Catching up of the Central Asian Economies by Trade-Driven Development and the EU Partnership

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1. Introduction

The central idea of this paper builds on the hard facts of transition pointing at a successful break-through. Once the business relationships in Central and Eastern Europe could be exempt from ideology and once open economic policies were proven to be successful in bringing a one-sided convergence towards capitalism in countries with highly distorted market institutions (meanwhile such policies were also beneficial to capitalist incumbents), why should not they be extended to other parts of the world characterised by cultural proximity? In particular, why should they not be transposed to the world of Central Asia (CA)?[1] Can the 'enlargement fatigue' of some of the EU incumbents negate the finding that the productive effects of cultural and trade partnership have become undisputed?

The methodology of this study goes to the roots of economic geography and builds on the economies of mutual exchanges. We explain first the mechanism of transition and illustrate its impacts on the EU relationship with Central Asia, which will help us outline the space for policies of closer alignment with this region. At the end, we discuss the development strategies of this region by means of the scenarios of growth.

2. Development in the Wider Context of Economic Geography

2.1. The Counter-intuitive Mechanism of Velvet Revolutions

The arguments of this paper are derived from the theory of economic gravity that is a part of the theory of economic geography (see Fujita, Krugman and Venables, 1999). The problem can be stipulated as follows. The intensity of trade from country *i* to country *j* (e.g. exports X_{ij}) depends on the economic size of partners (*i.e.* on the countries' GDP denoted as Y_i and Y_j respectively) and on the geographic and cultural distances (i.e. GD_{ij} and CD_{ij}). In case we study trade between the EU-27 (as an amalgamated group) and the rest of the world, the gravity equation can be derived from the following implicit function:

$$\underset{+}{\mathbf{X}_{ij}} = \mathbf{\Phi}\,(\underset{+}{\mathbf{Y}_i}, \underset{+}{\mathbf{Y}_j}, \underset{-}{\mathbf{GD}_{ij}}, \underset{-}{\mathbf{CD}_{ij}}, \boldsymbol{\varepsilon}_{ij}) \qquad \textbf{[eq. 1]}$$

Where i = {EU-27} and j = {1, 2, ... , n} are the remaining countries of the world. The signs below the variables represent the functional relationship (*i.e.* positive or negative changes) for making the X_{ij} rising. The $\boldsymbol{\varepsilon}_{ij}$ is the random term with unknown sign for particular cases *j*, which represents the difference between the potential for exchanges and their real values. Because the GDP of EU-27 is 23 per cent of the worlds' GDP, and the EU is thus the largest economy of the world, the dependence of trade of even remote small non-EU countries on the EU can still be quite strong. In addition, economic dependence on the EU could be even

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[1] In this study we will deal primarily with a region of former Soviet Central Asia that consists of five land-locked countries of Inner Asia (Kazakhstan, Uzbekistan, Turkmenistan, Kyrgyzstan and Tajikistan). However, we should also consider that region in a wider geopolitical context of the EU neighbourhood and include there three Caucasian countries and Turkey.

stronger if the variable of cultural distance (CD_{ij}) reflected a strong cultural proximity. Then we could presume that certain geographic clusters of countries j (let us call them $CA \subset j$) could have a combined cultural alignment with the EU, which would be stronger as a block than with other superpowers[2].

The neighbourhood Policies of the EU concern the parameter CD – their purpose is to make the cultural gap smaller. We can also extend the model and expect that a very similar relationship concerns not only exports but also imports, financial transactions, R&D and other exchanges (e.g. political or cultural). The problem is that the relationships between X_{ij} and explicit explanatory variables describe the potential for exchanges only. Therefore real exchanges can fall short of the potential, provided the countries do not fine-tune their policies represented by CD_{ij} for deeper partnerships. In such a case the term $\boldsymbol{\varepsilon_{ij}}$ acquires a negative value that results in low real X_{ij}.

Let us now switch our attention to the problems of socio-economic transition and to the potential for externalities (spillovers) of restructuring. The fall of communism was marked by a departure from autarchy to globalisation that became the main driver of local fast growth. Thus the adoption of specific policies is not an affair of internal random choice of individual transition countries. There are crucial exogenous forces calling for an internal response. Thus the conduct of transition is not neutral to the aforementioned changing potential of outward gravity. The parameter of CD_{ij} is actually the only one in the gravity equation that changes with transition. There arise new economic and political leaders who are subject to new criteria for decision-making and who have to form new alliances. The whole political economy and the institutional setup have got to be re-adjusted to the pressures of globalisation. It implies a re-alignment of past economic and cultural exchanges towards new centres of gravity. Both partner countries must then anticipate such a potential and react with respective policies of openness.

In contrast to both Cuba and North Korea, the fall of communism in 33 totalitarian countries of Europe came as a storm. Even though in all of them the police and military forces were kept ready in reserve, the final settlement of social conflict resolution was very peaceful in the vast majority of these countries. According to Kornai (2006), the Great Communist Transformations were unique in our human history because of their non-violence, external non-aggressiveness, enormous speed and the complexity of restructuring that covered all structures of the society. The direction of transformation was also straightforward nearly everywhere: going back to capitalism, even though to an aberration of capitalism that has not betrayed its local idiosyncrasy and even some of the past communist legacies.

It would be incorrect to presume that external interventions (e.g. of the USA) were the primary cause of the communist breakdown: the incentives for a change were generally internal at the level of social grass roots. However, velvet revolutions would not materialise so early and so easily if the EU's accommodating external policies did not make the parameters of CD_{ij} with European countries so credibly low. In the centre there was an intensive trading, without which inefficient communist economies could not function. Thus, these were the cultural spillovers encoded in the CD parameter of gravity that undermined the communist regimes. Already in 1990, that hidden gravity force leap-frogged and half of all exports of the former Soviet empire went freely to the EU-15. The EU then reciprocated by a wider accommodating liberalism.

Although the costs of trade diversion and specialisation were extremely high, the overall long-term benefits of liberalisation were apparent. The tamed reformed communists and the tamed EU capitalists behaved like complements for their future mutual advantage. The transition agenda, turning its incentives to investments and business exchanges open to domestic negotiations about factor reallocations, muddled through very successfully, so that during 8-14 years of transition, those countries became world leaders in terms of fast growth.

[2] Such are the cases of many countries in Central Asia (CA), whose cultural 'distance' to the EU is smaller than to the USA or China. Even though the culture of CA countries is closer to Russia than to the EU, their long-term orientation can be targeted more at the EU than at Russia because of the political precaution and higher economic strength of the EU.

