

CENTRAL ASIA AT TWENTY-FIVE

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1. Introduction

At the end of 2016, the five countries of post-Soviet Central Asia (CA) celebrated 25th anniversary of their independence, after breakup of the former Soviet Union (FSU). It is a good occasion to examine where they stand now, to which extent their transition from a centrally planned economy (CPE) to a market one has been completed and successful, and what challenges the region faces now and in the near future.

Beyond this anniversary pretext, CA makes an interesting study because of its unique landlocked location, and its historic legacy, including 70+ years of communist regime and CPE. Moreover, CA remains one of the most understudied regions of the world.

Despite a shared history in the last century and half and being referred as the single region, individual countries differ in their level of political and economic development, cultural and ethnic composition and relations to the outside world. Kazakhstan and Turkmenistan joined the upper middle-income group, while Tajikistan, Uzbekistan and Kyrgyzstan remain in the lower-middle income category¹.

In 1990s, CA shared many hardships of economic transition together with Central and Eastern European (CEE) and other FSU countries such as the skyrocketing inflation, rapid de-industrialization and collapse of the Soviet-type welfare system, to name a few. As of today, Turkmenistan and Uzbekistan still have not completed their transitions to a market economy yet.

CA countries are landlocked, except for the access to the Caspian Sea, which is not an open sea². Furthermore, the land transportation network inherited from the Soviet era has been concentrated on Russia and other Soviet republics while that with outside world has been almost non-existent. Despite some infrastructure investments in the last quarter of century, connectivity with the outside world remains a major bottleneck to trade and economic development. The same concerns intra-regional trade relations impaired by incompatibility of individual economic regimes, continuous political tensions, presence of prolonged conflicts in the neighbourhood (Afghanistan), and partly closed borders.

On the top of that, the recent decline in commodity prices has challenged, via trade, migrant remittances and financial market channels, commodity based growth strategies of 2000s and first half of 2010s, creating new sources of social and political risks in individual countries.

In this policy contribution³, we are going to analyse socio-economic and political developments in five CA countries and discuss major policy challenges faced by this region in the near future. In doing so, we will look at the historical background of the CA transition (pre-Soviet history, Soviet legacy, and post-communist transition – Section 2), geography and geopolitics, including trade and economic

¹ See <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519>

² The legal status of the Caspian Sea and its territorial delimitation are also subject of international controversy. Russia and Iran consider it as the lake rather than the sea (see Janusz-Pawletta, 2015).

³ Authors would like to thank Giuseppe Porcaro for drawing maps and Simone Tagliapietra, Georg Zachmann and other members of the Bruegel research team for their comments on the earlier version of this paper.

integration arrangements (Section 3), progress in economic reforms after 1991 (Section 4), and socio-economic performance of the region (Section 5). We will also discuss potential future policy agendas (Section 6), and the role of external actors in their implementation (Section 7). Section 8 suggests policy lessons coming from the recent CA experience.

Our paper is based on available cross-country comparable statistical sources, largely those offered by international organizations of the UN system. However, there is a number of data gaps, in particular, in case of Turkmenistan and Uzbekistan whose national statistical methodologies and data availability do not meet international standards yet. In those cases, we leave the gaps rather than try to present incompatible data.

2. Historical background

In the 19th century, the Russian Empire conquered most of the current CA except for the Northern part of Kazakhstan, which was colonized by the Siberian and Orenburg Cossacks earlier –in 17th and 18th centuries. Under the Russian rule, the territory of CA was divided between General-Governorships of Turkestan (capital in Tashkent) and Steppes (capital in Omsk). The Emirate of Bukhara and Khanate of Khiva retained their autonomy under the Russian protectorate until 1920 when they were defeated by Bolsheviks.

In the 1920s and 1930s, under the Soviet rule, territorial division of CA changed several times with the Union republic status of five now independent countries and current borderlines emerging only in 1936.

Until 1920s, the economy of CA retained its traditional agrarian/ livestock profile that reflected largely nomadic and rural character of CA population. Industrialization came only in the Stalin era in the 1930s and was intensified during the WWII when many industrial enterprises from the European part of the Soviet Union were evacuated to CA. At the same time, large irrigation projects such as the Great Fergana Canal were launched. Similarly to other parts of FSU, agriculture was forcefully collectivized in early 1930s.

The human costs of Soviet modernization of CA were enormous. They included, among others, several rounds of famine in 1920s and 1930s, massive terror of 1930s, building a large network of labour camps (the so-called Gulag system) where the supposed political opponents from the entire Soviet Union were imprisoned and perished in large numbers, massive resettlements (*ssylka* in Russian) of population from the European part of Soviet Union. The latter affected social groups such as *kulaks* (better-off farmers) and deportation of the entire ethnic groups, for example, Volga Germans, Chechens, Ingushes, Crimean Tatars, Crimean and Caucasian Greeks, Meskhetian Turks, Koreans, Karachays, Poles and others.

After the death of Stalin in 1953 and partial abolishment of the Gulag system, the Soviet-type forceful modernization and industrialization continued but with the use of less coercive methods. They included, among others, converting pastures (“Virgin land” or *tselina* in Russian) in the Northern Kazakhstan into large-scale grain farms, building the Main Turkmen and Karakum Canals, operating the Semipalatinsk Nuclear Test Site and Baikonur Cosmodrome (both in Kazakhstan). Many of those projects led to severe environmental damages (like disappearing of the Aral Sea or radioactive pollution of large areas in Kazakhstan), which have not been overcome yet.

Unlike in the Baltic and Caucasus regions, CA republics were not in the forefront of national emancipation movement in the late Soviet era. Until November 1991, their leaders participated in

negotiation on the “renewed” Union agreement with the Soviet President Mikhail Gorbachev. However, once the Soviet Union was dissolved in December 1991 the local political elites (mostly former leadership of the republican structures of the Communist Party of Soviet Union) grasped opportunity and started to build new authoritarian regimes based this time on national rather than communist ideology.

Rapid and forceful industrialization of the Soviet era (with strong focus on military needs) was associated with huge structural distortions and microeconomic ineffectiveness. After dissolution of the Soviet Union, many industrial enterprises in CA lost their previous markets and were unable to compete in the new market conditions. Thus, one should not be surprised with massive de-industrialization in the post-Soviet period.

After a painful transition period, growth picked up in 2000s, largely driven by export boom in commodities such as oil and natural gas (Kazakhstan Turkmenistan, Uzbekistan), aluminium (Tajikistan), gold (Kyrgyzstan), cotton (Uzbekistan and Tajikistan), other metals (Kazakhstan).

3. Geography, geopolitics, and economic integration

Kazakhstan has the largest territory (2,724,900 square km), and the second largest population in the region (17.5 million). Uzbekistan has the largest population (31.3 million) and the third largest territory (447,400 sq. km). Turkmenistan has the second largest territory (488,100 sq. km) but is the least populated (5.4 million). The two remaining countries – Kyrgyzstan and Tajikistan - have the smallest territories (below 200,000 sq. km) and populations of 6.0 and 8.5 million, respectively (see Figure 1).

Figure 1: Political map of the CA region



Source: Bruegel

For many reasons, geography and geopolitics in CA are not helpful in economic development.

First, the region’s location is quite distant to major centres of world economic activity in the North America, Western Europe, East and South East Asia.

Second, as mentioned earlier, all countries are landlocked (Kazakhstan is the largest landlocked country in the world and Uzbekistan is double landlocked, i.e., it borders with only landlocked countries) with limited transportation routes inside and outside the region. Major CA transportation routes built in the Soviet era crossed frequently inter-republican borders what was not the problem at that time. However, once intra-Soviet inter-republican borders were transformed into borders between newly independent CA states, with border and custom controls and, quite frequently, with visa requirements, this created a huge challenge not only to intra-regional trade but also to domestic movement of people and goods within individual countries, especially in the densely populated Fergana Valley shared between Kyrgyzstan, Tajikistan and Uzbekistan.

