

The Economics and Politics of the Eurasian Region



GLOBE Leadership Seminar, September 23 - 27, 2008
Tufts University European Center, Talloires France

Summary Report
Christoph Frei, University of St.Gallen

Preface

This report covers the third conference of a new initiative to foster dialogue between students, faculty members, and personalities with rich practical background in private or public international organizations from Europe, the United States and Asia. The GLOBE Leadership Seminar is a unique project in scope and aspiration. At this stage, the participating universities include five leading graduate schools of international affairs and public policy: College of Europe, Bruges, Belgium; Fletcher School of Law and Diplomacy at Tufts University, USA; Graduate School of International Studies at Yonsei University, Korea; Lee Kuan Yew School at the National University of Singapore, Singapore; and the Master of International Affairs Program at the University of St. Gallen, Switzerland.

The GLOBE Leadership Seminar 2008 was again held at the Tufts University European Centre in Talloires, France from 23 - 27 September. The center provides state of the art conference facilities in a renovated medieval Benedictine monastery, located in a resort village on the shore of Lake Annecy in a beautiful mountain setting. The event combined a three-day Student Seminar with thirty-five participants - seven from each school - and a one-day Leadership Seminar with students, faculty members and practitioners.

The Student Seminar focused on "International Regimes for Global Warming". Raimund Bleischwitz, Professor of the College of Europe and Co-Director for Material Flows and Resource Management at the Wuppertal Institute, Ann Florini, Professor and Director of the Centre on Asia and Globalization at the Lee Kuan Yew School of Public Policy, William Moomaw, Professor of International Environmental Policy and Director of the Center for International Environment and Resource Policy at the Fletcher School, and last but not least Rolf Wüstenhagen, Professor for Sustainability Management and Director of the Institute for Economy and the Environment at the University of St.Gallen provided a rich, multidisciplinary teaching program for students from both developed and developing countries. The very diverse personal background of these students gave rise to enriching discussions, and they prepared and presented a Ten Point Program for Global Action to a Jury of Experts.

The Leadership Seminar of September 27, 2008 convened upper echelon managers and administrators from private and public organizations together with faculty members and students from the five participating institutions for an informal exchange of ideas focused on the topic, "The Economics and Politics of the Eurasian Region." Obviously, the August 2008 violent conflict between Georgia and Russia was not foreseen when we chose that topic. In turn, the war inevitably hovered over the colloquium and made our exchange all the more topical.

The discussions were supported by short presentations which provided factual background and raised critical issues for dispute. Their clarity- and thought-provoking inputs greatly contributed to the understanding of the complex issues and proved enormously helpful for the deliberations. I thank the presenters in alphabetical order for their very helpful insights:

Anders Aslund, Senior Fellow, Peter C. Peterson Institute of International Economics, Washington, D.C.

James Davis, Professor of Political Science at the University of St.Gallen

Raffi Hovannisian, Founding Director of the Armenian Center for National and International Studies and former Minister of Foreign Affairs, Republic of Armenia

Sarah E. Mendelson, Director of the Human Rights and Security Initiative at the Center for Strategic and International Studies (CSIS), and Senior Fellow with the Russia and Eurasia Program

Shahmar Movsumov, Executive Director of the State Oil Fund of the Republic of Azerbaijan

Richard Pomfret, Professor of Economics, University of Adelaide

Johanna Popjanevski, Deputy Director of the Institute for Security and Development Policy (Central Asia-Caucasus Institute & Silk Road Studies Program)

Sharif Rahimzoda, Chairman of the National Bank of Tajikistan

Christof van Agt, Senior Researcher, Netherlands Institute for International Relations Clingendael

Once again, the meeting respected the Chatham House Rule, enabling all discussants to express their personal opinion without risk of public disclosure. Nevertheless, we find it helpful to make the main results of the discussion available to a wider public. Christoph Frei authored the following report which gives a candid summary of the issues discussed and the areas of convergent interpretations. Readers should keep in mind that the reported facts and figures represent the situation as of fall 2008 when the conference took place. I am convinced that I speak for all participants in thanking Christoph Frei for his lucid summary of a rich if not always fully coherent discussion.

In closing, I want to express my deepest gratitude to institutions and organizations which made this seminar possible. The Ecosciencia Foundation and the Holcim Group have provided invaluable financial support. Tufts University offered their splendid European Center in Talloires on the shores of Lake Annecy. The hospitality of Gabriella Goldstein, Director of the Tufts European Center, and her staff makes the Center a place to remember far beyond its physical attraction.

Heinz Hauser

The Economics and Politics of the Eurasian Region

Christoph Frei, University of St.Gallen

Introduction

In common parlance, the portmanteau term *Eurasia* refers to a huge landmass that comprises both the *European* and the *Asian* continent, two more traditional concepts which date back to classical antiquity. The colloquium's focus was on the very heart, so to speak, of that landmass. The region in question is bordered by Russia in the North, China in the East, Pakistan, Afghanistan, and Iran in the South, finally Turkey and the Black Sea in the West. In that area, several former Soviet Republics have turned into sovereign states and are now political actors in their own right: Georgia, Armenia, and Azerbaijan in the South Caucasus; Turkmenistan, Uzbekistan, Kazakhstan, Tajikistan, and Kyrgyzstan in Central Asia.

This truly 'broad' subject matter was structured into four sessions to give greater focus and thrust to our exchange. The summary presented here does not make any claims to completeness. All it hopes to achieve is to select certain focal points, questions as well as answers, which may in turn serve as starting points to further exploration and discussion. Last but not least, readers should keep in mind that the reported facts and figures reflect the situation as of fall 2008.

I. Instability in the Caucasus

Occupying roughly 440,000 square kilometers, the Caucasus is divided by a huge mountain range. On the current political map, the area north of that range comprises the southernmost portion of Russia including Dagestan, Chechnya, Ingushetia, North Ossetia, and other ethnically based administrative units. To the south, we find three newly independent sovereign states, that is, Georgia, Armenia, and Azerbaijan.

Located between Asia and Europe, on the peripheries of Turkey, Russia and Iran, the region has been an arena for political, military, religious, and cultural rivalries and expansionism for centuries. Thus, history is ever present in the affairs of the region, and no sober analysis can afford to disregard the multitude of conflicting interests that underlie the numerous (and dangerous) dividing lines that we still see today. Amongst other factors and forces, a long line of invasions has left its imprint on the character and culture of the Caucasian peoples. Middle Eastern influences, in particular, led to the dissemination of Iranian languages on the one hand and to the spread of Christianity and Islam on the other.

Modern history began with an extended period of rivalry between Ottoman Turkey and Persia, but was also marked by the advance of Russian language and culture, which penetrated farther and farther into Caucasia from the 16th century onward. Throughout this process, smaller ethnic groups took refuge in the ravines of the mountain ranges to survive.

In the 70-odd years of Soviet rule, South Caucasia—rich in water and natural resources—was transformed from a largely agricultural area into an industrial and urban region. At the same

time, Stalin's brutal divide-and-rule policies further complicated the existing ethnic patchwork. Severe restraints on national expression and, more generally, the legacy of the repressive Stalinist period roused widespread discontent. After General Secretary Mikhail Gorbachev allowed greater political expression and autonomy, popular movements for sovereignty and independence quickly undermined Soviet authority in Armenia and Georgia; in both instances, non-communist regimes won elections in 1990. With the dissolution of the Soviet Union one year later, Georgia, Armenia, and Azerbaijan gained full independence.

Given the presence of 50 different peoples in Caucasia today, mere mention of the term 'Balkanization' is worrisome. Ever since the collapse of the Soviet Union, the area has been subject to ethnic conflict, aggression, and war. To the north, protracted and bloody conflicts notably confronted Chechen separatist and Russian federal military forces. Further south, the young sovereign states, too, experienced instability, ethnic violence, and economic decline. More particularly, Georgia almost continuously fought off separatist movements in Abkhazia and South Ossetia, while the status of the mainly Armenian enclave of Nagorno-Karabakh in southwestern Azerbaijan sparked ethnic violence between Armenians and Azeris. In 1992, that conflict, too, exploded into war.