Such a surprising outcome has been the product of traditional economic principles of free trade, property rights and economic and cultural proximity. Indeed, these principles proved again to be leading determinants for growth due to knowledge diffusion, innovation and externalities of concentration and trust in cooperation (Krugman, 1991; Fujita et al., 1999; Robst et al., 2006; Linders et al., 2005).

Conflicts in societies could be solved either by force or by negotiations and concessions. The latter being the main message of the fall of communism. Nowhere in history was non-violence used for extinguishing such a deep conflict of social interests in such a wide geographic space, and imitated so quickly in time within such a different multi-cultural environment, than in the post-communist countries covering a third of the world's population. Some authors ascribe this approach to the post-war syndrome in Western Europe and the establishment of the EU (Rifkin, 2004; Soros, 2006). The approach of the US power politics towards the world, deepening the cultural distance between them, is then used as a contrast.

This message is often misunderstood. The crucial factor of Transformation is in the resignation of the communist elite to communist fundamentalism and in their expectations for transforming their informal access (quasi-ownership) to capital into a formally legal ownership by using their advantages in human capital and social (relational, networking) capital. The daily contacts with the surrounding western culture and businesses and the lack of external aggression were acting as catalysts for trading-off the political monopoly for economic power. The main problem of the initial stage of transition was how to accommodate the access of the communist nomenklatura to privatisation and entrepreneurship with new political forces (Benacek, 2001; Benacek, 2006; Winiecki et al., 2004). The paramount role of indigenous elites in bringing political shake-outs into local equilibria (in contrast to externally enforced changes) is undisputed.

The whole process of economic and political ‘tâtonnement’ among millions of domestic agents who exploded into disequilibria of reallocations is very costly and its settlement needs powerful incentives offering large productive (*i.e.* non-redistributive) gains. Here the EU-27 policies have a large potential not only for attracting the CA countries into its sphere of economic partnership but, in addition, for unlocking the socio-political stalemate that evolved with some other Islamic countries to the south of their region. The latter commence with Algeria and extend eastward through Palestine, Iraq and Iran up to Pakistan and Afghanistan. The spillovers of economic and cultural success with the much quieter belt of Islamic CA countries and Turkey could be used as a vehicle of intermediation aimed at a natural collaboration with the more radical Islamic countries.

Being supported by the EU´s economic potential, investments, cultural proximity and the know-how about peaceful and prosperous transition management, the EU-27 offers stability and sustained high growth to many countries of this part of Asia. The EU can thus offer to the transition countries of CA culturally more acceptable conditions than what can be offered e.g. by China and become a partner of similar standing as Russia. The experiences gained from partnership and association programmes, plus from the period of *perestroika* prior to the communist breakdown are quite unique and they should replace the deadlock policies of confrontation exercised in the southern environments of CA region by the present US government. It is the liability of the EU that the European Commission failed so far in implementing such policies.

2.2. The Neglected Sides of the EU Policies with Central Asia

In this part of the chapter we will look at the EU's politics and policies with CA in a wider geopolitical context, as was mentioned in footnote 1. We will see that the EU relations with CA, *i.e.* with a region that seems to be extremely remote from the European interests, is actually an important complement to the eastern politics of the EU, which include in the first place Turkey and Russia, plus Ukraine, Belarus and Moldova as the EU's direct neighbours. The economic and political cooperation with the extensive region around the Caspian Sea is

of strategic importance for the whole Europe, notwithstanding the fact that in the past it was not considered a traditional sphere of Western European concerns.

The CA region, extending up to Turkey, offers a very different vision on the belt of Moslem countries in its south (*i.e.* from Palestine to Afghanistan) where the politics of developed Western countries have been strategically involved for a long time. The EU involvement was not successful there, as this part of the world became for quite long a focus of the world instability. The connection to this area via Caucasus and Central Asia escaped for long the attention of the EU-15. With the EU-27 is now much more eastward, we can find out that all 12 new EU members have had a large experience with that region. We should keep in mind that ten of the recent accession countries were a part of this geopolitical area by being members of the Soviet empire.

Recent EU enlargements are the crucial point of departure for creating a new geopolitical orientation of the EU-27. Thus the European economic sphere of influence reached borders that were for long abandoned with the rise of the Soviet Union. After 1990, the EU-15 economic and political interests with this huge area concerned in the first place the access to supplies of oil and gas. However, with the enlargement to Eastern Europe, these concerns are much wider because they could be based on trade creation dictated by the externalities of geographic gravity and their impacts on growth.

They are being opened to the EU-27 extensive investment opportunities that go beyond the extraction of natural resources. They concern equipment and technologies servicing natural resources, as well as manufacturing and services subject to the rising local welfare. Even though Central Europe benefited from the manufacturing relocations from the West to the East, a large part of it will have to be shifted soon further to the east, as the labour costs in the new EU countries will continue to rise and as local traditional manufacturing will be crowded out by investments into more advanced technologies. Last but not least, the whole southern and eastern area of the former Soviet Union that is now trying to integrate into the Eurasian Economic Community (EurAsEC)[3], can be considered also as a source of trade with Turkey and the whole EU.

EU policies have responded to new opportunities by redirecting their attention further to the East. This process has been rather slow. According to data from EUROSTAT, the 12 new EU members constituted a mere 7 per cent of the EU-27 GDP in 2006 and their share in total external trade was even lower. Similarly the post-Soviet Commonwealth of Independent States (CIS) countries represented a mere 4.2 per cent of the world GDP, if measured in purchasing parity terms. These economic forces are not strong enough for striking a political change in the European Commission. The whole CIS group is even weaker in their trade attraction than traditional ‘EU neighbourhood’ countries of the Middle East and North Africa that attracted 4 per cent of the EU-25 exports in 2006.