Third, on various occasions CA countries suffered from their own political instability (underpinned by ethnic, sectarian, clan and regional conflicts and authoritarian regimes) and even more unstable neighbourhood. It is enough to mention the Tajik civil war in the 1990s, ethnic riots in Osh (Kyrgyzstan) in 1990 and 2010, popular uprising in Abidjan (Uzbekistan) in 2005, two revolutions in Kyrgyzstan (2005 and 2010), occasional incursions of jihadist from Afghanistan in late 1990s and early 2000s. Political ambitions and personal animosities between authoritarian leaders additionally limit chances of intra-regional cooperation.

The neighbourhood also poses numerous security risks and limits potential for trade, transit, investment, and tourism. Among others, this concerns continuous civil war in Afghanistan (since mid-1970s), separatist movement in the Xinjiang region of China, India-Pakistan conflict in Kashmir, frozen conflicts in the Southern Caucasus and long-lasting economic and political isolation of Iran.

Fourth, CA countries are not ethnically homogenous. The share of dominant ethnic group amounts to 63% in Kazakhstan, 72% in Kyrgyzstan and between 80%-85% in Uzbekistan, Tajikistan and Turkmenistan.⁴ Turkmen, Uzbek, Kyrgyz and Kazakh languages belong to the Turkish language family while Tajik language – to the Persian one. However, Russian language remains a regional lingua franca, especially in Kazakhstan and Kyrgyzstan.

Fifth, the region borders with global and regional powers: Russia, China and Iran. Although Turkey does not have common border with CA countries it seeks to develop close economic, political and cultural links with them referring to joint historical and language roots. The US as the global political and economic superpower has also been present in the region, especially in the time of the NATO led combat mission in Afghanistan (2001-2014) when Kyrgyzstan, Tajikistan and Uzbekistan hosted US military bases and offered transit and logistic support to NATO troops.

While Russia clearly dominated the region for the last two centuries, in the last twenty years China rapidly expanded its presence in CA, especially in respect to large infrastructure investments (see Box 1). As a result, CA countries will face an increasingly difficult challenge of navigating between the two⁵. In addition, the increasing nationalist and revisionist tendencies in Russian politics, especially in the context of annexation of Crimea and ongoing Ukrainian conflict, has raised serious concern in Kazakhstan, which has a large Russian speaking minority and long land border with Russia.

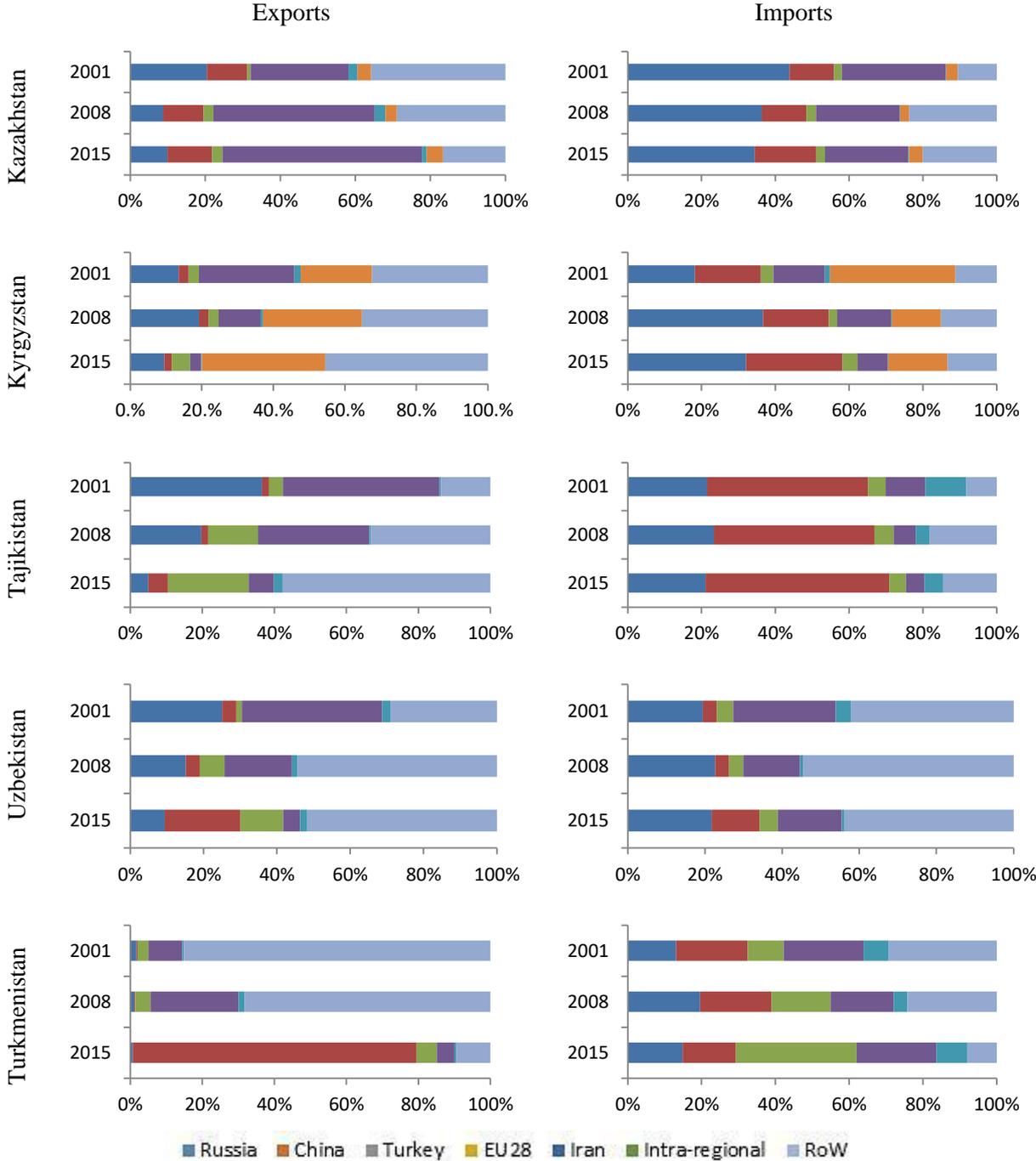
All CA countries are relatively open to trade. The least open is Uzbekistan, which reflects its autarkic development strategy and largely unreformed economic system (see Section 4). In terms of geographic directions of exports and imports (Figure 2), the share of Russia tends to decrease over time and that

⁴ 2012-2014 census data for all except Uzbekistan, where 1996 is the most recent data available.

⁵ Hypothetically, the Shanghai Cooperation Council consisting of Russia, China and four CA countries (all except Turkmenistan) should ease potential and facilitate political, security and economic cooperation in the region. However, the actual role of this organization remains limited so far.

of China – increase. The EU is the largest export market of Kazakhstan and its role remains quite important in imports to Kazakhstan, Turkmenistan and Uzbekistan. Turkey is an important destination of Tajikistan’s exports and source of Turkmenistan’s import.

Figure 2. Main trading partners' share in total exports and imports



Source: Bruegel based on the Trade Map of the International Trade Centre. Note: Intra-regional trade data is missing for Tajikistan, Uzbekistan and Turkmenistan. Iran’s data is for 2005 instead of 2008 and 2011, instead of 2015, for all countries.

Kazakhstan and Turkmenistan can benefit from transit trade between China and Iran. In 2015, when sanctions on Iran were lifted the first train from China arrived to Tehran through Kazakhstan and Turkmenistan, which took two weeks instead of one month if conducted through a sea route.

The list of major trade partners reflects both the geography and geopolitics of the region, as well as its institutional trade arrangements (Table 1). Only three countries of the five belong to the World Trade Organization (WTO): Kyrgyzstan (since 1998), Tajikistan (since 2013) and Kazakhstan (since 2015). The importance of the Commonwealth of Independent States (CIS), the organization created by the former Soviet republics at the end of 1991 to retain free trade and visa-free movement of people has been decreasing over time (Turkmenistan does not belong to the CIS). The Russia-led Eurasian Economic Union (EAEU) which intends to create a single market involves Kazakhstan and Kyrgyzstan. However, its economic modernization potential is limited. Recently, this project has been negatively affected by geopolitical tensions related to the Russian-Ukrainian conflict such as the Western sanctions against Russia, Russia’s trade countersanctions against the US and EU (not followed by other EAEU members), and unilateral Russia’s trade sanctions against Ukraine. The Economic Cooperation Organization (ECO), which includes all CA countries as well as their Southern neighbours, does not involve free trade arrangements.