Unsurprisingly, the numerous unresolved conflicts in the region entail cumbersome side-effects in the shape of illegal trade, religious and nationalistic radicalism, and human rights abuses. All of these factors are further impediments to long term political and social stability.

In light of the geopolitical context and given the region's lavish endowments with natural resources, the presence of external actors is hardly surprising. Once again, Russia, Turkey and Iran are not just friendly neighbors, but active participants in a power game that includes geographically more distant players such as China, the United States, and the European Union.

One explicit objective of our colloquium was indeed to shed light upon the chronic instability of the Caucasus. In preparing the event, we had no idea just how timely our topic would be. Early in August 2008, Russia launched a large-scale military operation in Georgia in response to real or alleged provocations from the other side. The operation sent shock waves reverberating throughout the rest of the world as the magnitude of the operation and its implications became clear. Small wonder, then, that the first part of our discussion remained more or less glued to this hot spot. What had actually happened? What were the roots and implications of the conflict?

A brief chronology of events

The 1991–1992 war between Georgians and Ossetians had left most of South Ossetia under de-facto control of a Russian-backed, but internationally unrecognized regional government. Some ethnic Georgian-inhabited parts remained under the control of Georgia—a configuration very similar to the situation in Abkhazia after the violent conflict there (1992-1993).

That configuration was basically unchanged when Mikhail Saakashvili came to power in Georgia's Rose Revolution which ousted President Eduard Shevardnadze in 2003. In the years that followed, Saakashvili's government pursued a program to rebuild weak state institutions, create passably democratic institutions and implement what many viewed as a pro-US foreign policy. One of Saakashvili's primary objectives has been Georgian NATO membership, one of the main stumbling blocks in Georgia-Russia relations. In 2007, Georgia spent 6 percent of GDP on its military and had the highest average growth rate of military spend-

ing in the world. Restoring South Ossetia and Abkhazia to Georgian control has been seen as a top-priority goal of the Saakashvili administration.

Even with hindsight, it is impossible to determine the beginnings of an endless series of hostile tit for tat between Russia and Georgia. In the spring of 2006, Russia introduced an import ban on Georgian wine and mineral water, Georgia's most lucrative export products, citing health and quality concerns. In September 2006, Georgia expelled six Russian intelligence officers accused of espionage. In April 2008, a Russian presidential decree instructed the Russian government as well as Russian regions to open political, social and economic relations with Abkhazia and South Ossetia. In Tbilisi, this was immediately interpreted as a move to prepare and legalize a Russian annexation of the two regions. In May 2008, Abkhazia's leader Sergey Bagapsh requested permanent Russian military presence in Abkhazia. In July, Russia launched a large-scale military exercise, *Kavkaz-2008*, in several areas in the vicinity of the Georgian border. Early in August, tensions in South Ossetia escalated when a military vehicle carrying six Georgian police officers was hit by remote-controlled explosive devices while travelling on a bypass road linking villages in the disputed area with Georgia proper. On August 5, approximately 50 Russian journalists arrived in Tskhinvali, the capital of South Ossetia, expecting "something to happen," as reported by Said Tsarnayev, a freelance reporter for Reuters.

Tensions escalated again in the afternoon of August 6 with exchanges of fire between Georgian and South Ossetian separatist forces. On August 7, the Head of the South Ossetian Security Council, Russian officer Anatoly Barankevich, announced that armed groupings from North Ossetia were headed towards South Ossetia to assist the separatist army to fight the Georgian troops. On the same day, the Georgian authorities received foreign intelligence reports about the movement of Russian troops towards the Roki tunnel connecting North Ossetia with the South Ossetian conflict zone. Georgian President Saakashvili consulted Western diplomats. He was advised by U.S. Deputy Assistant Secretary of State Matthew Bryza not to fall into a trap and to avoid a confrontation with Russia.

At approximately 7 pm on August 7, the Georgian government announced its decision to cease fire in order to defuse tensions and offered to engage in talks. A few hours later, the Georgian authorities reported that several Georgian-controlled villages had come under heavy fire from South Ossetian separatist forces. At approximately 11 pm, President Saakashvili was informed that a convoy of over 100 Russian military vehicles was passing through the Roki tunnel. The Georgian government informed U.S. envoy Bryza that it had no other choice but to advance towards the tunnel in an attempt to push the Russian troops back. Shortly before midnight, the Georgian Ministry of Defense announced its decision "to restore the constitutional order" in South Ossetia. Later on, Russian sources claimed that Russian forces did not enter Georgia until the afternoon of August 8, but repeatedly failed to state the exact time of entry. An undisputed fact is that Russian and Ossetian forces clashed with Georgian troops in a three-day-fight for Tskhinvali, the largest battle of the war.

Upon mediation by the French presidency of the European Union, the parties reached a preliminary ceasefire agreement on August 12, signed by Georgia on August 15 in Tbilisi and by Russia on August 16 in Moscow. Yet, fighting did not stop. Russia pulled most of its troops out of uncontested Georgia while buffer zones were established around Abkhazia and South Ossetia. Moreover, Russia created check points in Georgia's interior (Poti, Senaki, Perevi). Last but not least, on August 26 Russia formally recognized the independence of South Ossetia and Abkhazia.

Spontaneous reaction or premeditated aggression?

After invading Georgian territory on August 8, Russia scored some initial successes in portraying the invasion as both an adequate and appropriate response to a Georgian decision to militarily enter Tskhinvali. For days on end, Russian television was broadcasting reports about genocide and ethnic cleansing in the region. On August 10, the Russian ambassador to the United Nations evoked "the terrible precedent" of Srebrenica. While it is likely that Georgian forces indeed hit a limited number of civilian targets in South Ossetia, independent human rights organizations have been able to substantiate fewer than 150 casualties there, in stark contrast to Russia's initial claim of 2,000 deaths and allegations of ethnic cleansing.

Scholars will continue to debate whether the main responsibility for the immediate outbreak of the war falls upon the Russian or the Georgian side. More importantly, however, a growing and increasingly conclusive body of evidence has emerged ever since, implying that Russia's response to the Georgian provocation had been premeditated rather than reactive.

It is the very scope of the Russian response that gave pause to the analytic community as the Kremlin immediately broadened the conflict zone of South Ossetia to include the opening of a second front in Abkhazia and systematic attacks on military and economic infrastructure across Georgia's territory. According to many observers, the rapid deployment of coordinated ground, air, and naval attacks within hours of Georgia's entry into Tskhinvali could not have been undertaken without meticulous planning. Within days, tens of thousands of Russian troops and hundreds of tanks and armored vehicles were roaming Georgian roads. Russia's subsequent decisions to ignore the terms of a cease-fire agreement it signed, and to recognize the independence of the breakaway republics of Abkhazia and South Ossetia further enhance the impression of a long-hatched plan. As one respected Russian military analyst put it, the political decision to start a war in Georgia had in fact been taken "in Moscow as early as April 2008" — a perception that many participants in the colloquium shared.

The cost of indifference

While discussants agreed to disagree on several aspects of the conflict, there was a strong consensus as regards the role that the European Union and the United States had played in the years and months prior to August 2008. If one word were to capture and express that consensus, the notion of 'failure' would clearly seem most appropriate.

The broad picture emerging from individual contributions to the discussion is sobering indeed: Ever since the first conflicts and wars broke out in the 1990s, the international community at large has failed to take charge of processes of conflict resolution in a credible way. Initially, this omission was largely due to the presence of other conflicts that required UN peace efforts, such as Rwanda and Bosnia. At the same time, however, there was an underlying tendency to rely on Russia as the guarantor of peace in its own backyard. Consequently, Russia was left free to win a monopoly over these peacekeeping and negotiating structures.

Was it appropriate to leave the Kremlin with this responsibility? One discussant recalled that throughout the 1990s and well into the current decade, Russia was seen as moving forward on a path toward ever more glasnost and democracy. What is more, Russia time and again upheld the majority line in the Security Council in favour of Georgia's territorial integrity. Why worry, then?