However, as Dabrowski (2007) pointed out, if we consider certain groups of EU countries – those that could form an ‘Eastern’ coalition – the picture would be more revealing. If such a coalition is formed by all 10 post-communist new members, joined by Finland, Germany and Greece (all of which trade with the CIS significantly above average), the Commission cannot but yield to their pressure and redirect their policies to the East. If the trade attraction is calculated for the EU's external trade only, then the share of trade with the CIS/EurAsEC region rises to 18 per cent. What is even more important are the dynamics of such trade and its quality. Concerning the former, the growth rates of exports and imports with the CIS are definitely above average among the EU partners. The fast growth in Eastern Europe and Central Asia needs investment goods, technologies and their servicing, and the EU has the best position for gaining such contracts. On the import side the CIS countries supply the

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[3] EurAsEC, as a potential customs union, was founded in 2000 by Russia, Kazakhstan, Kyrgyzstan, Tajikistan and Belarus, followed in 2006 by Uzbekistan, comprising thus a population of 240 million people. Moldova, Ukraine and Armenia are the observing participants. It is evident that the exclusion of Turkey (a member of the preceding Central Asian Cooperation Organisation) weakens the westward orientation of the block that makes the relationships with Russia dominant. The involvement of the EU, China and Iran (at least as observers) would turn this organisation into a powerful instrument of development where politics should not dominate economics.

decisive volumes of the EU's external energy needs. The trade relations with these countries are gradually approaching the qualities pointing to a strategic partnership that require political safeguards.

Table 1: Share of exports to the EU-25 in total exports of these countries

Azerbaijan	65	Kazakhstan	32
Russia	50	Tajikistan	32
Turkmenistan	40 (est.)	Georgia	30
Armenia	38	Ukraine	27
Moldova	38	Uzbekistan	17
Belarus	37	Kyrgyzstan	5

Source: UNCTAD, Statistical Handbook, Geneva, 2005

We can see from the data of table 1 that many of the countries within the CA region, depend vitally on the trade with the EU. If we added to them the trade with Turkey (as a potential future EU member and a country that already became a strategic player there)[4], their trade directed towards the EU and Black and Mediterranean Seas has a strategic significance for the whole CA/EurAsEC group. The economic interdependence of EurAsEC and the EU is to a large extent complementary (in contrast to the trade with Russia) and irreplaceable by any other economic alignment of the Central Asian countries. The strategic directions toward Japan, Korea or China are too distant (both in a geographic and cultural sense) and lacking appropriate infrastructure. The bordering Chinese vast province of Uygur Xingjiang only has 20 million inhabitants and is economically weak.

Another attraction of the region of CA is in its high growth that moves around 7 per cent (database of UN ECE, Geneva, 2007). All of these countries are now a part of a common boom caused by rising prices of natural resources and high investments supported by policies attracting foreign capital. Except for a rapid growth of natural resource industries, these countries have a high potential for developing manufacturing industries that used to be there during the Soviet days. As the experience from Central Europe confirms, such a know-how and educational capacities survive for more than a generation.

2.3. Policy Considerations for a Closer Partnership with the EU

As was further elaborated by Asadov and Benacek (2006), the enormous potential for growth in the countries of CA can be underpinned by advancing further their economic transformation in order to achieve its sustainability. The priority should be given to the four pillars of transition:

- Progressing further with market reforms, namely with the support to the legal system underpinning property rights, private initiative and the separation of the State from the liabilities of enterprises.
- The countries must free themselves from constraints in their low domestic aggregate demand by opening up to trade with highly dynamic and developed economies. Poor infrastructure, corruption and bureaucracy are the main barriers. The bottleneck rests in two strategically positioned countries – Turkmenistan and Uzbekistan – that are the least reformed and which block the access to Black Sea.
- The financial system should be open, supporting new businesses under the criterion of hard budget constraint from both sides: the internal one by promoting the creation of *de novo* firms (mainly the small indigenous firms) and the external one by promoting the incoming FDI.

[4] Turkey shares a common (or similar) language with inhabitants of Turkic origin in Kazakhstan, Uzbekistan, Kyrgyzstan, Turkmenistan and Azerbaijan, where they have a majority; plus with Russia, Iran, Moldova and Bulgaria, where they have a minority population. The population speaking Turkic languages is close to 150 million.

- Transforming the financial sector into a highly efficient international system supporting investments and the discipline of restructuring.

Coordinated policies of the EU, optimally based on multilateral agreements, could strike a break-through in overcoming these barriers and enhance the intensity of exports in the western direction. The EU, Turkey and the whole Mediterranean region, to which France strained its interest recently, could benefit from such a new injection of economic exchanges. Present mono-product exports from the EurAsEC countries could then be turned into a more diversified portfolio of products driven by new investments and imports from the EU.

At present the situation of mono-product exports and of barriers limiting the trade in the western direction benefits the political oligarchs, whose ventures are not subject to competition or to rules enforced internationally. The same problem was encountered in Central Europe in the first stage of the transition process (e.g. in 1990-96) where similar barriers to growth initially resisted all internal attempts for its dismantling. The requirements of EU entry were the final force that broke that resistance. Without EU entry, the compliance to the *acquis* and to the trade and competition policies, no such backlash would have been probable.

Another player that benefits from the dysfunctional alignment of CA with the EU is Russia. Even though, after the collapse of the Soviet empire, it seemed that Russian interests would keep weakening in this area, the Russian grand come-back came suddenly with the rising prices of oil and gas. As the EU eastward trade remains to be blocked by infrastructural and institutional misalignments with CA, Russian capital (whatever limited in terms of value, financial expertise and technological capacities) is again dominant and able to collude with local oligarchs and the political elite. This is quite a paradox because national politics in the CA have a strong internal lobby towards policies countervailing the traditional Russian economic power. The hesitating EU could finally end up losing the strategic alliance with the whole region of Central Asia, contrary to the potential of gravity and to the expectations of its population.

From a geopolitical point of view, the EU should anticipate the restructuring of integration groupings in Asia. The most dramatic change can be expected from Chinese expansion in South-East Asia, meanwhile its pan-Asian plan need not succeed so much in the northern and eastern directions because of the national policies of Russia, Korea and Japan. Then the CA region will keep standing as a niche in search of an anchor for trade expansion and cultural alignment. As the economic potential of the current EurAsEC is still rather low (measured by their total GDP), the solution can be found in a closer partnership of CA countries with the EU, provided that Turkey will become a connecting bridge. Culturally, such a flexible economic alliance will be free from Islamic fundamentalism that nowhere in this region was present in the last 80 years. Once the dominant role of Russia in EurAsEC would be countervailed by intensive economic and cultural relations with Turkey and the EU, the prosperous Islamic CA zone will exert a constructive economic influence on large neighbouring Muslim countries exposed to religious fundamentalism: Iran, Afghanistan, Pakistan or Syria.