Table 1. Trade and economic integration

Organization	Kazakhstan	Kyrgyzstan	Tajikistan	Turkmenistan	Uzbekistan	Membership
World Trade Organization (WTO)	yes	yes	yes	no	no	Uzbekistan is an observer
Community of Independent States (CIS)	yes	yes	yes	no	yes	all FSU states except Baltics, Georgia, Turkmenistan and Ukraine
Eurasian Economic Union (EAEU)	yes	yes	no	no	no	two Central Asian countries, Belarus, Russia and Armenia
Economic Cooperation Organization (ECO)	yes	yes	yes	yes	yes	Afghanistan, Azerbaijan, Iran, Pakistan and Turkey

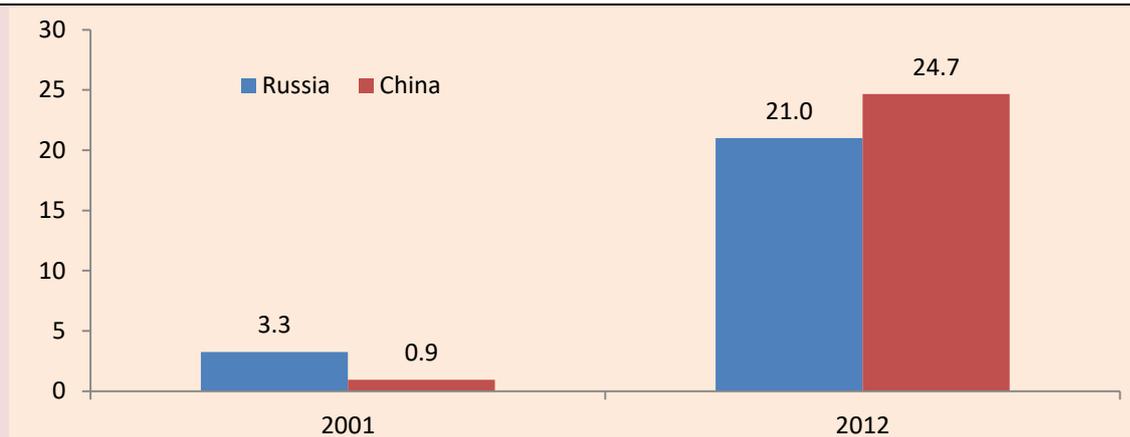
Source: Bruegel based on websites of individual organizations

Interestingly, despite its increasing share in CA exports and imports China does not advance formal free trade arrangements with the region and trades with its CA partners on the WTO terms.

Box 1. China’s role in Central Asia and the new Silk Road

The ancient Silk Road went through CA with Samarkand and Bukhara (today in Uzbekistan) being one of the biggest and most prosperous trading centres along the route. Today China is reviving the old trading route through its ambitious “Silk Road Economic Belt” project whereby it will develop infrastructure across CA, South Asia and onto Europe. There are three major “belts” that have been proposed - North, Central and South. The North route will go through CA (Kazakhstan) and Russia to Europe. The Central belt will go through CA, West Asia, Persian Gulf and the Mediterranean. Finally, the south route will stretch from China to Southeast Asia, South Asia and the Indian Ocean. All CA countries, except for Turkmenistan, are members of the Asian Infrastructure Investment Bank (AIIB), which is due to fund this project. In the last 10 years, China has been actively increasing its presence in CA through investing in energy and infrastructure projects. The total trade between China and CA countries surpassed their trade with Russia (Figure 3), with dominant share of commodities.

Figure 3: CA total trade with China and Russia, bln. \$



Source: Bruegel based on Trademap.

Figure 4: Map of the newly built and planned pipelines and railways in CA



Source: Bruegel

China has been actively investing in oil and gas pipelines, roads and railways, and accompanying infrastructure. These projects include (Figure 4):

Oil. China constructed the Kazakhstan-China oil pipeline, which came into operation in 2006 and China's oil imports from Kazakhstan increased almost tenfold between 2005 and 2008.

Gas. China has completed a construction of a major gas pipeline to Turkmenistan and another one, the Line D through Uzbekistan, Tajikistan and Kyrgyzstan will be built, increasing gas imports from Turkmenistan even further (Farchy, 2016). The pipeline broke the previous dominance of Russia's Gazprom but at the cost of creating a near total Turkmenistan's dependence on China. Turkmenistan's exports to China constituted 1% of its total exports in 2009, increasing to almost 80% by 2015, almost all of which is natural gas; the second largest Turkmenistan's trading partner, Turkey, constitute only 5% of its total exports.

Railway and other infrastructure. China committed to building the railway from Khorgos on the China-Kazakhstan border to the Aktau port on the Caspian Sea, including supplementary industrial

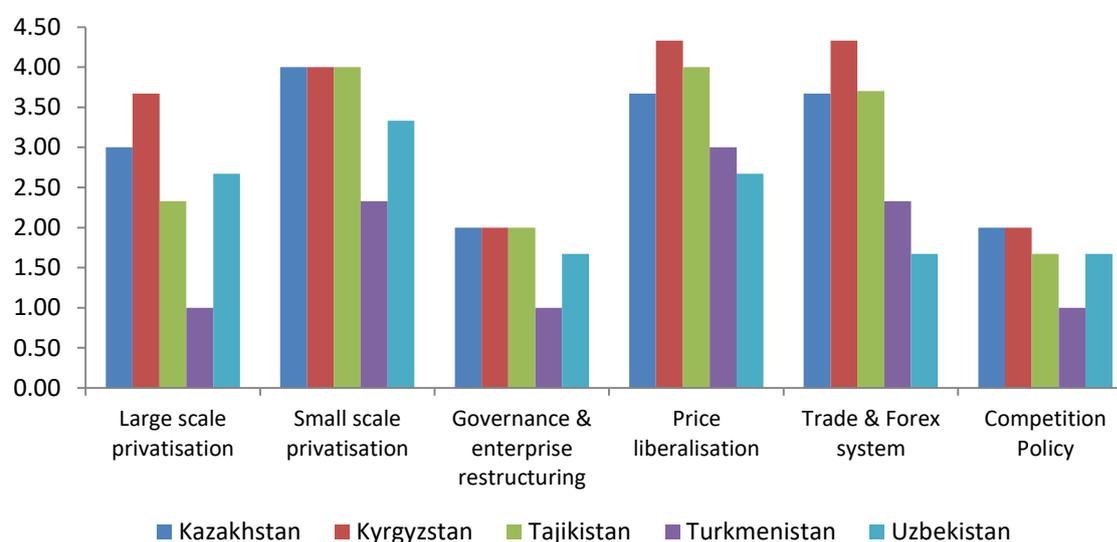
and infrastructure projects in Khorgos as the hub. Another project, the China-Kyrgyzstan-Uzbekistan rail route, started in 2016.

4. Reform progress

After collapse of the FSU and its economic system in 1991, economic transition in CA started with delay, progressed slowly and with an uneven pace. One of the reasons, which caused that delay was continuation of the common rouble area in 1992 and most of 1993 with the single currency (Soviet rouble) managed by several central banks (Dabrowski, 2016a). This led to very high inflation in the entire post-Soviet space, including CA. Kyrgyzstan was the first to introduce its own currency in May 1993 followed by Kazakhstan, Turkmenistan, Uzbekistan (all three in November 1993) and Tajikistan (May 1995).