Yet European and American governments remained aloof even when Russia's foreign policies began to evolve in the aftermath of Vladimir Putin's accession to power. The second war

in Chechnya hardly caused a stir. Even President Clinton's alleged human rights administration responded in a way that was ambivalent at best. Therefore, Russia paid no price for what was an astonishingly brutal war on its own territory. Gradually, Moscow began reasserting its influence in the 'near abroad.' In Georgia's separatist regions, this entailed handing out Russian passports to the citizens, providing military support to the separatists' armies and directly appointing members of both the South-Ossetian and Abkhazian leadership. In the years following the 2003 Rose Revolution in Georgia, Russia began explicitly rejecting requests for Georgia's territorial integrity in the Security Council.

As a response, Georgia repeatedly pleaded with the international community to support it in disqualifying Russia as the peace facilitator in the region, but was continuously ignored. Unable to reach a consensus on alternative strategies, even Georgia's closest Western allies failed to make a real contribution. As a result, the Russians could confidently continue to challenge Georgia's sovereign borders. Even when they crossed those borders on several occasions in the summer of 2007, international reactions remained conspicuously absent. At the NATO summit in Bucharest (April 2008), Georgia was assured it would be offered membership at an unspecified point in the future, but was denied a Membership Action Plan.

Thus, in spite of Russia's so clearly revealing itself as a party to the conflict with no real intention of resolving it, the Europeans and the United States continuously refrained from putting pressure on Moscow or from offering any alternatives. As a result, the Caucasus was left outside any effective international policy framework. While the West had kept evoking stability and democratization in the South-Caucasus as highly desirable on the rhetorical level, it seems to have in fact contributed to the opposite. For the first time since 1979, Moscow arguably waged a premeditated war against a neighboring state, and this occurred on the fringes of the European continent, against a member country of the Council of Europe and the OSCE.

Prudent decisions or dismal precedents?

How to account for so much Western indifference? As regards the United States, plausible explanations are not hard to find. In the wake of Nine Eleven, first Afghanistan and then Iraq were such an overwhelming preoccupation for the Bush administration that many other issues were basically left to themselves. Obviously, the situation in the Caucasus needed senior oversight. As a result of higher-level U.S. engagement elsewhere, however, the diplomats then assigned to the regions were fairly junior.

It is, of course, one thing to deplore wrong priorities, internal divisions and the lack of a coherent strategy on the part of European governments and the Bush administration. It is quite another thing to agree, even with hindsight, upon alternative courses of action that the West should have chosen. Was it a mistake not to grant Georgia and Ukraine a Membership Action Plan at the NATO summit in Bucharest? More generally, would it be prudent to commit (or even issue security guarantees) to countries encumbered with unresolved conflicts? Should the United States have delivered arms to Georgia early on?

Another issue was hotly disputed. In February 2008, the Republic of Kosovo declared independence. President Putin immediately claimed that, if recognized by western states, this would set a precedent with consequences for Abkhazia and South Ossetia. A few weeks later, when many states had indeed recognized the Republic of Kosovo, Konstantin Zatulin, Deputy Chairman of the Duma Committee on CIS and Compatriot Affairs, suggested in an interview that it was important "to move now, while Kosovo [was] still a fresh issue."

Could and should the West have acted differently? Regardless of political, legal, and moral arguments, the alleged Kosovo precedent lacks basis in reality at least to some extent. In Kosovo, as in Bosnia, multilateral international intervention sought to prevent ethnic cleansing from succeeding. In Georgia's break-away republics, the Russians claimed a right to defend persons to whom they had just given passports in view of altering the demographic setup ("the most obvious wrong of all wrongs" according to one discussant). Moreover, Moscow had explicitly or implicitly endorsed and rewarded the ethnic cleansing of approximately 240,000 persons, mainly ethnic Georgians, from Abkhazia in 1993, and the forced emigration of several tens of thousands of ethnic Georgians from South Ossetia as a direct result of Russia's military operation in 2008. "In many ways, therefore, Russia really stands the Kosovo precedent on its head." Nevertheless, questions remain as to whether it was politically prudent and legally correct on the part of the West to support Kosovo's quest for sovereignty in 2008.

While the merits of some policies remain open for debate, it is harder to defend the West's notorious ambivalence in the face of human rights abuses (examples abound)—and hard indeed to excuse a general mood of indifference. "Had a truly internationalized peacekeeping and negotiation format been in place in South Ossetia and Abkhazia, Moscow would have been much less likely to go to war." The statement once again illustrates the West's consistent failure to attach a higher political cost to Russia's increasingly aggressive stance toward former Soviet Republics.

Apart from exposing complacency, internal division and lack of political will and vision, recent events in the Caucasus also seem to reveal the inherent weakness of international law. On the one hand, it is rather rigid. The Montevideo Convention, for example, features basis criteria for statehood. Changing these criteria is possible in principle, but would require a consistent practice on the part of governments. This kind of consistency, however, is sadly absent today as governments (not just authoritarian ones) almost routinely give in to the temptation of putting legal precepts at the service of political objectives. As one panelist cynically put it: "Since every major power seems to have taken its own unilateral decision to recognize one or the other territory as an independent state, China will probably recognize Nagorno-Karabakh any time soon..." The inconsistency in how governments around the world respond to appeals for sovereignty or the elimination of human rights abuse is remarkable indeed and cannot but lead to insecurity on the part of the actors involved.

Reservations and amendments

Whereas U.S. administrations and European governments were strongly criticized in light of their past policy record in the Caucasus, EU crisis management in August 2008 was repeatedly praised in the course of our discussion. The immediate response had been for the French EU presidency (President Sarkozy and Foreign Minister Kouchner) to fly to Tbilisi and Moscow and to initiate negotiations.

Drawing lessons from the conflict, several discussants called for the elaboration of a long-term strategy on the part of Europe and the United States. Failure to agree on a clear political and economic vision will make the international community complicit in all that can go wrong in the future instead of making it a stakeholder in the benefits that Eurasia can bring. "So shift your gears strategically; engage more actively in the region!" Yes indeed, but how should that be done? Here again, there were as many questions as answers. For example, how should the burdensome issue of peacekeeping be handled in the years to come? Has Russia permanently disqualified herself as a peace facilitator in the region? Some deem it

necessary for Europe to dispatch a strong mission to secure Georgian statehood by interposing a force that would serve as a deterrent against renewed Russian aggression. These forces' mandate would have to encompass the entire territory of Georgia including the conflict zones in South Ossetia and Abkhazia so as not to serve as a tacit legitimization of new borders. Others do not want to go that far, but call for comprehensive aid packages to strengthen Georgia's state institutions, defense capabilities, and economy.

Impressive statements came from representatives of the region itself. They, too, called for a clear strategy and long-term engagement on the part of the West to prevent similar crises and wars in other parts of the region, Nagorno-Karabakh above all. At the same time, however, they put emphasis on the role and responsibility of the Caucasian countries themselves. How can there be genuine progress when good governance is still mostly absent from the region? "Azerbaijan has what seems to be a dynastic approach to governance. Georgia saw the Rose Revolution, but, while it has taken positive steps in the direction of rooting out corruption and arbitrariness, it is still quite unclear to what extent there is democratic process or respect for minority rights. In the fifteen years of its sovereignty, Armenia has lost over a million people due to brain drain, injustice, lack of human rights and sham elections. And nobody else is to blame for that, neither Turkey nor any other neighbour. In fact, we are to blame for that." The implication is clear: Support from the outside is welcome, yet the young Caucasian states need to take responsibility for their own problems.

II. The Caucasus and Central Asia: A Concern for International Security?

While the first session was almost exclusively devoted to recent events in the Southern Caucasus, the second session was supposed to broaden the picture. One fundamental question stood at the heart of a lively exchange: How do we account for the notorious instability in (and among) former Soviet Republics? Intriguingly, we ended up talking about the relative importance of structural factors as opposed to real people—and about Russia.