The basic tenet of this chapter is that violent forms of Islamic fundamentalism (Islamism) cannot be eliminated by similar violent forms of external pressures on them. Fundamentalism and its terrorist extremism can be effectively neutralised only by internal forces of the world of Islam. It is an illusion to assume that (religious) differences between two cultures can be solved by escalating the conflict between them. Unimpeded business contracts with post-communist countries were found to be the most effective instruments for defusing such tensions. Therefore the policies of integrating countries of smouldering conflicts into an intensive trade area and in a mutual competition for prosperity are the most convenient constructive ways forward. According to economic geography, the EU-27 with its 23 per cent share of world output, can become an important beneficiary of such an eastern expansion. We should therefore expect that the EU neighbourhood policies will have to be much more active in that direction.

The countries of CA, Caucasus and Turkey can be turned into beneficiaries of the EU partnership, countervailing the growing Russian political ambitions in the region and

mitigating the risks of using the energy deterrent in the hands of Iran, Saudi Arabia or Venezuela. Alternatively, the countries of CA cannot but fall into a strategic subordination to Russia and double the bargaining force of the Kremlin. The EU should therefore use its natural South-East economic potential via Turkey, Ukraine, the Caucasus and the Caspian Sea.

The first step in this direction would be the proposal for the European CIS and Southern Mediterranean countries to establish an upgraded cooperation framework within the European Neighbourhood Policy (ENP). Unfortunately, as a result of the 'enlargement fatigue', the re-design of this scheme does not offer an accession perspective. However, in its more recent version (ENP, 2007), it at least helps the 'neighbourhood countries' harmonise their political, economic and legal systems with the *acquis*. It is only a partial step forward because it offers hardly anything concrete in exchange from the EU side. This is nothing like the fast-track participation in the EU internal market, similar to the status given to Norway or Turkey, or the policies of association granted to the pre-accession countries of Central Europe.

Another drawback of the ENP is that it is conducted via bilateral Action Plans, which put the participants into a position of competitors for 'favours', instead of offering them a system of common conditions. So far, the ENP alliance was established with Armenia, Azerbaijan, Georgia, Moldova and Ukraine[5]. Thus it misses the objectives outlined in this paper: the build-up of an economic and cultural partnership on the whole track between Warsaw and Almaty. The European Commission, at its meeting of the 27th of April, and the European Council on 22 June, 2007, decided about the EU´s new strategy with CA (see CA IP, 2007 and CE SNP, 2007), whose agenda fell short of the potential offered by the ENP. According to Dabrowski (2007: 8): "A general weakness of ENP consists in the lack of balance between far-going expectations in respect to neighbours' policies and reforms, and limited and distant rewards, which it can potentially offer".

The present main attractions of the ENP for its association countries – those of trade liberalisation in a narrow sense (such as the abolition of mutual tariffs on manufactures, something that hardly reaches the status of a free trade area) – are far short of the potential that an intensive alignment could bring to both participating sides. The agreement should shift to institutional harmonisation, cultural exchanges, free movement of services and capital, and to concessions in terms of labour mobility. The latter should be reciprocated by liberalising the investment climate among the Asian partners. The narrow EU partnership with CA will become a powerful incentive for the absorption of new capital and innovations, as well as for speeding-up political reforms towards democracy and economic liberalisation free of totalitarian forms of Islamism.

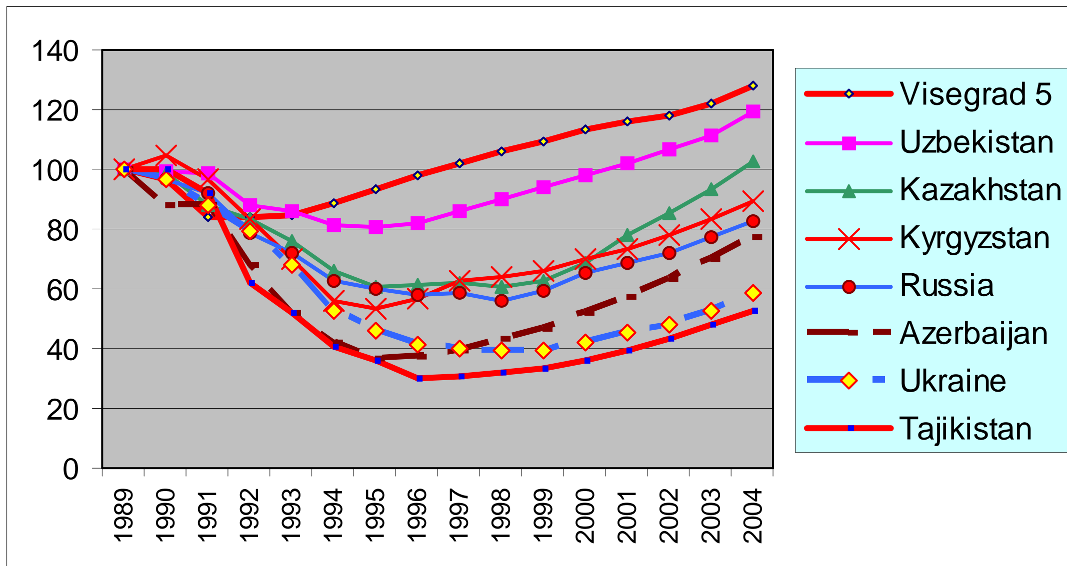
3. Growth Strategies and Scenarios

3.1. Strategic Considerations about Fast Growth in the Region of Central Asia

The aim of this section is to provide an empirical evidence for the statement that the present economic level of some countries in Central Asia, as measured by indicators based on GDP, lies below the potential of these countries, given their endowment of labour, skills, human capital and the history of development in the times of Soviet industrialisation. The problem rests in a massive decline in their output after 1990 and its delayed recovery. A large part of the decline in their economic performance could be explained by the initial losses in aggregate demand of both a domestic and foreign origin followed by a permanent liquidation of many capacities and a departure of specialised labour. The known trajectory of a J-curve should apply here, as it manifested itself in all transition countries in Europe.

[5] Russia has received a special status. She opted out from the ENP, but in 2001-2003 she established a programme of "Common European Economic Space between the EU and Russia". Since 2007, Russia should benefit from the European Neighbourhood Policy Instrument that replaces the TACIS agreement. The EU thus discriminates between Russia and its former members of Soviet Union in Central Asia.

Figure 1: Growth trajectories of selected transition economies
in the GDP per capita at domestic constant prices (1989=100 %)



Source: UN ECE, Geneva, Economic Survey of Europe, no. 2, 2005, p. 70.