As result, macroeconomic stabilization effort and market-oriented reforms in Kyrgyzstan and Kazakhstan started in 1994-1995 only, and a few years later in Tajikistan, after the end of its civil war (1997). Turkmenistan and Uzbekistan resisted market transformation for much longer period, trying to continue many instruments of the command economy until now. The uneven pace of economic reforms is reflected in Figure 5, which presents the 2014 EBRD Transition Indicators (the last available). Scores of two regional reform leaders – Kyrgyzstan and Kazakhstan – are similar to those of FSU countries in Eastern Europe and Caucasus (except Belarus which is another reluctant reformer) but below those of EU new member states and candidates. Turkmenistan and Uzbekistan demonstrate little progress (except small-scale privatization in Uzbekistan). Tajikistan represents an intermediary case.

Figure 5. EBRD Transition Indicators, 2014



Source: Bruegel based on EBRD.

All CA countries are doing poorly in the areas of governance and enterprise restructuring and competition policy, which points out to the limited progress in more complex institutional and legal reforms. This observation is confirmed by other available surveys and rankings.

According to the Heritage Foundation (HF) Index of Economic Freedom (Table 2) only Kazakhstan and Kyrgyzstan managed to achieve partial economic freedom (the HF category of “moderately free”). Tajikistan is rated as “mostly unfree” (similarly to Russia) and two other countries – as “repressed”.

Table 2. Heritage Foundation Index of Economic Freedom, world ranking, 2015

Country	World Rank in economic freedom	Status
Kazakhstan	69	moderately free
Kyrgyzstan	82	moderately free
Tajikistan	140	mostly unfree
Turkmenistan	172	Repressed
Uzbekistan	160	Repressed

Source: Bruegel based on Heritage Foundation

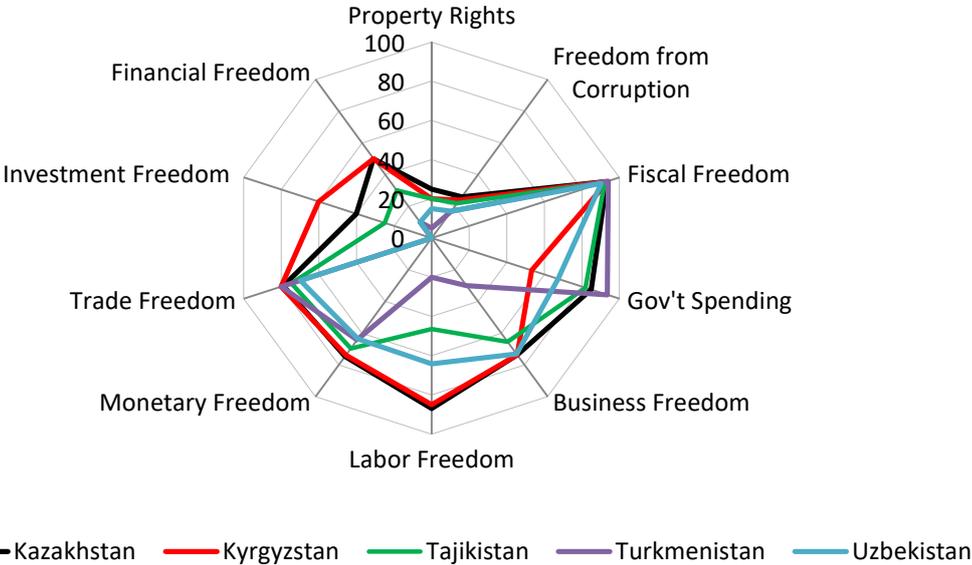
Table 3: Transparency International, Corruption Perception Index (100-very clean), 2015

Country	CPI
Kazakhstan	28
Kyrgyzstan	28
Tajikistan	26
Turkmenistan	18
Uzbekistan	19

Source: Bruegel based on Transparency International

Corruption remains a major problem in the region, particularly in Turkmenistan and Uzbekistan, as shown in Table 3. Corruption is an additional burden, especially on the poor, in their access to public and private services. Corruption, nepotism and favouritism hinder private sector development, particularly the small and medium-size enterprises.

Figure 6. Index of economic freedom, 2015



Source: Bruegel based on Heritage Foundation.

When we disaggregate the summary HF ranking into individual policy fields (Figure 6) most CA countries score low in terms of property rights, freedom from corruption and financial freedom, which, among others, reflect low quality of the judicial system and its inability to enforce contracts. Moreover, weaknesses in the judicial system discourage foreign investors and, therefore, slow down

modernization of CA economies. Generally, business environment remains uneasy and poses a big obstacle to diversification of CA economies out of commodity dependence (see Sections 5-6).

Kazakhstan, Kyrgyzstan and Tajikistan have achieved some progress in building market-oriented financial sector. In particular, Kazakhstan is open to foreign investment in the financial sector (Table 4). It has also the largest banking sector as measured by the ratio of credit to private sector to GDP (53.8% in 2010) while in Turkmenistan it equalled to only 2.2% of GDP in 2009. Currencies of Turkmenistan and Uzbekistan are not convertible even for current account transactions and Uzbekistan continues multiple exchange rates. Their financial sectors remain highly repressed.

Table 4. Financial sector development

Variable	Kazakhstan	Kyrgyzstan	Tajikistan	Turkmenistan	Uzbekistan
Current account convertibility	Full	Full	Full	limited	limited
Interest rate liberalisation	Full	Full	Full	limited	limited
Exchange rate regime	managed float	managed float	managed float	fixed	crawling peg
Number of foreign owned banks	39	21	13	11	
Domestic credit to the private sector (% of GDP)	53.8	11.5	22.5	2.2	14.6

Source: Bruegel based on EBRD. Note: The data covers a period until 2010, except for the exchange rate regime change from pegged to float in Kazakhstan in 2015. Data for domestic credit to the private sector for Tajikistan and Uzbekistan are for 2009, for the remaining the data is for 2010.

The largely authoritarian character of political systems determines poor governance and business climate, insecure property rights and rule-of-law deficit. According to the Freedom House Freedom in the World 2017 report⁶ only Kyrgyzstan is rated as “partly free” country, while others – as “not free”. Uzbekistan and Turkmenistan belong to the group of 10 most politically oppressive countries in the world (“Worst of the Worst”), on equal with North Korea and Eritrea.

5. Economic and social performance since independence

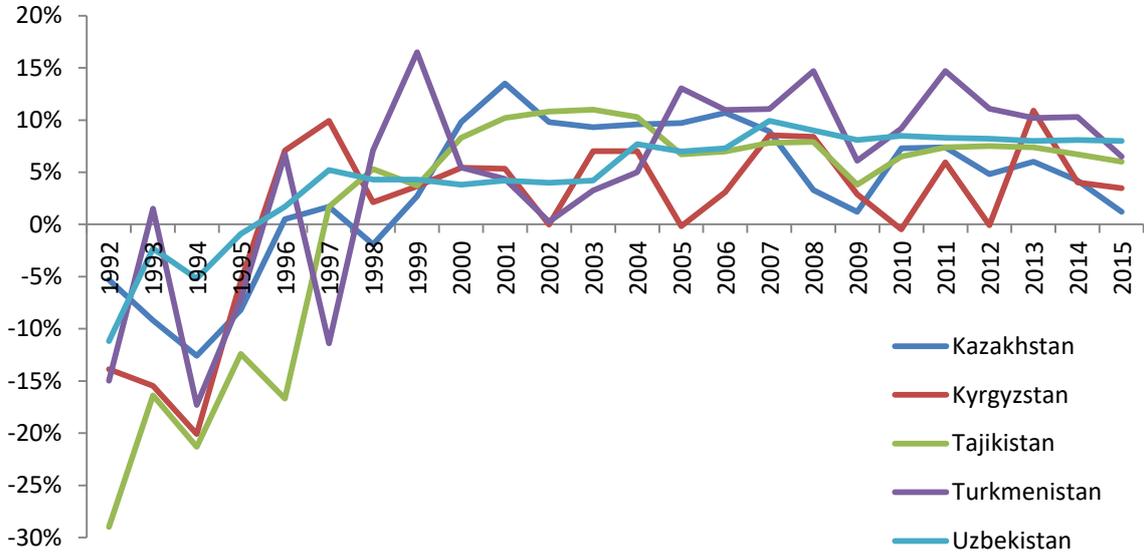
As already mentioned, in the first half of 1990s CA countries went through a painful transition process when they had to correct huge macroeconomic imbalances and structural distortions inherited from the communist era, and deal with consequences of the partial loss of the FSU market (especially in the military-industrial sector) and termination of direct and indirect transfers from Russia. Growth recovery started in 1995-1997 (Figure 7) but accelerated only in 2000s when new investments in hydrocarbons and other mineral resources production were completed and global commodity boom started. However, annual growth rates have remained volatile, largely due to fluctuations in global commodity prices.