The standard geopolitical argument

One could start with a line of interpretation that can easily be found across the academic board and in the media. According to this standard argument, the collapse of the Soviet Union led to a power vacuum in the region which in turn was an invitation for renewed geopolitical struggle. The most important regional players, that is, Russia, China, Turkey, and increasingly Iran, are seeking to either reassert or gain new influence in the region. As Central Asian states dispose of natural resources in a period of perceived energy scarcity, there are further incentives for the Americans and the Europeans to get into the game. Recent efforts to construct and operate a number of pipelines that would circumvent Russia demonstrate to what extent economics and geopolitics are intertwined in the region.

Another facet of the standard geopolitical argument is that the present situation is basically a result of Nine Eleven and the United States' infamous War on Terror. It led the West into Afghanistan and a protracted conflict which is now spreading into Pakistan. It also led the United States to lease two former Soviet military bases in the region, one in Uzbekistan and one in Kyrgyzstan. In fact, Uzbekistan, Tajikistan, and Turkmenistan are all of vital interest to NATO. They are Partnership for Peace countries and Robert Simmons, the Secretary Gen-

eral's representative for the Caucasus and Central Asia, repeatedly claimed that the Alliance could draw on its rich experience to become the guarantor of the area's energy security.

On the other side, we find the Shanghai Cooperation Organisation, a regional security organisation whose members include China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan. India, Mongolia, Iran and Pakistan have observer status. Originally created to deal with some border issues amongst the member states, it has increasingly been seen as a potential vehicle for Russian influence, but the Russians seem to have miscalculated the degree to which they would receive political support from this organisation in the most recent conflict over South-Ossetia and Abkhazia.

According to the standard geopolitical argument outlined here, the perspective for conflict and instability in the region is basically to be found in old-fashioned international politics. States pursue their interests and thus compete for influence. When and wherever there is a power vacuum, it is expected that competition will become more intense. Obviously, there is something to all of these facets of the standard argument. Skeptics contend, however, that it does not touch upon the fundamental problem.

A structural argument

According to a different line of interpretation, the fundamental problem is to be found in the imperial legacy of the region—a legacy left behind by the rapid and comprehensive collapse of the Soviet Union. To understand why issues such as good governance or the lack of state capacity are so prevalent there, we would have to think about the sort of system the Soviet Union constructed and the results of its rapid collapse.

Empires are characterised by certain features, notably by a core and a periphery. In some ways, these structures resemble a wheel, with a hub and spokes going out to peripheral units. The units at the periphery do, of course, not have direct relations amongst themselves. In other words, the wheel is incomplete because the rim is missing. Since the economic and political relations have always been between the periphery and the core, but never amongst the peripheral units themselves, the collapse of the imperial core and the emergence of independent units at the periphery leave these units in a particularly weak position with respect to dealing with one another.

As a result, these new states often have to deal with a security dilemma. They do have some military capabilities, but increasing their strength to ensure their security inevitably makes their neighbours nervous. The very fact that there is no antecedent for their dealing with one another on these security issues creates a very real potential for misperception and the sort of arms race dynamic that can easily get out of hand and cause trouble. This seems particularly to be the case for Armenia and Azerbaijan.

Imperial collapse also tends to breed revolutionary leaders and these leaders usually want to build a strong state. From this perspective, efforts to capture state power and centralize control can hardly come as a surprise. It should be noted, however, that political elites at the core have a much greater capacity to exert their power than those at the periphery. The core, after all, still has a remnant of its previous imperial habitus and prestige; thus efforts to reassert control are likely to be more successful here than at the periphery.

According to this line of argument, Russian attempts at reasserting authority in the former imperial periphery look almost natural. More importantly, they should be seen not as a func-

tion of a leader such as Vladimir Putin but of deeper, structural factors. "Putin makes it worse, but if he were not there, somebody else would try to achieve much the same."

Usually, post-imperial elites—both in the periphery and in the core—depend on some legitimizing and often rather nationalistic type of ideology. As regards the core, it would be interesting to compare the ideology of Putin-based elites today with previous Russian ideologies such as the one developed in the 19th century to legitimise Tsarist rule. Orthodoxy, autocracy, pan-Slavism, xenophobia... Here is an older set of ideas that can be revived if need be. How much of the stress laid in Moscow today on the menace confronting Russia from the outside (NATO, USA, EU) is founded not on real antagonisms, but rather on the need to explain and defend the consolidation of authority and to reassert Russian control over distant and unconnected parts of its former empire?

It is interesting in this regard to examine how the experience in the Caucasus and Central Asia differed from that in Eastern Europe. In Central and Eastern Europe, many states had a relatively robust institutional apparatus. By disregarding that fact, we tend to draw a false analogy between the situations in the two regions—and wonder why things cannot be better in the Caucasus and Central Asia. Yet, by keeping in mind exactly how the Soviet Republics were locked into a system of imperial control, we find a plausible explanation.

In conclusion, what would the Caucasus and Central Asia look like if they were left alone; if we had no geopolitical competition over energy resources there, no War on Terror and no clash of civilisations? The structural argument holds that the entire region would still be prone to instability.

Against the structural argument: The Putin factor

Not surprisingly, the merits of the structural argument were hotly debated. "Practitioners realize that individual leaders are important while political scientists argue that that cannot be the case, it's an old story." According to the skeptics, even post-imperial states can act in two ways: Either they forget their former empire or they try to revive it. Political choices depend on leaders, on their political will and on configurations of power. Rather than trying to reassert control over a lost empire, President Yeltsin and his prime ministers were strongly committed to the national integrity of the former Republics. In fact, Yeltsin concluded no less than six agreements on the national integrity of Ukraine, a position which President Putin has been trying to reverse. Clearly, then, political leaders matter more than structural factors! The fundamental problem, according to this view, is former president and current Prime Minister Vladimir Putin. "Russia's aggressive foreign policy makes little sense for Russia, but a lot of sense for Putin. Russia has today 2.5 percent of world GDP and 7 percent of the US military expenditures. Obviously, the country does not have the strength for the policy it pursues. Why does the leadership pursue it nevertheless? Because Putin's first and foremost goal is enrichment pure and simple."

Enrichment seems to occur in many ways. One example is Gunvor, one of the world's major independent companies specializing in the trade, transport and storage of oil and petroleum products. Incidentally, Gunvor is the name of the grandmother of Torbjorn Tornqvist, who in turn is a partner of Gennady Timchenko, one of Putin's men. Registered in Geneva, Gunvor today is the third-biggest oil trader in the world. It is buying oil from four Russian oil companies, two of which are state-owned and two are private, at ridiculously low prices. "So partly this is enrichment from state companies, partly this is money laundering and tax evasion and possibly extortion from private companies—all to the benefit of Mr. Putin."

On many accounts, big money is diverted in Russia as well. "In order to be able to do that, Putin needed an authoritarian state. In order to build an authoritarian state, he needed external threats and enemies that would justify an aggressive foreign policy. Had not the West done everything to bring about the collapse of the Soviet Union?" A sober analysis corroborates that kind of statement rather than disqualifying it. Ever since he became acting president in 1999, Vladimir Putin has moved progressively to snuff out even the faintest flickers of democracy that he inherited from Boris Yeltsin. He has crushed opponents, emasculated the courts and parliament, eliminated independent broadcast media, scrapped the autonomy of Russia's regions and blatantly manipulated elections. In short, President Putin has managed to dismantle all democratic institutions and build a highly authoritarian system. Today, Russian state TV spews nationalist propaganda, and if the Prime Minister himself does not encourage racism, he does call for ethnic discrimination in favor of Russians. A shrewd manager of his own image, Putin has established a strong personality cult reminiscent of the czars, not least with the aid of broad and firmly entrenched youth organizations such as *Nashi*. A politician rather than a statesman, he seems to pursue neither higher purposes nor a political vision. His main objective, instead, is money and power—the more of it, the better.

To many observers, it was a foregone conclusion that Putin would stay in control beyond his second term as president of Russia—and with hindsight, the cynicism of 'Operation Successor' seems worthy indeed of Mr. Putin's former employer, the old KGB. On many accounts, the sham transition in the spring of 2008 came as the ultimate eye-opener for those observers who had still believed in the possibility of democratic reforms and who had been trying to bring Russia into the Euro-Atlantic community. As one discussant put it, "it was a kind of collapse of all the aspirations that we had. It was the end of our dreaming of a democratic Russia."