Figure 1 shows how varied the depth of the losses was among transition countries when compared with the Visegrad Five of Central Europe, whose policies of transformation were most efficient. In many studies (see e.g. Kornai, 2005) it was concluded that the success of the latter could be ascribed to the openness of their economic environment, intensive trade with the EU countries, learning by doing, imports of technologies and managerial techniques via intensive FDI inflows and fundamental upgrading of institutions by accepting the *acquis communautaire*. The evolution in the CIS countries (maybe with the exception of Russia) lacked such incentives and their development was significantly less persuasive. It is the aim of this section to use the experiences of Central European countries for transfiguring them to recommendations helping the CA countries in their own reforms.

We can therefore presume that the degree of decline, the length of recovery and the rate of revived growth depend to a large extent on institutional measures undertaken by reforming governments and on the competition and incentives that drive economic agents in their decisions. Crucial decisions concern the tradeoffs between the short and the long-run gains, and between the motives to create new wealth versus indulging in redistributive activities (e.g. in asset-stripping). Taken from these points of view, the relative performance in 2004 that revealed wide differences among countries, could be explained not only by different strategies and policies undertaken in individual countries, but also by their ability to act collectively – e.g. in absorbing spillovers from international cooperation. Nevertheless, we should also consider how the development and the choice of strategies depended on objectively given circumstances, such as different factor endowments of the countries (e.g. the endowments in natural resources such as oil and gas, contrasting with endowments in human capital or labour only).

At this juncture, a question about the suitability and the methodological consistence of macroeconomic statistics for the measurement of development could be raised. First, there could be wide differences between the GDP at PPS (purchasing power standard) and the GDP in nominal dollars, *i.e.* at commercial (market) exchange rates (denoted hereafter as CER). Second, the distribution of GDP in the population can be grossly unequal in some countries, resulting in a bias given by the average values of GDP per capita. Third, the GDP need not be correlated with the welfare measured by the human development index or by the GDP adjusted for the shadow economy, hidden foreign income and terms of trade changes.

Last but not least, the success (or failure) in economic transition, as measured by human welfare, is not easy to measure by mere differences in official growth figures during the

transition period. For example, Uzbekistan, Kazakhstan, Kyrgyzstan and Tajikistan were standing at approximately comparable levels of development in 1989 (according to Soviet statistics), meanwhile in 2004 their GDP per capita and growth rates differed widely. At least the relative standing of Kyrgyzstan, if compared to Tajikistan in 2004, could be explained by more successful reforms and civil stability (e.g. no civil war) in Kyrgyzstan, but the comparison of Kazakhstan and Uzbekistan fails since a much smoother and elevated path of Uzbekistan (according to their own growth data and data published by UN ECE, 2005) resulted in a paradox: in reality there was a superior position of Kazakhstan in 2004 with its GDP per capita in PPS reaching $ 7,418, versus a mere $ 1,934 achieved by Uzbekistan [6].

In addition, the methodology used by central planners usually overestimated their GDP figures in PPS, which exaggerated the fall in the GDP after initiating the transition process. The width and the depth of market reforms and their multi-criterial assessment, as characterised by country studies by the World Bank, IMF or United Nations (see e.g. UN DP, 2005, as an example), offers therefore a better approach to estimating the growth than official GDP figures.

3.2. Conditions for Convergence in the countries of Central Asia

Let us return again to the hypothesis that the path of transition and the choice of strategies for restructuring depend significantly on factor endowments that are crucial sources of comparative advantages. It is especially so if the endowments are exogenously given, being located in easily marketable natural resources underpinned by their rising world prices. A country rich in oil and gas can perform better than a country lacking such resources, even though the former have not been privatised or sufficiently restructured. That can be the case of comparing unreformed but (relatively) prosperous Turkmenistan with toiling but reforming Kyrgyzstan. Ideally, natural resource rich countries should also be intensive reformers that complement its primary sector with the development of manufacturing and services, as can be illustrated by the policies of Kazakhstan.

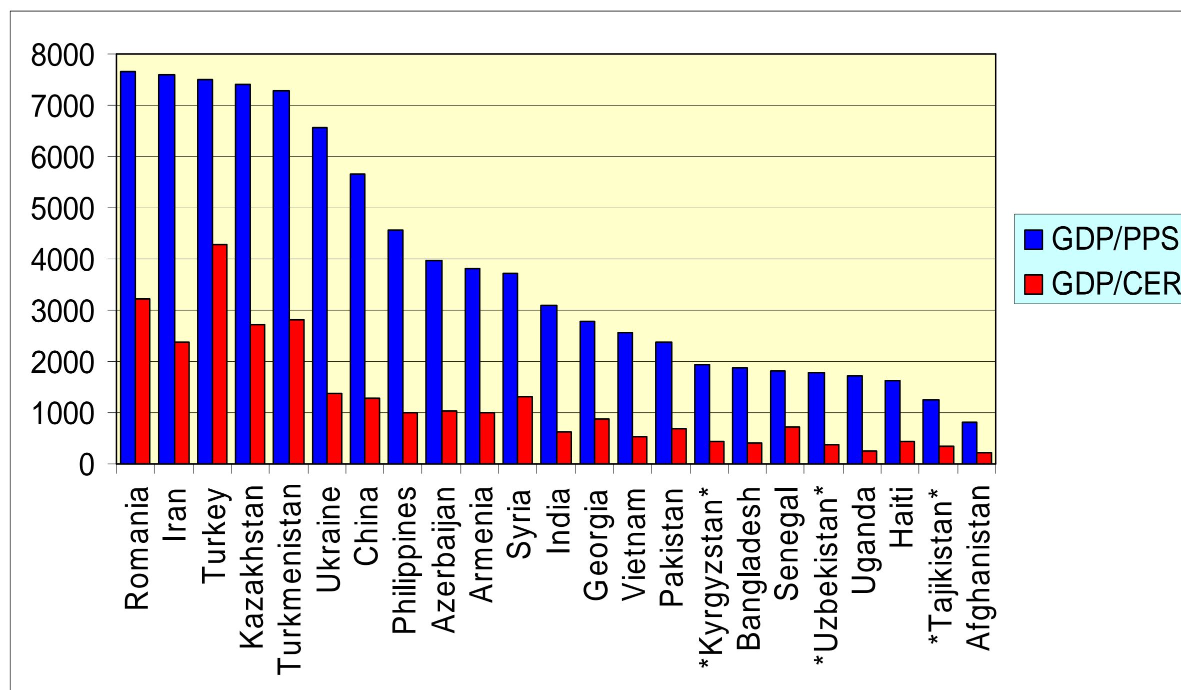
We will look more closely at the progress done during the 15 years of transition and compare the development of countries in CA with other countries in the world (see Figure 2). The anomalies between them are accompanied with paradoxes. The development in Kazakhstan is at par with such countries as Turkey, Romania, Turkmenistan or Iran, provided the PPS measure of GDP is applied (all around $ 7,500 per capita). Statistics of GDP per capita at CER may reveal, however, deep differences. Therefore, as a measure of competitiveness among countries, we construct the index of exchange rate deviation by dividing the GDP per capita at PPS by the GDP at CER. The lower the value of this index, the higher their production for exports and import substitution can withstand the competition from abroad. For example, Turkey with the index of 1.75 is a country much better adjusted to world trade than the other four mentioned, whose values vary between 2.6 and 3.1. Even Romania, which does not have an advantage of being an exporter of energy and is the greatest laggard among the EU accession countries, has a stronger index than Kazakhstan that is still performing as a top star among the CA reforming and natural rich countries. Thus there are other countries in CA, which lag far behind Kazakhstan (e.g. Uzbekistan), even though their starting position in 1990 did not look different. Our main concern will therefore be these poorer countries of the region.