Figure 8 summarizes economic progress achieved since independence. After the period of output decline in the first half of 1990s (see above) GDP per capita in current international dollars in PPP terms have systematically increased in all CA countries. However, only Kazakhstan and Turkmenistan have managed to grow rapidly, largely due to hydrocarbon bonanza. Both countries continue to have higher GDP per capita than rapidly growing China. Kazakhstan overtook Turkey (at the beginning of 21st century) and caught up with Russia in 2015. Uzbekistan, Kyrgyzstan and Tajikistan grew at

⁶ <https://freedomhouse.org/report/freedom-world/freedom-world-2017>

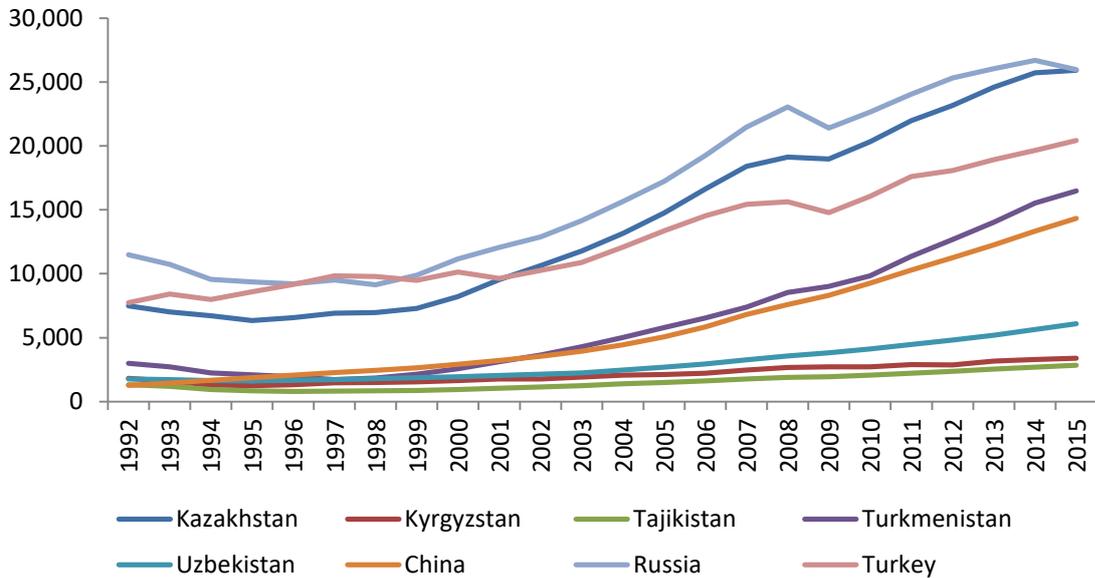
slower pace. As result, income per capita differences between those two subgroups of CA countries increased in the last 15 years.

Figure 7. Year-on-year GDP growth rate, percent



Source: Bruegel based on World Bank WDI.

Figure 8. GDP per capita in PPP terms, current international \$, 1992-2015



Source: Bruegel based on IMF World Economic Outlook database, October 2016. Note: IMF staff estimates for Turkmenistan (2005-2015), Uzbekistan (2014-2015) and Tajikistan (2015)

Looking at other macroeconomic indicators (Table 5 presents their multiyear averages) one may distinguish few periods. The first one, i.e., the turbulent 1990s, was characterized by tree-digit inflation figures in Tajikistan and Turkmenistan and three-digit government debt as a share of GDP in Kyrgyzstan and Tajikistan (part of the latter was owed to Russia, another part to the World Bank, other international development institutions and official creditors). The second period, between 2000 and 2008, associated with the global commodity boom, was marked by high growth rates, lower

inflation (but still higher as compared with most other emerging-market economies), some fiscal consolidation, rapidly growing international reserves and current account improvement. In the third period, consequences of the global financial crisis of 2008-2009 have led to slower growth and some deterioration in fiscal and current account balances. The decline in commodity prices since mid-2014 further deteriorated macroeconomic environment. Currencies of all CA countries sharply depreciated (in particular, the Kazakhstani tenge), inflation went up, fiscal balances and balance of payments deteriorated, and growth further slowed down (Dabrowski, 2016b).

Table 5. Selected macroeconomic indicators

Country	Inflation %			Government debt (% of GDP)			CA balance (% of GDP)		
	1992- 2001	2002- 2008	2009- 2015	1992- 2001	2002- 2008	2009- 2015	1992- 2001	2002- 2008	2009- 2015
Kazakhstan	15.7	8.8	7.4	-	10.2	12.9	-8.8	-1.9	0.5
Kyrgyzstan	16.1	7.6	7.1	114.8	78.6	54.4	-11.5	0.2	-4.3
Tajikistan	248.8	11.3	6.7	104.8	47.1	33.1	-11.2	-0.2	-3.7
Turkmenistan	180.8	6.9	5.0	47.6	7.2	13.7	-5.9	6.0	-6.9
Uzbekistan	37.8	12.5	11.0	40.1	27.5	9.3	-2.5	6.2	2.8

Source: Bruegel based on IMF WEO.

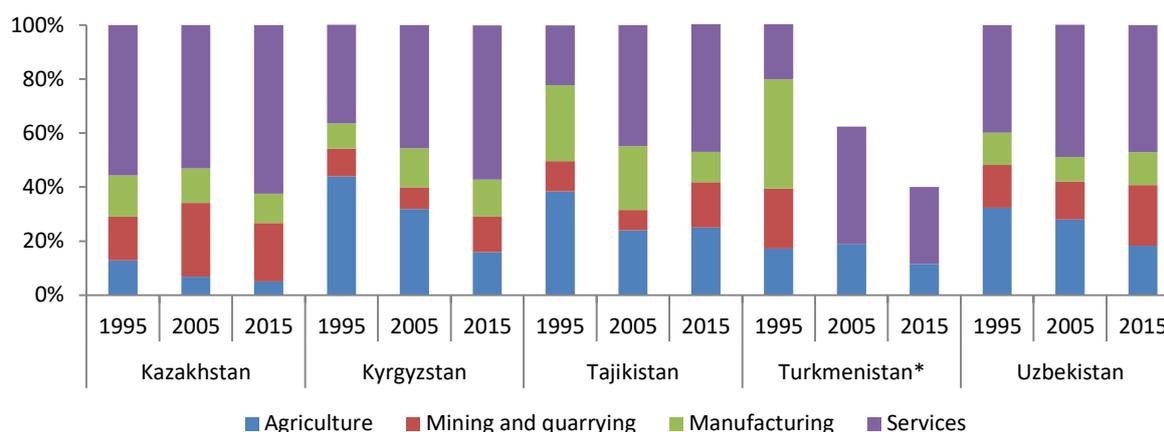
Kazakhstan (since 2000) and Turkmenistan (since 2008) used boom years to create oil and gas related sovereign wealth funds. However, their transparency remains either low (Kazakhstan) or non-existent (Turkmenistan)⁷. Furthermore, at least the Kazakhstan National Fund has served, to large extent, as the source of financing large infrastructure projects and other public investment rather than a reserve fund for rainy days. Kazakhstan has also used an increasing part of oil revenue for current spending purposes. As result, its fiscal break-even oil price, i.e., the price at which fiscal balance is zero, went up from 65.4 USD per barrel in 2009-2013 to 88.1 USD per barrel in 2015, exactly at the time when oil prices sharply declined to the level below 50 USD per barrel. Turkmenistan managed to bring down its fiscal break-even oil price from 81.6 USD per barrel in 2009-2013 to 50.4 USD per barrel in 2015 (IMF, 2016, Table 5).