How stable is Russia?

While President Putin obviously managed to restore centralized control, many find it hard to see a stronger government today. They point to the fact that Russians still have to put up with a patently flawed bureaucracy, notoriously weak law enforcement, and poor public infrastructure. The common denominator of all these problematic sectors is public ownership. Bad governance and state failures, in turn, are reflected in endemic corruption, high murder rates, and high numbers of traffic deaths. Few social indicators have actually improved for ordinary citizens. Weaknesses of this kind seem to be common features of the new Russia. Corruption, in particular, has become more pervasive than ever and seems to be a driving force even in the upper and top echelons of business and politics. "Particularly at those higher levels, being corrupt is totally acceptable." Thus Vladimir Putin effectively reintroduced major elements of the czarist and Soviet system: over-centralization, minimal feedback, and pervasive corruption.

But again, how stable is the system today? One discussant offered this analogy: "If there had been no energy crisis at the end of the 1970s, the Soviet Union would have collapsed much earlier. Today we see much the same thing in that higher oil prices are prolonging the life of the Russian Federation. What would happen if a genuine economic downswing occurred?" Studies across the board indeed indicate that there is only one truly relevant factor for public opinion, namely the economic confidence index, which has been understandably 'good' in recent years of high oil prices and exorbitant growth. Should times get tough economically, public sentiment could swing.

What are the prospects, then? Will the young generation make a difference? Hardly, our skeptics say. They point to the fact that the so-called Putin generation, ranging in age from sixteen to twenty-nine, agree very much with Prime Minister Putin that the collapse of the Soviet Union was the greatest geo-political catastrophe of the twentieth century. Even more disturbingly in a country where tens of millions of people were killed as a result of World War II, young Russians are convinced that Stalin did more good than harm.

In the short term, then, there may be little reason for optimism. In the medium and long term, however, things may change for the better. Russia is gradually turning into a society with middle income segments accounting for a quarter of the total population. Ever more young Russians opt for higher education. According to UNICEF statistics, the share of Russian college-age youth that go to university nearly doubled from 25 percent in 1989 to 47 percent in 2005. On the basis of a broader definition of higher education, UNESCO arrived at 71 percent for 2005, which is more than the average number for the European Union.

The farther we are looking ahead, the brighter the prospect becomes. Historical experience shows that economic and political pluralism have largely developed in parallel, with market developments usually preceding democracy. At some point, Russian society may be too rich, too economically pluralist, too educated, and too open to be ruled in an authoritarian way. A natural development would then be that Russia in due time will throw off its authoritarian yoke and opt for more genuine and more tolerable versions of democracy.

Coping with the Russian bear

Throughout the 1990s, there was not much of a Russian foreign policy. Things started to evolve in 2004 and, more particularly, after Russia had paid off its debts in early 2005. Ever since, one conspicuous feature of Russian foreign policy has been that the Kremlin prefers to deal on a bilateral rather than a multilateral basis. At a time when the Europeans cultivate a rather elastic conception of sovereignty, Russia is resolutely marching in the opposite direction and does not seem to pay much attention to the rest of the world—an attitude that comes easier in the absence of clear signals and coherent responses on the part of inter- and supra-national bodies such as the Council of Europe, the OSCE, and the European Union.

Over time, then, Russia's foreign policy has become much more assertive on just about every front. The introduction of hard power is one important aspect in this context, another element is the systematic projection of soft power abroad. In the United States, the Russian government is paying for inserts in the *Washington Post*, for example. On some accounts, Russia has not even stopped short of challenging the very integrity of NATO. The remarkable 2007 Cyber War on Estonia may plausibly be interpreted that way. In the Caucasus, Russia's foreign policy mix includes military, political and economic elements. "In Armenia, they have crept in through the energy sector, by gradually taking over crucial components of the entire system."

What are plausible policy options for Europe and the United States? What could and should the West do with a view of fostering stable political and economic relations with the Russian bear?

As the Cold War is over, *containment* does not seem to be an option. Today, 90 percent of the titanium that Boeing buys comes from Russia: one figure to suggest that a new version of containment would not only be hard to implement, but would also hurt both sides. Next, *integration* of Russia has clearly failed so far. Is it worth trying again, as long as Putin's system is in place? If not, what is there to replace containment and integration? An ideal approach

would, of course, start with a coherent U.S.-European strategy. Only, how much quiet diplomacy would be necessary to accomplish just that?

In light of the structural argument discussed above, at least some general points can plausibly be made. As a start, Western policy toward the newly independent states of the Caucasus and Central Asia should be geared to strengthening state capacity, improving governmental relations between these countries, and fostering closer ties between their societies. In an odd way, even Russian efforts to create some sort of counterbalance to the US and NATO with arrangements like the Shanghai Cooperation Organisation seem to boomerang as these organisations are bringing their member states together and allowing them to talk about political and strategic issues in new ways.

Beyond that, the West would do well to think about how to strengthen civil society within Russia and, more specifically, how to use international institutions to strengthen certain domestic interest groups and civil society at large. Here again, however, impediments are legion. "There are so many things we could have done in terms of supporting civil society in Russia and Georgia. The Bush administration, however, has cut funding for democracy and human rights programs almost every single year for Russia."

At the same time, practitioners who have worked closely with Russian human rights organisations emphasize that there is a dramatic lack of capacity on the ground. More particularly, "there is an enormous amount of elitism within these organisations, and yes, it is true that in many instances Russian NGOs tend to look outside and serve foreign interests (e.g., donors) rather than be responsive to the needs of the Russian population. We have done a lot of work to find out what kind of assistance the Russian population thinks is all right. The result is sobering once again, as anything having to do with elections is not considered good, which brings us back to the issue of authoritarianism."

Finally, one plausible objective with regard to the Kremlin would be to increase the cost associated with attempts to reassert imperial control and at same time show the Russians ways and options of guaranteeing their own security. But again, how should this be accomplished? By further expanding NATO? In this context, several discussants complain "a real lack of thinking" in the last fifteen years on the part of the security community. "No matter what the problem is, the only reliable tool that we have is NATO and NATO expansion. Clearly, there must be a wider range of security tools than just NATO expansion, as the latter cannot be our response to every challenge."

III. Central Asia and Its Potential for Sustained Economic Growth

Central Asia, while physically very large, is small indeed in terms of both population and economic output. The region never held a dominant stationary population, nor was it able to make use of natural resources on its own. Instead, Central Asia was divided, re-divided, conquered out of existence, and fragmented time and time again.

In addition to sharing a long history and religion (Islam) as well as ethnicity, for much of the 20th century the five countries of Central Asia also had a common political and economic system as an integral part of the Soviet Union. After its collapse, economic ties with Russia and amongst themselves withered away. While the newly independent states went through a difficult decade in the 1990s, all five enjoyed economic growth since the turn of the century.

The transition process away from central planning is basically over, and the market-based economies emanating from this process vary considerably. Their prospects, too, are very unequal, which means that we need to focus on the national rather than the regional level. Even at that more individual level, however, predictions are hard to make. Countries such as Turkmenistan and Kazakhstan have become almost entirely dependent on the revenues from oil; their economic prospect is largely a function of how long the commodity boom will last and how they make use of the windfall.

Zooming in

All countries in the region have retained 'super-presidential' political systems with very weak parliaments. In such systems, the quality of individual political leaders clearly matters as much as structural factors. In the two largest countries, Uzbekistan and Kazakhstan, we still find Gorbachev-appointed presidents—and no one quite knows what is going to happen when they leave office.

Of the five countries, *Turkmenistan* is the easiest to analyse in that it has the simplest economic structure. Ever since the end of central planning, reforms have been rare. The economy is highly rent-dependent; the most reliable estimates are that during the 1990s, 40 to 60 per cent of GDP consisted of rent from cotton and oil.

Where has the money gone? First of all, revenues were spent on populist policies such as free gas and free electricity to keep the population acquiescent. Secondly, money was spent on fairly wasteful industrial projects intended to replace imports. Huge sums were invested in textile mills that produced jeans whose value was less than the value of the cotton that went into their production. Thirdly, money was spent on building statues, palaces and monuments for President Turkmenbashi.

