevertheless, it is a stark example of the tragedy of the anti-commons by which the imposition of a series of high transit charges along roads crossing several countries chokes off the trade so that nobody benefits.<sup>63</sup>

Many regional organizations have included transit among their terms of reference but the situation has deteriorated rather than improved since the dissolution of the USSR. The main economic goal of the CIS was to maintain as many elements as possible of the Soviet economic space, including secure rights of transit, and many of the regional trade agreements among subgroups of CIS members have included transit clauses. Central Asian regional trading agreements (RTAs) such as the Central Asian Economic Community and its successor the Central Asian Cooperation Organization included clauses on transit rights, but members continually complained about contravention of the agreement by other members. The Russian-led Eurasian Economic Community—of which Kazakhstan, the Kyrgyz Republic and Tajikistan have been members since the 1990s and Uzbekistan joined in 2005—has also promoted freer transit. The Economic Cooperation Organization—to which all five Central Asian countries acceded in 1992 and whose members also include Afghanistan, Azerbaijan, Iran, Pakistan and Turkey—has negotiated two transit agreements but neither has been ratified by all national parliaments and the agreements are essentially dead. The fundamental problem with these regional trade agreements has been a lack of national commitment and a tendency to view them in political terms which has often widened regional fissures rather than promoting cooperation.

The involvement of international agencies in promoting regional cooperation on trade facilitation and, specifically, trying to facilitate improved transit arrangements in Central Asia began from the date of independence but has a limited record of achievement. TRACECA, launched in 1993 with the support of the EU, aimed to create a transit corridor linking Central Asia to Europe through the Caucasus, focusing on hard infrastructure and trade facilitation (e.g., harmonizing border crossing procedures and implementing a unified policy on transit fees) with funding available for technical assistance in modernizing customs services. Such grand schemes, often phrased in terms of creating a new Silk Road, may have helped long-distance traders but do not address the more pervasive local problems.

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<sup>63</sup> This is most obviously apparent for Uzbekistan which is double-landlocked and hence any exports must cross at least two other countries in order to reach an ocean port, but in practice it also applies to much of the trade of the other Central Asian countries due to the nature of the inherited transport system.



Various external *ad hoc* organizations supported by multilateral aid agencies (e.g., SPECA, supported by ESCAP and ECE, or CAREC, supported by the ADB and IMF) have devoted resources to promoting regional cooperation in trade but with very limited practical outcomes. One problem has been to define the geographical coverage, e.g., SPECA includes only the five Central Asian countries, while CAREC does not include Turkmenistan but does include Azerbaijan, Mongolia and Xinjiang autonomous region of China. Such groupings have fallen foul of the kind of geopolitics described above; regional organizations such as ECO or the CIS or Eurasian Economic Community are jealous of the jurisdictional overlaps, even though improved transit arrangements in any part of Central Asia would be desirable. In the late 1990s, for example, SPECA became associated with the pro-Russian countries at a time when Uzbekistan was in the opposite camp.<sup>64</sup> The current prospects for CAREC may be more positive because its membership overlaps that of the Shanghai Cooperation Organization which is currently in favour with all of the Central Asian countries except Turkmenistan, but that could change if any country decides to distance itself from Russian or Chinese influence.

A more practical approach to trade facilitation may be to focus on specific transport corridors and provide supporting funds. One of the most successful examples of an international agency's role as a broker and facilitator of regional cooperation involves bilateral relations between Kazakhstan and the Kyrgyz Republic. With the help of the Asian Development Bank, the two countries signed a cross-border agreement on 15<sup>th</sup> November 1999 to ease the movement of people, goods and vehicles across the common border. To try to ensure that this does not become just another paper agreement, implementation has been given a contractual basis by writing it into the conditions of the ADB loans and technical assistance grants to the two countries for the Almaty-Bishkek regional road rehabilitation project. Among its terms, the cross-border agreement provides exemption from export and import duties on transit trade, attempts to standardize customs documentation and procedures, and brings truck weights and dimensions as well as vehicle inspection and clearance procedures on to a common basis. Bilateral relations between the two countries were the most cordial in Central Asia and may have been sufficiently good to achieve these goals without external assistance and the coverage of the cross-border agreement is limited, but nevertheless the ADB's intervention at a minimum accelerated the process of regional cooperation to facilitative transit.

## 6 Conclusions

This paper analyses why it has been difficult to coordinate aid for projects which require regional cooperation and whose economic benefits appear to be so clearly positive. After setting out the background and history of aid provision to the Central Asian countries which became independent in 1991, the paper analyses the interests—both real and perceived—of major players: aid donors, national governments and groups within countries. Much bilateral aid has been viewed through the zero-sum prism of geopolitical competition, and individual donors have shown little interest in promoting

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<sup>64</sup> In practice, despite a convention of not criticizing other international organization, there is also competition among the external bodies, with the ADB, for example, favouring CAREC as a vehicle for regional cooperation on trade matters.

regional cooperation. Geopolitical considerations have also characterized the proliferation of regional trade agreements, and have prevented regional organizations from effectively addressing region-wide issues such as transit.

Multilateral agencies have an opportunity to promote regional cooperation by offering technical advice and support, by acting as an honest broker in negotiations, and by providing funding to compensate losers or to reduce other obstacles. The initial steps in Central Asia during the 1990s were unsuccessful because the reputation for impartial advice was tarnished by the IMF's position on the ruble zone (i.e., by assuming a strong company line on a topic where the appropriate advice was unclear) and because the World Bank's regional focus was on an important but in the circumstances intractable regional problem (desiccation of the Aral Sea). Other multilateral economic agencies arrived on the scene later and took time to establish a presence and create an identity.

The prospects for coordinating multilateral aid for regional cooperation are improving in the twenty-first century. Donor cooperation in the CIS-7 initiative of aid for the poorest CIS countries (which include the Kyrgyz Republic, Tajikistan and Uzbekistan) was a step towards institutional coordination although the prospects for regional cooperation within this framework are hindered by the composition of the CIS-7 which does not include Turkmenistan or Kazakhstan. The ADB has been designated as the lead institution on matters of transport and transit and cooperated with the UNDP in an analysis of regional cooperation on trade, transport and transit, which placed a strong emphasis on national involvement (UNDP 2005; ADB 2006). These studies have highlighted the potential win-win outcomes which exist for regional cooperation in trade facilitation and made a first attempt to calculate the gains from regional cooperation.

What lessons can be drawn from the experience of coordinating aid for regional cooperation in Central Asia? To date, the results have been disappointing, indicating pitfalls to avoid in a region where the potential benefits from cooperation are large. A key role for aid donors is to provide technical assistance in analysing and explaining benefits, and how these affect the various interests—a role which requires establishment of a reputation for honest-dealing and technical competence. Donors may facilitate implementation by providing financial assistance although, as illustrated by the Aral Sea programmes of 1992-97, this alone is unlikely to be sufficient to promote regional cooperation when the national governments are unconvinced of the benefits. A better strategy in the context of national jealousies and suspicions is to start with less contentious areas for cooperation, especially if it is possible to identify win-win situations, as in areas of transit and trade facilitation.

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