Despite its decreasing importance, agriculture continues to contribute around a quarter of value added in Tajikistan and Uzbekistan (Figure 9). All countries recorded expansion of mining and quarrying, especially Kazakhstan, Uzbekistan and, most probably Turkmenistan, due to the role of oil and natural gas industry. Manufacturing in CA is concentrated in labour-intensive sectors, such as food and textile industries. The service sector remains relatively underdeveloped, except Kazakhstan.

Agriculture's share in total employment (Table 6) is higher than in total value added (Figure 9), indicating a lock-up of substantial part of labour force in this low-productivity sector. In Kyrgyzstan, for instance, share of agriculture in total value added is 16% while its share in total employment is almost twice as high. The similar situation is in Tajikistan. Since natural resource extraction is capital rather than labour intensive, it does not have the capacity to create significant employment. As result, employment in the industry sector (dominated by mining and quarrying) is small as compared to agriculture and services. Limited expansion of the service sector (except for Kyrgyzstan) could be explained by the fact that between half and three quarters of the population in CA countries live in rural areas (Table 7).

⁷ See <http://www.swfinstitute.org/sovereign-wealth-fund-rankings/>

Figure 9. Sectors' value added, percentage of GDP



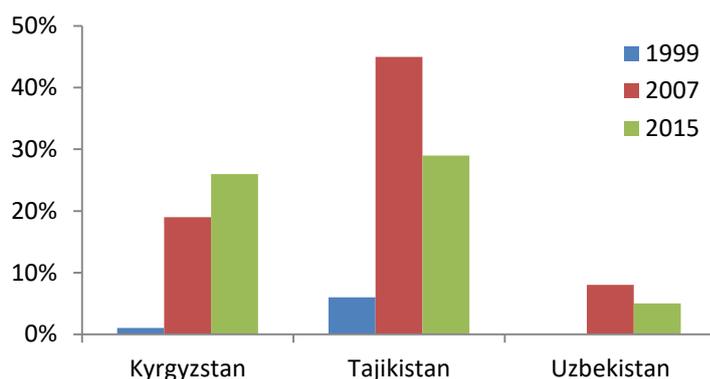
Source: World Bank. Note: Industry is disaggregated between (1) mining and quarrying, and (2) manufacturing. Comparative share of both sectors for Turkmenistan is missing for 2005 and 2015.

Table 6. Employment by sectors, share in total employment, %

Country	Year	Agriculture	Industry	Services
Kazakhstan	1999	26.7	20	53.2
	2013	24.2	19.8	56
Kyrgyzstan	1999	52.4	11.6	36.1
	2013	31.7	20.2	48.1
Tajikistan	2004	55.5	17.9	26.2
	2009	52.9	15.6	31.1
Uzbekistan	1999	38.5	19.4	35.2
	2013	-	-	-

Source: Bruegel based on World Bank. Note: Data for Turkmenistan is missing. Industry includes manufacturing; due to data limitations no separate data is available.

Figure 10. Personal remittances received, % of GDP



Source: Bruegel based on World Bank.

Remittances of labour migrants play an important role in Tajikistan, Kyrgyzstan and Uzbekistan (Figure 10). Russia is the major receiving country of CA labour force. Turkey and Kazakhstan also attract part of CA migrants. In case of Tajikistan, remittances account for approximately one-third of its GDP. They help low-income households escaping poverty; they also boost consumption and growth in the sending economies, finance their large trade deficits and contribute to developing financial sector.

However, labour migration is not without social and economic costs. Among others, they involve loosening family ties, often a brain drain, below-skill employment, and adaptation problems in the receiving countries. Individuals from remittance-receiving households are less likely to enter labour market, which creates additional pressures on the domestic supply of labour (Justino and Shemyakina, 2012). Better policies are needed to lessen the potential negative effects of labour migration in both sending and receiving countries, and closer cooperation between them. The latter is not always the case, despite free movement of labour provisions in the EAEU treaty.

As mentioned before, the early years of transition from CPE involved substantial social hardships. In 1990s, in all CA countries but Kazakhstan the poverty headcount rates at \$1.90 and \$3.10 a day (in 2011 PPP) were high or very high (Table 7). In 2000s, as result of rapid growth they started to decline systematically, except for Tajikistan where they remained high and increased again in 2010s. There is no data for Turkmenistan (since 1998) and Uzbekistan (since 2003). Most likely, however, the share of population living below both World Bank absolute poverty thresholds in Turkmenistan decreased as result of the hydrocarbon boom.

Overall, cross-country differences in poverty statistics reflect differences in GDP per capita levels (Figure 8). The same observation applies to the comparison with three major economic partners – China, Russia and Turkey.

Table 7. Poverty headcount ratio at \$1.90 and 3.10 a day (2011 PPP) (% of population)

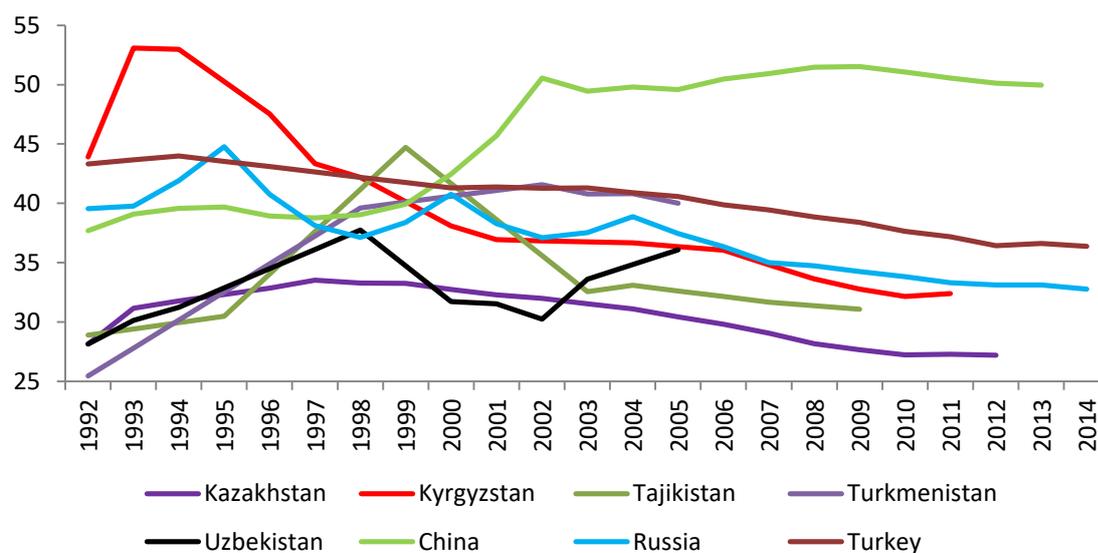
Country	at \$1.90 a day					at \$3.10 a day				
	1993	1998	2003	2007	2013	1993	1998	2003	2007	2013
Kazakhstan	6.5	6.3 ^c	4.5	0.5	0.0	23.1		21.3	3.7	0.3
Kyrgyzstan	44.3	30.6	28.1	9.9	3.3	63.9	51.5	67.6	33.6	24.0
Tajikistan		54.4 ^b	30.8	10.4	22.6		86.1 ^b	64.8	32.7	60.8
Turkmenistan	80.9	42.3				94.2	69.1			
Uzbekistan		45.5	66.8				69.2	87.8		
China	57.0	40.5 ^b	32.0 ^d	14.7 ^e	1.9	82.3	67.2 ^b	56.4 ^d	33.0 ^e	11.1
Russia	2.4	1.7	1.1	0.2	0.0 ^f	10.1	7.3	5.1	1.2	0.5 ^f
Turkey	2.6 ^a		3.7	1.4	0.3	12.1 ^a		13.2	6.3	2.6

Source: Bruegel based on World Bank. Notes: a – 1994, b – 1999, c – 1996, d – 2002, e – 2008, f – 2012.