For these reasons, the economy was in exceedingly poor shape by the end of the 1990s; it picked up in 2000 as the earnings from gas started to improve. In 2006, President Turkmenbashi died. In the West, this was seen as a splendid opportunity for genuine reforms. Not much has changed, however, and today, the situation is hard to assess. In August 2008, for example, there was fighting in the northern suburbs of the capital; first reports on BBC and Al-Jazeera were about Islamic militants fighting the security forces. Half an hour later it was said to be a drug-related battle. Apparently, even people living in the capital do not really know what is going on.

The other country that is very energy-dependent is *Kazakhstan*. There, too, the economic turnaround started at the end of the 1990s. In spite of pervasive corruption at all levels, economic development is much more firmly based than in Turkmenistan. While the President of Kazakhstan had become the richest ruler in the world by 2000, there were also fairly substantial reforms, and today Kazakhstan has the best-functioning market economy in Central Asia. Economic policies have basically remained on the right track in the 2000s. At least parts of the oil revenues are used for investment in education, diversification of the economy, strengthening agriculture and the establishment of an Oil Fund. In the wake of a recent, home-grown housing bubble and banking crisis in Kazakhstan, good macro-economic management is crucial. There is also much uncertainty as regards the succession to President Nazarbayev. Even so, chances for sustainability in terms of economic development seem intact.

Kyrgyzstan was probably the most reformist of the Central Asian countries in the 1990s. Today, the economic prospects seem less bright than elsewhere, partly because of poor resource endowments, partly due to geographic isolation. Moreover, there are hardly any effective

institutions to support the market economy. In the wake of the Tulip Revolution of 2005, there was another period of political and economical instability, and pessimists worry that the country may actually be descending into social and economic chaos.

Tajikistan also suffers from being isolated, from a lesser endowment with natural resources and from a highly destructive civil war between 1992 and 1997. A major source of revenue, about a third of GDP in fact, is labour remittances from abroad. In other words, the economy is heavily dependent on economic cycles in neighbouring countries such as Russia and Kazakhstan.

Uzbekistan matters not only because it is the most populous state in the region, but also in light of its geographical situation: it is the only Central Asian country bordering on all four others. In spite of a population of 27 million, it has a much lower GDP than Kazakhstan with 16 million inhabitants. These are the two largest countries in the region but clearly, Uzbekistan is the more enigmatic case. The country underwent limited reforms during the 1990s with Tashkent, formerly the capital of Soviet Central Asia, still serving as a mini-hub of sorts. Therefore, Uzbekistan had the least bad economic performance in the 1990s of any Soviet successor state including the Baltics. Limited reforms, however, provided a poor basis for growth in the subsequent period. Moreover, there were a series of dubious, if not outright erroneous policies towards the end of the decade, particularly in regard to the regulation of the foreign exchange market. The result was a new wave of interventions in, and regulation of, the economy.

Regional issues

Marked differences amongst these five countries notwithstanding, there are a number of common concerns. A first one is security, fighting "terrorism," for example—an issue that is used by several regimes to justify various levels of repression. A second common concern is the supply of water and energy. The five countries under scrutiny actually define Central Asia in geographical terms, as they are located in the basin of the two rivers that feed the Aral Sea. Undoubtedly there has been a major ecological disaster in that area. The spectre of water shortages looms large, and there is a potential zero-sum conflict between the upstream states on the one hand and downstream states on the other. The upstream states (Tajikistan and Kyrgyzstan) need water for hydro-electric power, whereas the downstream states (Uzbekistan, Turkmenistan, and Kazakhstan) need this precious good for irrigation, which requires release at different times.

A third regional issue is trade facilitation. All Central Asian economies are more or less open, as is demonstrated by high export/GDP ratios. Still, they trade below potential on many accounts. Why? One major reason is the cost of trade, a cost multiplied by bureaucracy, manifold obstacles to crossing borders, and regulation—and a cost exacerbated when several borders have to be crossed. Uzbekistan, for example, is among the few double-landlocked countries in the world: each country bordering Uzbekistan is a land-locked country as well.

While there have been several attempts at enhancing regional cooperation, most of them have broken down. Regional agencies and organisations with an economic agenda have not made much progress, either. The Russian-led *Eurasian Economic Community*, for example, meant to achieve a customs union by 2005, recently announced that over 5,000 tariff lines had been unified between Russia, Uzbekistan, Kazakhstan, Kyrgyzstan and Tajikistan. It turns out, however, that these are tariff lines with no or little impact. *The Central Asian Regional Cooperation* in turn, sponsored by the Asian Development Bank and other multilateral institu-

tions, is considered the broadest and most promising forum in operation. Yet here, too, progress towards facilitating trade in the region is painfully slow. The primary objective of regional agreements such as the *Shanghai Cooperation Organisation* is to foster political rather than economic cooperation.

The bottom line is sobering: even though there are a number of commonly shared problems and concerns, regional cooperation worthy of that name is indeed hard to find, be it in the realm of security, be it on water and energy supply, be it on trade facilitation. In the words of one representative of the region: "Central Asian countries do not differ much in terms of language, culture and mentality. Still, we have not really developed relations with our neighbours as yet. In Soviet times, there were ten flights from Dushanbe to Samarkand on each and every day. Today, there is not even one flight, there is not a single flight to any Uzbek city from Tajikistan."

Neighbours, living together apart

What is behind this remarkable lack of cooperation? In search of answers, we are reminded of the structural argument discussed earlier on. Since economic and political relations in the Soviet Union were mainly between core and periphery, the collapse of the core leaves the newly independent units in the periphery in a weak position with regard to dealing with one another. "When Central Asia became independent from Moscow, all countries started out by closing their borders to demonstrate their newly found independence." In the early 1990s, there were indeed no borders at all. Part of the nation-building process was to erect fences, barriers and border guards. As time went by, the corresponding installations became more and more sophisticated. Incidentally, they were financed by EU programs to support border-management. In many instances, new borders cut formerly integrated areas in two.

In the absence of a recent history of cooperation, the security dilemma is an ever present problem as well. Misperception comes easily, and there is deep suspicion even amongst neighbours. It does not help relations, for example, when the president of Turkmenistan accuses the president of Uzbekistan of plotting a scheme including his own assassination.

Of course, these factors do not suffice to explain Central Asia's economic ailments. Compared to Latin America, growth rates are about twice as high in Central Asia after all. Higher education is also better. Why, then, is progress so slow?

We discussed four central drawbacks. A first and huge one is corruption ("by far the biggest vice in the region") with a devastating impact on the economy in general, on entrepreneurship in particular, and last not least on the rule of law. In this context, Russia provides a terrible example right next door. In many places, corruption has reached a point where infrastructure can hardly be built anymore. In Russia, the overall length of paved roads and oil pipelines has not increased since 2000. At this stage, many companies are so corrupt that they take the money rather than build—and the kickback for the little that is built are half or more of the total amount.

A second problem is emigration. Many among the former Soviet Republics have lost a considerable portion of their populations. The worst-hit have been Georgia and Armenia with losses of around 25 to 30 percent of their population. Tajikistan has also lost 20 percent, but can compensate quite well thanks to a high birth rate. Thanks to immigration from these states, Russia is stable in population while Muslim countries at the periphery are growing. Today, the Caucasus and Central Asia are clearly among the most active parts of the world in terms of migration. Of course, that need not necessarily be bad in itself. Migration, however,

must be embedded in a framework of accepted rules. In the absence of such rules, migrant workers may lack even basic protection.

A third problem stems from over- rather than from under-regulation and sheds further light upon the notorious lack of cooperation in the region. Uzbekistan and Turkmenistan, for example, have highly regulated price systems. One implication is strict border controls, because selling subsidised goods abroad would mean supporting one's neighbours rather than oneself. Equally, if anyone were to allow free trade for goods that are highly taxed at home, they would lose tax revenues. There cannot be any integration between Uzbekistan and Turkmenistan as long as these countries maintain Soviet-style command economies, which is really what they seem to do.