Three of the CA countries, marked in figure 2 by asterisks, experiment a competitiveness of their tradable sector that lags significantly behind: Tajikistan, Kyrgyzstan and Uzbekistan. We shall call them CA-3. The characteristics of underperformance in these three are more general. They are also present in vast agricultural regions in neighbouring countries otherwise rich with natural resources (Russia, Turkmenistan, etc). At the same time, the average income of all nine post-Soviet countries enlisted in figure 2 is also exceedingly low, if compared with

[6] All data about the GDP at purchasing power standard (PPS) or in nominal values converted at national commercial exchange rates (CER) of 2004 used in this paper are from the Statistics of the World Bank Development Report (see World Bank, 2006) and are related to the year 2004.

their past record before 1990. The average GDP per capita of these nine countries (without Ukraine) at $ 3,870 trails far behind that of Russia (at $ 10,180). The GDP level of CA-3 is approximately similar to that of Senegal, Uganda, Mozambique, Bangladesh or Cambodia that are considered to be very poor.

Figure 2: Ranking of the GDP per capita in dollars at purchasing power standard (PPS) with the corresponding GDP at commercial exchange rate (CER), 2004.



Source: The World Bank Development Report (see World Bank (2006))
Asterisks mark the CA countries that reveal a low degree of competitiveness.

There are hardly any reasons why the CA-3, with their 2004 GDP per capita denominated in PPS at $ 1,246, $ 1,766, and $ 1,934 respectively, should not be as wealthy countries as is the Eastern undeveloped part of Turkey ($ 3,680 per capita), India ($ 3,080), Indonesia ($ 3,703), Syria ($ 3,724), Sri-Lanka ($ 3,882), or even Perú ($ 5,560) and the Philippines ($ 4,561). We could also compare them with Ukraine ($ 6,554) – a relatively much richer country plagued by a low intensity of reforms, high corruption and an unsatisfactory performance of its international trade. All these are also countries without rich natural resources and with a large part of the population relying on agriculture.

The situation looks even more dismal if the GDP per capita is calculated at CER. Although the GDP per capita at CER does not say very much about the standards of living, it reflects better the international competitiveness of its products. Namely, it concerns both the exports and the domestic products competing with imports, as well as the whole domestic economy as assessed from the position of foreign investors. If the competitiveness of tradable goods of some country is low and if its inflows of FDI are weak, so is also the exchange rate of that economy. It must undervalue the local wages in order to compensate for the weaknesses. Such a country is then poor 'externally' – *i.e.* in its relationship to the potential of gains from exchanges with the globalised world economy.

If we look at the figures of GDP per capita at CER in the CA-3 with $ 329 for Tajikistan, $ 375 for Uzbekistan and $ 433 for Kyrgyzstan, we can see that they are lagging far behind Romania ($ 3,207), Albania ($ 2,154) or Georgia ($ 883), whose endowments of human capital are not significantly different and which also cannot rely on natural resources. In the subsequent considerations we will distinguish between countries of medium-term and long-term convergence targets for CA-3. The former are represented by countries like Pakistan,

Senegal or Nicaragua with the GDP per capita at $ 700-800 at CER in 2004. Then there are countries like Morocco, Syria, Guatemala, Peru, the Dominican Republic, Sri Lanka, Philippines or the Eastern parts of Turkey that have a GDP per capita in CER terms over $ 1,000, *i.e.* two to four times higher than that of the CA-3. These can be considered the 'long-term convergence targets' because the CA-3 have a higher educated labour, and skills inherited from the days of communism in sophisticated industries and in the operation of technologically advanced instruments (e.g. in healthcare, agriculture or army), including their production.

Even though we could expect that the geographical disadvantage, which the CA-3 have in comparison with countries located at sea shores, could represent a 'discount' slowing down the catching-up process by a factor of 1-1.5 per cent per year, the process of convergence to the level of countries of medium-term convergence could be achieved relatively quickly. Our scenarios for estimates of GDP growth measured at CER are based on the rates **r** defined as:

$$\mathbf{Y_t = Y_0 \cdot e^{(r'+r'') \cdot t}} \qquad \text{[eq. 2]}$$

where Y_0 and Y_t are the initial and the targeted GDPs per capita in dollars at commercial exchange rates of compared countries; r' is the real growth rate of the GDP per capita in domestic currency at constant prices and r'' is the average annual rate of real exchange rate appreciation; t is the time of catching up in years. The growth rate r' is a function of real domestic (internal) growth and the growth rate of r'' is a function of external competitiveness in trade, foreign exchange earnings and attraction of capital on financial account. Both r'' and r' can be interrelated. For example, the incoming FDI appreciates the exchange rate and later boosts the GDP growth by risen productivity and exports. The latter appreciates again the exchange – thus the GDP gets on a sustained growth path in both domestic and foreign currencies.

If our concern is the convergence between two countries – that of the CA-3 (C) compared with the country of targeted convergence (T), which grows at lower rates of r' and r'', then we enquire in which year t there will be $(Y_t)_C = (Y_t)_T$. For example, as we estimated the scenarios of catching-up between Tajikistan (C) and Senegal (T) we assumed that C must grow much faster in terms of both rates due to their accumulated (and unused) potential during the 16 years of transition without high trade openness. The growth of C should evolve into a high real convergence when the barriers to entrepreneurship are lifted and the capacity expansion is led *via* exports, FDI and recovered domestic demand. At the same time, there is a nominal convergence of the prices in C, which is not reflected in the weakening of the exchange rate in C because of the Balassa-Samuelson effects (*i.e.* by rising wages and prices in the non-traded sectors induced by high productivity gains in the export-let sectors).