The first period of transition was also marked by increasing income inequalities (Figure 11). However, in 2000s and 2010s, Kazakhstan succeeded in bringing Gini coefficient below 30, Tajikistan and Kyrgyzstan stabilized it between 30 and 35, i.e., below the high levels recorded in China, Russia and Turkey. That is, income inequalities in three CA countries look similar to EU economies rather than those of other FSU and developing countries. Recent data for Turkmenistan and Uzbekistan are not available.

Around half of the population of Kazakhstan and Turkmenistan and slightly above 35 percent of the population of Kyrgyzstan and Uzbekistan live in urban areas. In Tajikistan, this share is even smaller – it accounted for 26.8 percent in 2015 and hardly changed since the beginning of the 21st century (Table 8). This corresponds with the still high poverty level at that country (Table 7) because of low productivity in agriculture and other employment in rural areas (Table 6 and Figure 9). The low share of urban population also means constrained access to public services, quality education, healthcare and business opportunities.

Figure 11. Gini coefficient of income inequality



Source: Bruegel based on Standardized World Income Inequality Database (SWIID) by Solt (2016), last updated July 2016, <http://fsolt.org/swiid/>

Table 8. Other socio-economic indicators

Indicator	Kazakhstan		Kyrgyzstan		Tajikistan		Turkmenistan		Uzbekistan		Lower-middle income countries	
	2001	2015	2001	2015	2001	2015	2001	2015	2001	2015	2001	2015
Unemployment rate (%)	10.4	4.1	7.8	8.1	12.0	10.9	11.3	10.5	10.9	10.6	6.0	5.3
Urban population (% of total)	55.5	53.2	35.3	35.7	26.5	26.8	46.1	50.0	37.3	36.4	33.2	39.0
Fertility rate (births per woman)	1.9	2.7	2.4	3.2	3.9	3.5	2.8	2.3	2.5	2.2	3.4	2.8
Under 5-mortality rate (per 1000 live births)	41.2	14.1	46.4	21.3	86.6	44.8	79.2	51.4	61.4	39.1	89.2	52.6
Life expectancy (male)	60.5	67.1	65.0	66.5	60.3	66.2	60.2	61.5	63.8	65.0	61.7	65.5
Life expectancy (female)	71.3	75.9	72.6	74.5	68.0	73.2	68.0	69.9	70.4	71.8	64.6	69.1
Population aged 0-14 years, (%)	26.9	26.7	34.3	31.4	42.1	34.8	35.4	28.2	35.9	28.5	35.4	30.9
Health expenditure (% of government expenditure)	8.4	10.9	11.9	11.9	6.4	6.8	13.7	8.7	9.6	10.7	6.3	6.7

Source: Bruegel based on the World Bank. Note: (*) Data for 2009.

In the Soviet era, health services were provided largely by the state-owned health institutions and financed by the state budget but informal out-of-pocket payments by patients and their families played an important role either. After transition to the market system, health care has become financed from

three major sources – out-of-pocket financing by households, general budget financing and social health insurance system (Leive, 2010). Nevertheless, CA countries (except Tajikistan) still record higher share of health related expenditure in total government expenditure (Table 8) as compared to the average of lower-middle income countries.

Despite attempts to legalize and cap the amounts of patients' co-payments for healthcare services, the practise of informal payments and bribes remains widespread in the region (Scheil-Adlung and Kuhl, 2011). If one adds costs of medicines, which are rarely subsidized or refunded, total out-of-pocket payments for healthcare constitute substantial financial burden for households, particularly the low-income ones.

Public health insurance systems financed by mandatory employees and employers contributions were introduced in Kyrgyzstan in 1996, and in Kazakhstan in 2016 (Rechel et al., 2012). However, this mechanism is not easy to operate in CA countries where large part of population is engaged in the informal sector. The role of voluntary private health insurance in CA remains very limited (it plays some role in Kazakhstan only).

Since the beginning of 2000s, both male and female life expectancy increased, especially in Kazakhstan, Kyrgyzstan and Tajikistan (Table 8). Child mortality decreased, in particular in Kazakhstan and Kyrgyzstan, in line with progress accomplished in the rest of the developing world. Fertility rates increased in Kazakhstan and Kyrgyzstan while they slightly decreased in other countries. They remain high (over 3) in Tajikistan and Kyrgyzstan, which can be partly explained by the large share of population living in rural areas.

Overall, the high share of population under age of 14 and continued population growth (in some countries rapid) point to favourable demographic perspectives with ample supply of young labour force in forthcoming decades (unlike in other FSU countries, Europe and East Asia). Moreover, secondary education enrolment and associated literacy rate in CA countries is much higher than in other emerging market economies, reflecting the positive legacy of the Soviet education system. While tertiary education system is not without imperfections, Kazakhstan, Kyrgyzstan and Turkmenistan have the highest tertiary education enrolment ratios, with female enrolment exceeding male enrolment. Tajikistan and Uzbekistan have lower enrolment ratios with prevalence of male students. The challenge in CA countries is to retain young talents, strengthen education links to labour market and improve education quality (Chubrik et al., 2011).

6. The way ahead

Decline in prices of oil, natural gas, metals and agriculture raw materials in the second half of 2014 meant a huge adverse shock to CA economies. It exposed their vulnerability vis à vis changes in the world commodity markets and made the postulate of their structural diversification towards more manufacturing and services even more urgent.

In any economy, policies aimed at structural diversification are not easy to conceptualize, coordinate and implement. The right approach is to rely on market forces, including international trade and investment rather than administrative dirigisme, government planning and public investment (except infrastructure where public authorities have important role to play). However, in CA where memories of central planning and dominant public ownership are relatively fresh there is a natural temptation towards etatism and dirigisme (often associated with corruption and favouritism). In particular, this

concerns reform laggards, i.e., Turkmenistan and Uzbekistan. Going in such direction would mean welfare losses and further region's marginalization in the world economy.

Market-oriented diversification requires supportive macro- and microeconomic environment. Decline in commodity prices led to nominal and real depreciation of CA currencies, especially the Kazakhstani tenge, easing the so-called Dutch disease. That is, non-commodity sectors increased their international competitiveness, other things being equal. This created macroeconomic room for structural diversification. However, to grasp this opportunity, economic agents in non-commodity sectors must be able to develop and expand their businesses with minimum administrative obstacles, low transaction costs and protection of their property rights. This requires, in turn, improvement in business climate and governance, which means adopting a broad spectrum of economic, institutional, and political reforms (Section 4).

The list of required reform measures differs between countries but also contains a common agenda for the entire region.

Turkmenistan and Uzbekistan must complete basic market reforms: domestic price liberalization, reducing explicit subsidies to food, energy and water, and cross-subsidization (in public utilities), unification of exchange rate and current account convertibility, trade liberalization, WTO accession, advance privatization and eliminate barriers to private entrepreneurship both domestic and foreign, building financial market infrastructure, etc.

On the other hand, all CA countries, including reform-advanced Kazakhstan and Kyrgyzstan, face the same challenge of oppressive and predatory post-Soviet state⁸. Here are the deep systemic roots of corruption, rent seeking, state capture, administrative harassment of business and, more broadly, high degree of business uncertainty and property rights insecurity. Situation looks particularly bad in all areas where economic management interacts with authoritarian political system and legal institutions, especially the ones related to judiciary, law enforcement agencies and public administration. Resolving these problems will not be possible without at least partial political reforms.

Closer intra-regional cooperation would also improve business and investment climate. Given region's remote geographical location, its complicated border lines, infrastructure inherited from the Soviet times and cultural proximity (Section 3), unrestricted movement of goods, services, people and capital between CA countries would greatly help in economic development. Currently this is only partly the case.

7. Role of external actors in supporting Central Asia

External actors could also play an important role in supporting CA development and reforms as they played in the CEE region. Unfortunately, geographic location and geopolitics limit these opportunities (Section 3).