At present, only five of the twelve countries of the Commonwealth of Independent States are members of the World Trade Organisation. Even where there are free-trade agreements, they do not have much of an impact, as there are no sanctions for non-compliance. The best solution, therefore, is not a new trade agreement—there are plenty already. Instead, all Central Asian countries should simply follow the example of Kyrgyzstan and join the WTO.

A fourth and last issue is inflation. In Central Asia, it is currently around 15 percent on average. Rather than moving on to flexible exchange rates, several countries still stick to fixed rates, and while the effects of poor exchange rate policies should not be overestimated, they certainly can thwart economic growth and development in the short and medium term. The same holds true for the current financial and economic crisis which is rapidly proliferating to the region (in the fall of 2008).

What others (could) do

Obviously, the outside world is present in Central Asia. Russia continues to be the dominant external stakeholder even if China has a considerable and increasing impact on the region. (Let it be said at this stage that China's role was evoked on several occasions. This crucial actor was ever present, but alas not represented in our discussion.) Turkey, in turn, exerts considerable influence on account of its ethnic and linguistic ties; visa requirements for citizens of the Central Asian Turkic republics were eliminated in 2008. Iran, too, the seat of former empires which controlled parts of Central Asia after all, has manifold links to the region and is vying to construct an oil pipeline from the Caspian Sea to the Persian Gulf.

And the West? The United States was remarkably quick in opening embassies in the former Soviet Republics, but has had difficulties in finding an interlocutor ever since. At some point in the 1990s, Uzbekistan became a curious ally of sorts. There actually was a vote in the United Nations, where the U.S. was in a minority of three along with Israel and Uzbekistan—a rather peculiar configuration. Today, American armed forces still employ (and pay for) a military installation near Bishkek, the capital of Kyrgyzstan. Overall, however, there is much reluctance about American presence and involvement on the ground.

The European Union, in turn, has tried to promote values, while money was mainly spent on programs to support border management and to fight the illegal trade of narcotics. The EU's physical presence has been rather modest. It did increase in 2007 under the German and Portuguese Presidencies, but came to a complete halt afterwards. Apparently, it is not only in the United States that priorities shift with presidencies.

Over the last decade, Central Asia has seen considerable foreign investment, in some countries to the tune of 25 percent of GDP. These investments mostly came from Russia and

China, and the money mostly went into the energy sector. The flow of money, of course, is only one aspect. If foreign direct investment has been so crucial in the energy sector, for example, it is because of the technology transfer that goes along with it.

The amount and quality of foreign direct investment is one area where the outside world might be able to help. Also, Western governments may try harder to bring Central Asian countries together with a view of reaching agreements on trade facilitation. Progress writ large, however, will require large-scale efforts and reforms in the Central Asian countries themselves, efforts and reforms which in turn depend on more adequate institutional arrangements on the one hand and political will on the other.

IV. The Economics and Politics of Oil and Gas Resources

After devoting the third session to Central Asia at large, the colloquium turned its attention to recent trends and developments in the oil and gas sector. Here, the discussion was structured along four specific questions. (1) Since any country that is lucky (or unlucky) enough to be endowed with energy resources has a chance of monetising the reserves, a first crucial question is how to develop and organise a national oil-strategy. - (2) To what extent should external oil and gas companies be engaged in the process? - (3) Another relevant issue is transportation, that is, access to markets. There is a lot of oil and gas in the region, but reserves are landlocked mostly. Getting the commodities from A to B brings cross-border, if not wider geopolitical issues. - (4) A last issue concerns revenue management. Once the oil is produced and revenues are handed to the treasury or to the government, the question still is how to use the money. If things go astray in this context, not much will have been achieved beyond waste, fraudulent personal enrichment or a blend of the two.

Through the prism of energy markets, we recognize a conspicuous shift in dynamic. While dominant producing regions such as Russia and the Middle East have been declining in relative terms due to deferred investment, several factors have enhanced the political and economic relevance of both Central Asia and the Caucasus and amplified the need for the region to become fully accommodated in economic and security terms.

Wider market developments have been directing the region's rise to prominence in world energy markets: an energy demand shock in the Asian-Pacific and declines in Euro-Atlantic production pushed crude oil prices from \$18 per barrel in the late nineties up to peaks of \$140 in 2008. On top of that, asymmetric energy market policies among increasingly assertive state producer markets on the one hand and liberalized consumer markets on the other keep deterring urgently required energy-sector investments in both major production and demand centers.

Geopolitical concerns in the wake of Nine Eleven as well as technical constraints on major field development in Siberia have further contributed to this shift in dynamic. While hitherto-dominant players still try to fix the terms for investment and technology transfer to launch the next major investment cycle in Russia and the Middle East, an Eurasian small-field policy is particularly favorable to Caspian investment, but also encourages new market entrants and outlets.

These trends combined continue to push the Caspian and Central Asian countries to the centre of energy markets. In this context at least, the region is going global at dazzling speed. It

will certainly use what is widely perceived as a window of opportunity to attract investments on better terms than thought possible before. The wider world, on the other hand, has been remarkably slow to recognize the crucial need for oil and gas market diversity and this region's strategic location between Euro-Atlantic and Asian-Pacific players for satisfying this need.

In the oil sector, much remains to be done in view of full integration into world markets, but things are moving forward along predictable, market-driven rules and patterns. In the gas sector, progress is slower and more erratic. Why? Because gas is notoriously subject to political games. In this game, some excel and others don't. "The United States has to be complimented in that it has a policy worthy of that name, and one which in fact has been rather effective. The European Union, on the other hand, sadly lacks a consistent policy on the issue." Some even argue that it was precisely the absence of a clear EU energy policy outreach to the Caucasus that invited Russian assertiveness in keeping the gas game under its control.

A strategic game with many players

Beyond politics, there is a market logic for Russia's position. Central Asian gas provides a crucial bridge that Gazprom needs to maintain supplies to the European Union—and a strategic time-window of opportunity for implementing huge investments needed in the Yamal Peninsula where Russia's largest natural gas resources await exploitation.

From the European perspective, Central Asia provides a gateway that allows for diversification of gas imports. This aspect has been (or rather, should have been) obvious ever since President Putin, holding the G8 presidency at the time, confirmed that Russia would not ratify any Energy Charta or related treaties. It became clear, then, that the Kremlin was not going to play the energy game in accordance with OECD-type market rules. Subsequent supply cuts and much erratic rhetoric further enhanced the importance of southern corridors and of Central Asian gas to diversify rising import dependency on monopoly-controlled exports.

From the Asian-Pacific perspective as well, Central Asian energy supply bridges deferred investment in Russia's gas fields, and, more particularly, offers a back door to China's dependency on sea-bound supplies. The Chinese have indeed been keen on getting access to Central Asian gas, particularly in Turkmenistan, where China is the only foreign investor that has been allowed to develop on-shore resources. This, in turn, might soon start to eat into the volumes that Turkmenistan has pledged to export to Russia, though the Turkmens themselves believe that they can export in all directions and "be everything to everyone at the same time." For the time being, prospects are that Turkmenistan could indeed export to Russia, China, Iran, the trans-Afghan pipeline, and the trans-Caspian pipeline at the same time.

The example of Turkmenistan is telling. Can Central Asian and South Caucasian stakeholders, whose rational self-interest is quite naturally to seek multiple export and investment options, become and remain everything to everyone at the same time? Or do choices have to be (un)made in favor of 19th century-styled alliances in the wake of the Georgia crisis? While the jury is out on this question, investment decisions of Euro-Atlantic stakeholders are likely to be slow-tracked once again.

Certainly, the Georgia crisis will have an impact on further developments. Russian moves included bombing sites that were close to the South Caucasus Pipeline and the Baku-Tbilisi-Ceyhan Pipeline. The bombings suggest that Moscow could, if it would, harm or destroy these facilities. To some discussants, therefore, the recent conflict challenges the reliability of

the Southern Corridors. Alternatives offered by the Russian gas monopoly, such as the South Stream project, would then appear to be more reliable and, certainly for Central Asian producers, closer at hand. To others, Russia's "proven unpredictability" is exactly what vindicates them: Oil and gas flows have, in fact, not been affected in the Georgian-Russian conflict, other than by precautionary shutdowns. Therefore, confidence in their reliability should be intact.