After separating the exponents and taking logarithms of the growth formulae for both countries under comparison, we can estimate the duration of convergence t by:

$$\mathbf{t = (\ln (Y_0)_C - \ln (Y_0)_T) / ((r'_T + r''_T) - (r'_C + r''_C))} \qquad \text{[eq. 3]}$$

This formula can be used for simulating potential growth scenarios in the catching up process of CA countries with other developing countries in the world.

3.3. Growth Pattern Scenarios and International Comparisons

Once the financial account of the balance of payments is in surplus due to the influx of FDI, the current account can be left in deficit – a move which increases the domestic standard of living. Thus the gross absorption can grow faster than the GDP. It also exerts pressures on appreciating the domestic currency. In case when exports and imports grow in parallel, such a strengthening of currency is not a peril to the external balance. New investors, new capacities and restructuring, all exert pressures on upgrading the productivity of labour. Also, the rising quality of exports increases the export prices, and the terms of trade gradually improve

(Benacek *et al*., 2005). Thus, the balance of trade can be for a long time in a sustainable deficit – financed from FDI inflows, even though the real exchange rate appreciation progresses annually by 3-5 per cent.

Then a typical outcome occurs: the growth rate of GDP in US dollars can be proportionally, *i.e*. by 3-5 per cent, higher than the real growth in the domestic currency (e.g. 6-8 per cent). The fast long-term appreciation is a phenomenon typical to transition countries with large losses in output during transformation. The past losses actually boost the potential for future Balassa-Samuelson gains in the catching-up, which is further enhanced by quality improvements that the standard methods of GDP measurement in domestic currency often undershoot as a real factor of growth.

The annual catching-up in CA-3 can thus proceed at the amalgamated rate of around 11 per cent, provided our criterion of convergence is the GDP per capita in constant dollars at CER. Our scenario concerns the catching-up with countries having the GDP per capita in US dollars at CER exactly twice as high as the CA-3 at present. We will illustrate the catching-up potential in the case of Tajikistan ($ 329 per capita at CER in 2004). The targeted real countries for comparison could be Pakistan or Senegal, which have their GDP per capita at $684 and $734. However, in order to avoid the caveats of realists attacking our simplifications, we will compare Tajikistan (C) with a hypothetical targeted country 'T' with the GDP per capita at $ 658 at CER in 2004.

We will assume in our moderate scenario that our country 'T', after implementing the external and internal liberalisation in an environment of deepening international partnership (as was discussed earlier in this chapter), will sustain its present high internal growth at 7 per cent per capita and gain a growth bonus of 4 per cent from the long-term annual appreciation of their currency relative to the US dollar (or euro). The compared country 'T', as a stabilised developing market economy lacking the history of painful transition, will have a steady internal growth at 3.4 per cent per capita and a 1 per cent gain in real exchange rate appreciation. Thus the growth differential will be 11 per cent versus 4.4 per cent, *i.e*. 6.6 per cent.

The catching-up of Tajikistan with a developing country having its present GDP per capita at commercial exchange rate twice as high will take 10.5 years, given the above assumptions. In other words, we could expect that within this period the GDP of 'C' at $500 per capita in 2008 measured in CER terms, could rise not only to the present level of the targeted country 'T' ($ 1,000 in 2008), but to its expected future value of $1,587 (at constant $ prices of 2004 in the USA), when the GDP in both countries would equalise (*i.e*. the Tajik GDP per capita will nominally treble). In ideal circumstances that could happen in June 2018.

A mere doubling of the GDP per capita in C from $500 to $1,000 would require 6.3 years. A similar conclusion can be reached about the convergence in any of the countries in CA. Thus by using the same abstract reasoning we could estimate that Uzbekistan and Kyrgyzstan could rise to the levels of Nicaragua, Sri Lanka, Cameroon, Egypt or Philippines (with approximately double of the GDP per capita in CER terms) also during the transition period of 10-11 years, reaching in 2018 GDP per capita of $1,800 - $2,000 at CER constant prices. By using similar assumptions about the potential for growth, Tajikistan could catch-up with countries of the long-term convergence target that have now their GDP per capita in CER three or four-fold higher (such as Egypt, Syria or Morocco) in between 16.5 and 21 years.

Our convergence paths for CA countries is full of paradoxes: these are countries with a high industrial performance in the past and with high pre-conditions for an accelerated endogenously-led growth, while in their starting position they are grouped with countries lacking such preconditions. For example, the paradox is revealed if the scenario for potential convergence would include the differentials between human capital in CA countries and the compared countries of the world that have a similar or slightly higher GDP per capita (such as Mozambique, Bangladesh, Haiti, Pakistan or Senegal). A profound difference can be found in the differences in literacy. For example, the rate of illiteracy in Tajikistan and Kyrgyzstan is 2-3 per cent, meanwhile in Eastern Turkey, Africa and many countries of Asia it is five to ten times more. Also the attendance rate of secondary schools or universities is higher in CA by several ranks compared with the countries with a GDP per capita up to four times higher.

Generally it is higher in the CA than in all countries in Africa or Asia with a GDP below $8,000 in CER terms. The catching-up of the CA-3 in their GDP expressed in CER terms means that the competitiveness of exportables and domestic import replacements in the CR-3 must be significantly and speedily upgraded. As the Central European transition countries have shown (Benacek *et a*l. 2005), the export-led approach to transformation, where FDI inflows introduce new technologies into the economy, know-how and human capital, is a highly successful strategy for accelerating the growth.

This is a crucial statement of our study. Modern growth theories derived from the seminal paper of Lucas (1988),[7] emanate from an hypothesis that societies that are able to base their dynamics of growth on a sustainable build-up of human capital endowments grow faster. There are various channels for the human capital prolificacy in developing countries. Some can fall among 'development/industrial policies' targeted at the improvements in education, science, absorption of FDI, more efficient public administration or the performance of SMEs (Rodrik, 2004). An even faster convergence can be achieved if such policies are exercised in an international environment of intensive exchanges within economic and cultural partnership. For example, a developing country can start by generating surplus on the financial account due to high FDI inflows, which also results in net inflows of both foreign exchange and know-how. The former can be used for financing the current account deficit and thus enhancing imports of needed technology or input material for upgrading domestic production. The increased domestic competitiveness has a quick impact on the exchange rate, which appreciates. The convergence of GDP at CER then accelerates with the support of three factors: the real growth in domestic currency, the nominal convergence due to quality improvements and currency appreciation. This is the growth scenario in all Central European transition countries.