Although the two big powers directly bordering the CA region – China and Russia - are engaged in providing financial and development aid it largely serves their national and geopolitical interests. The same concerns investment coming from both countries, major part of which is provided by state-controlled corporations or companies remaining in close relations with governments of both countries. Often these projects lack in transparency.

⁸ The same challenge is shared by other FSU countries, including Russia and Ukraine.

To lesser extent, the same also concerns two other regional players, i.e., Turkey and Iran. None of the mentioned neighbours is interested in supporting more political freedom and deeper institutional reforms in CA countries.

The role of the US and EU has remained limited in the region. Both provide technical assistance but its scale has decreased over time. The US interest in the region decreased after ending the NATO combat mission in Afghanistan. The perspective of its future engagement under the Trump administration remains unclear.

The EU economic and political interests are also limited. For the first period of post-communist transition, the EU external policy tried to follow a common regional approach to all CIS countries, including the single development aid framework – the Technical Assistance to Commonwealth of Independent States (TACIS). However, with launching the European Neighbourhood Policy (ENP) in 2004, the CA region, which remained outside this policy framework, was moved to a general basket of developing countries, also in terms of technical assistance programs. Occasionally, Kyrgyzstan and Tajikistan received the EU Macro-Financial Assistance (in the form of loans and grants) as the supplement to the IMF programs (see below).

Formally, the EU relations with the region are governed by the strategic document on “The European Union and Central Asia: Strategy for a New Partnership” adopted in 2007⁹ and bilateral Partnership and Cooperation Agreements (PCAs) with each country. Application of the Most-Favoured Nation (MFN) tariffs in bilateral trade relations, even before individual CA countries’ accession to the WTO is the most important economic provision of the PCAs. In 2015, the new-generation Enhanced PCA between the EU and Kazakhstan was signed in Astana. Kazakhstan remains the most important economic and political partner of the EU in the region what comes, among others, from its status of major oil exporter.

Given Kazakhstan and Kyrgyzstan’s membership in the EAEU, the EU cannot offer them negotiation on free trade agreements, similarly to Georgia, Moldova and Ukraine. The same applies to Turkmenistan and Uzbekistan, which are not WTO members and have not completed basic market reforms yet. Thus, the potential EU toolkit of policies, which could support economic and political transition in the CA region, is limited.

With the limited engagement of bilateral donors¹⁰, the IMF, World Bank, various UN agencies and the Asian Development Bank (ADB) have provided major financial and technical support to CA economic transition and modernization. This included IMF, World Bank and ADB lending on concessionary terms to Kyrgyzstan and Tajikistan.

Turkmenistan and Uzbekistan’s relations with the international financial and development institutions are more limited due to their non-market economic systems and information closeness. Thanks to its upper-middle-income status, Kazakhstan is considered as the country, which is no longer eligible to participate in most development aid programs.

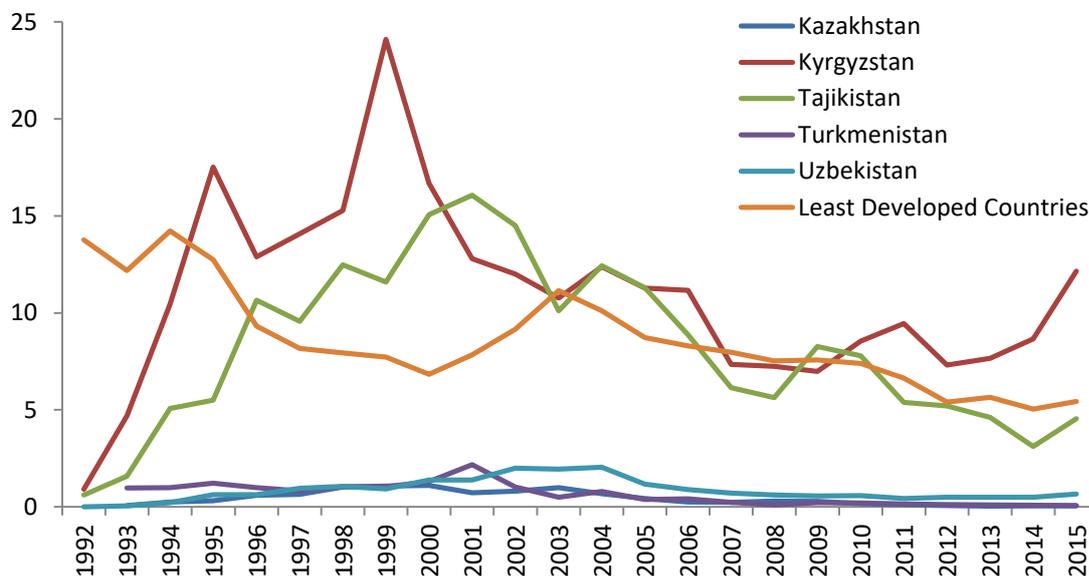
Overall, Kyrgyzstan and Tajikistan received the largest official development assistance (ODA) as a share of gross national income (GNI) in the region, on the level comparable with the group of the least developed countries to which they belonged during most of the analysed period (Figure 12). Its peak came at the end of 1990s (Kazakhstan) and early 2000s (Tajikistan) and then gradually declined in the

⁹ https://eeas.europa.eu/sites/eeas/files/st_10113_2007_init_en.pdf

¹⁰ With exception of Japan, which financed some infrastructure projects in Kyrgyzstan and Tajikistan on concessionary terms.

entire region (except for Kyrgyzstan when it grew again since 2013). In Kazakhstan and Turkmenistan ODA almost disappeared after 2005.

Figure 12: ODA as a % of Gross National Income



Source: Bruegel based on OECD DAC2a database. Note: The list of Least Development countries contain 48 countries (for more information refer to

<http://www.oecd.org/dac/stats/documentupload/DAC%20List%20of%20ODA%20Recipients%202014%20final.pdf>)

8. Few policy lessons

Our overview of CA post-communist transition in the last quarter of century suggests some policy lessons, some of which may also apply to countries outside this particular region:

1. Geography matters. The remote geographic location (far from major centres of world business activity), landlockedness and underdeveloped transportation infrastructure do not help in integration into the world economy and, therefore, in economic development even if a given country/ region is well-endowed in natural resources and educated labour.
2. Geopolitics also matters. Geographic disadvantage matters even more if it is associated with negative geopolitical factors – unstable neighbourhood with unresolved conflicts, limited appetite for intra-regional cooperation, assertive policies of regional powers and limited interest of two global powers (the US and EU), which traditionally support democratic and market reforms.
3. Importance of institutional legacy. The total absence of tradition of modern capitalist economy, political freedom and democracy in CA did not help in its political and economic transition since independence. However, such a historical background cannot be seen as the fatal factor, which will be in force forever. Good policies can help overcome poor institutional legacy as it happened, for example, in some Asian countries.
4. Authoritarianism does not help in economic reforms. Results of our analysis suggest that there is a correlation between progress in political and economic reforms in the CA region, like elsewhere in transition economies. The most politically unfree regimes (Turkmenistan and Uzbekistan) are also economically least free with several remnants of CPE system. On the

other hand, a politically partly-free Kyrgyzstan is a regional leader of economic reforms. In all CA countries, hard or soft authoritarianism creates the obstacle to reform predatory post-Soviet institutions, establish rule of law, fight corruption, nepotism and rent seeking.

5. Natural resources are both blessing and curse. Presence of mineral resources, especially of hydrocarbons, helped CA countries to grow rapidly, eradicate poverty, and launch large infrastructure projects, despite their geographic, geopolitical, and institutional disadvantages and, in some cases (Turkmenistan), in the absence of genuine market reforms. However, resource booms have their limits as documented by the 2014-2015 decline in commodity prices. Furthermore, presence of large natural resource rent creates obstacle (via real appreciation of exchange rate) to development of internationally competitive manufacturing and service sectors. It also encourages corruption and helps in consolidating authoritarian regimes.
6. Going forward. The best strategy for CA countries would be to seek a closer intra-regional cooperation rather than further isolationism as is the case of Turkmenistan. Closer cooperation will help them in balancing their interests with those of major neighbours, by formulating a common approach.

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