A rough estimate of the economic under-performance of our CA-3 countries is that they perform at 40 per cent through 50 per cent of their present economic potential, provided we estimate their long-term potential GDP at $ 2,800-3,900 (of PPS in $ prices of 2004). An even higher performance, estimated at $ 3,500-4,500, could be targeted if we would adjust their potential output to the levels of education and human capital. Reaching the potential given at the economic levels of Syria, Egypt, Morocco or Philippines would not require a substantial change in the endowments of CA-3, provided the latter would be able to retain their channels for generating the human capital, attract back from Russia the labour in temporary emigration and emulate some of the lessons the Central European countries learned during their hard, but finally very successful path to economic prosperity.

Policies proposed in this study, *i.e.* those underpinning trade and financial openness, competition, human capital, entrepreneurship, property rights and international partnership targeting the economic and cultural proximity can be contrasted with the socio-economic governance dominant in many post-Soviet countries characterised by rent-seeking, dominance of bureaucracies over the activities of entrepreneurs, internal collusions of oligarchs and the alliance of large former state-owned corporations with politics. Their network of social capital (*i.e.* the politics of crony capitalism) has a natural bias towards the policies of autarchy. Thus the proposed new institutional schemes are in a conflict with them.

The success of catching-up in countries without rich natural resources has at its base two intertwined dilemmas to be solved: that of the ethics (e.g. equality, fairness or merits) and that of the politics. Democratic methods of the search for optimal solutions may often result in second-best (*i.e.* sub-optimal) outcomes due to necessary social compromises. The specificity of post-communist countries rests in their legacy of communist social capital. Their endowment was of particular importance in the early stages of transition because it gave the owner of such an asset the highest returns.[8] The experience from the most successful

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[7] See Hoff and Stiglitz (2001) for a literature review.

[8] The value of any factor (financial capital, human capital, labour, natural resource) is given by its discounted returns. According to economic theory, it is the marginal productivity of factors that sets their share on the GDP. The experience from transition in Central Europe reveals that the 'ownership' of relational (social) capital is a resource that can be at least as powerful in returns as the ownership of any alternative type of capital. In addition, the cost of acquiring such an asset was zero for a large part of the nomenklatura. In the early stages of transition

transition countries in Central and Baltic Europe (e.g. in Slovenia, Estonia or Czechia) shows that the embeddedness and path dependency of institutions, ethics, politics and ruling elite determine the crucial strategies in transition (McDermott, 2004). The downgrading of the role of social capital can be only gradual and the crucial problem concentrates on the speed of its gradual dismantling in the later stages of transition. The keys to success in transformation rest therefore in the ability to conduct institutional changes in areas such as market contestability, competition for contracts, property rights enforcement, hard budget constrains or efficiency of public governance. Here again, once we assess the present situation in countries of Central Asia, the EU policies of economic and cultural proximity offer a high potential for improvements on both sides of such a partnership.

Our scenarios thus remind us of the extremely fast catching-up preceding in China, or in Ireland, or in Japan in the second half of the 20th century. Such an accelerated catching-up in the GDP per capita at commercial exchange rates has also been present in all transition countries that became EU members in 2004. Bulgaria and Romania joined such a strategy at the break of the millennium only and their outcome proved to be successful from the very start. We could presume that their adoption in countries of Central Asia, especially in the ones less endowed with natural resources, could lead to similar sustainable growth patterns.

4. Conclusions and Policy Recommendations:

Creating a partnership along the broad line between Brussels–Ankara–Astana, whose economic externalities would spill both to the north (Ukraine and Russia) and to the south (Israel, Syria, Iraq, Iran and Afghanistan) belongs to the questions of world geopolitical importance. It offers advantages for all its members, for the whole Europe and for the rest of the world. We stressed particularly its following aspects: first, its policies bring prospects of prosperity and political independence to countries still toiling with transition or being constrained in their development by Islamism. Second, they increase the safety in international fossil energy supplies in Europe. Third, such a partnership solves the stalemate in the Turkish accession by granting Turkey a position of a strategic partner, with an option for full EU membership based on economic convergence. Fourth, it offers new economic perspectives to Iraq, Iran and Afghanistan – countries stricken by a conflict with the US and an international isolation. Launching new directions to local development in Moslem countries and a more active EU presence in this part of the world could help settle the conflict between Israel and its neighbours.

Concerning the analysis of the countries in Central Asia (CA), we have concentrated on the issues summarised below. The economies of all studied CA countries perform below their long-term potential because their internal transformation was not completed and externally they are constrained by impediments to international exchanges. Three countries of the region, which are not sufficiently endowed with easily exportable natural resources – Tajikistan, Kyrgyzstan and Uzbekistan – perform below 50 per cent of their potential GDP per capita. Filling this gap by converging at their full capacity would require a doubling of their productivity of labour. That could be achieved within approximately 7 years, provided some immediate steps in policies and internal behaviour of economic agents are undertaken.

In the very long run (up to 20 years) the economic potential of the poorest three can be enhanced even further by catching-up with the medium-income developing countries (such as Morocco or Egypt). The other countries, backed by energy exports, can catch up with economic targets present among the new EU members. The weak chain in the development of Central Asia rests in insufficient trading with neighbouring regions within the reach of 1,200 km in diameter, where the enlarged EU could still remain their most important trading

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(when privatisation was the most important political issue) the access to social capital (*i.e.* to political circles) could become temporarily the absolutely most important asset, deciding also about the access to dominant other assets in the future: to the ownership of natural resources, physical capital or human capital.

partner, notwithstanding the fact that the highest growth must be expected in the intra-regional trade flows within EurAsEC. The EU-CA partnership should become the most important vehicle for upgrading economic and cultural exchanges between Europe, this rapidly growing western belt of Asia and its controversial southern neighbourhood. Countries of CA need the EU for re-vamping thoroughly their infrastructure, improving the economy of natural resources, re-deployment of manufacturing by the absorption of new technologies, upgrading its financial system and supporting them with the progress in public governance. The exchange rates in CA economies still reflect local barriers to competitiveness of their non-energy exports. It will be to their advantage that, in accordance with the new policies of opening-up and partnership, the real exchange rates will keep appreciating, enhancing the speed of real convergence that would correspond to the level of local human capital endowments.

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