Be that as it may, it seems only natural for both the Euro-Atlantic and the newly independent states of the South Caucasus and Central Asia to strengthen economic ties in order to counterbalance Russian and Chinese interest with Euro-Atlantic complements. In gas markets, this amplifies the need for diversification to avoid over-exposure to the unchecked market dominance of monopolists. The fact that gas prices for Turkmenistan and Azerbaijan have continued to rise in recent months (September 2008) quite simply reflects the fact that viable alternatives in terms of demand and exportation are indeed in place. Should the three major oil and gas producers in the region, that is, Azerbaijan, Turkmenistan, and Kazakhstan, fail to pursue credible gas export alternatives, gas prices will eventually slide back down again to reflect Gazprom's negotiating strength as a buyer.

Only, why should the Central Asian players stop pursuing their best self interest? There is a clear economic rationale for pursuing diversification. In other words: it is not the political agenda that matters most in this context. It is not, then, an issue of bypassing Russia, but simply of diversifying markets per se—which looks like a sensible thing to do in any scenario. "You want a choice, after all, which is one of the fundamental principles that markets function upon."

If this analysis is correct, there is indeed no need to be intimidated by Russian protestations about being bypassed. There is also no need to fret about whether Europe should diversify its energy supplies or not. Again, there are splendid economic reasons for diversification. Europe should, therefore, be much more proactive. That may well be their strategy, even though the aftermath of the Georgian conflict will be sending everybody back to the drawing board.

Has Western Europe been willing to accommodate the latest trends and recognize Eurasia as a new centre of gravity between the Euro-Atlantic and the Asian-Pacific? The Georgia crisis indicates that it has not. So far, European policies on the region, if formulated at all, have remained muted and reactive. Yet, what should the Europeans do? If we consider the Caucasus and Central Asia as a whole, enhanced market mechanisms and the facilitation of trade, once again, look clearly more promising than alternative courses of action in the medium and long term. This brings us back to the World Trade Organization, of course, but it could also lead us to envisage and develop bolder visions including full integration and EU accession. "If we could only start by making some genuine progress with regard to Turkey, it would already project tremendous confidence into the region."

Developing a national oil strategy: the case of Azerbaijan

After discussing Eurasia's increased relevance in the energy markets in a broad and comprehensive manner, the colloquium turned to more specific questions. Since any country endowed with energy resources has a chance of monetising reserves, a crucial issue is how to organise a national oil strategy in the first place. Do you operate on your own or do you engage external partners? What happens with the money once money is there? We discussed the example of Azerbaijan.

Early in the 1990s, Azerbaijan was in rather bad shape. The country was at war with Armenia over Nagorno-Karabakh; the economy was close to collapse; there were separatist movements in several regions of the country; state institutions were weak, if not non-existent. In 1994, a number of agreements called Contract of the Century were signed—and this marked the beginning of a concerted Azerbaijan national oil strategy. Its main objective was to make use of the oil and gas reserves to rebuild the country.

Azerbaijan's national oil strategy consists of four major components. Since capital, know-how and technology were lacking all-around, the first component was to invite major oil companies from all over the world to come and invest. Compared to the size of its economy, Azerbaijan actually managed to obtain huge foreign direct investments in the oil sector. In the wake of the Contract of the Century, about twenty-five different production-sharing agreements were signed with international oil companies led by British Petroleum. Two of them turned out to be a clear success, another ten or so were more or less successful.

The second component of the national oil strategy was to improve transportation routes. In addition to an existing pipeline to Russia, three pipelines were built, one minor line towards the Black Sea, plus two major projects, the South Caucasus Pipeline (SCP) and the Baku-Tbilisi-Ceyhan Pipeline (BTC). At first, these projects were considered to be geopolitical ones without any commercial viability. Today, however, an extension of BTC is under serious consideration, as there is not enough capacity to transport all the oil. Incidentally, Azerbaijan also built a gas-transportation route through Turkey and can fully meet the gas demand of Turkey and Azerbaijan. Since there are links between the Turkish and the European grid, there is a transportation route for Azeri gas right into Europe already.

Russia, of course, does not like that prospect. In January 2007, Gazprom offered to sell gas to Azerbaijan. "They offered a price of \$230 and said that was the price for everybody. We in Azerbaijan said that if it was for everybody, fine. However, Azerbaijan soon found out that this price was a rather specific price indeed and refused to pay. Russia then offered \$235. Azerbaijan decided not to buy Russian gas anymore and to invest heavily in its own production instead. In the summer of 2008, Gazprom asked us to sell our gas to them." The episode goes to show that if Russia tries to sell its gas to Europe at higher prices, there actually are viable alternatives. "We believe that there is enough gas in the Caspian region to at least marginally reduce the windfall profits of Russia in Europe, and therefore we hope to become a player in the European markets. Our first aim, however, is to develop multiple transportation routes and provide as many opportunities as we can—and then to cooperate in all possible ways and directions."

The third component of Azerbaijan's national oil strategy is effective accumulation and management of oil revenues. At this time, the world is consuming about 82 million barrels of oil per day. One million barrels of that oil comes from Azerbaijan. From these sales, the newly created Azeri Oil Fund gets a monthly income of about \$2 billion. The Fund is expecting to receive about \$100 billion in the forthcoming five years at an oil price of \$70 per barrel. The Oil Fund is a sovereign wealth fund owned by the government. It accumulates all the oil and gas revenues and then transfers a certain share of the money into the government budget. This is different from other countries where all revenues go into the state budget and then the surpluses are taken out. In Azerbaijan, all the oil and gas revenues first go into the national oil fund; then the government decides how much it will transfer to the regular state budget and how much remains in the Fund.

The fourth element of the national oil strategy is investment in sustainable development. Different proposals have been examined for that purpose. People influenced by Soviet-style

planning wanted to establish big factories and create jobs directly—the more jobs, the better. In the end, however, another course of action was chosen. Its primary objective is to develop the basic infrastructure of the country as a stimulus for the private sector to create jobs. In other words, how could the private sector flourish as long as there is no water supply, no electricity, no highways and roads? Over the last five years, government spending into basic infrastructure has increased tenfold.

Revenues are used for social projects as well. In the aftermath of the war with Armenia, money from the Oil Fund was used to construct temporary settlements for large numbers of refugees from Nagorno-Karabakh. More recently, money has been channelled into education. According to one initiative, the Oil Fund fully finances students who are admitted to universities all over the world. The only requirement is to come back upon finishing college and work in Azerbaijan for five years.

What happens with the money the Fund does not allocate through the governmental budget? The economics of investment look simple and straightforward. All the money which is left in the Fund has to be placed outside the country in order to fight the Dutch disease. Investments go into international markets with a long-term, highly conservative strategy as laid down in fixed guidelines. The supervisory board is headed by the prime minister and includes the minister of finance, the minister of economic development, the chairman of the National Bank, the vice-speaker of the parliament and some members of parliament and representatives from academia.

In a country that owns and produces oil and gas, raising taxes and duties will hardly make its citizens happy. Still, the government has raised charges for electricity and water on several occasions since 2007 so as to avoid subsidization of entire sectors of the economy. In 2008, Azerbaijan was ranked top-performer by the World Bank in its doing-business report, moving significantly in terms of improving business environment. In spite of transparency and anti-corruption policies, however, corruption remains a huge and unresolved problem. According to insiders, the best way to avoid the diversion of oil revenues is to spend the money on tangible, manageable, feasible projects.

No level playing field

Toward the end of our discussion, the focus tended to shift back to the broader political and economic context in general, and to Europe's notoriously ill-defined positions and policies in particular.

One recurring topic was Nabucco. This pipeline project is an initiative by the Austrian OMV Group and south-eastern European gas companies to construct a major pipeline transporting gas through Turkey into Central Europe, thus diversifying European gas supplies. Obviously, this pipeline would create gas-to-gas competition with Russia with implicit relevance not only in terms of physical volumes but also in terms of prices. Nabucco, however, is not only an expensive but also a complex project. Many transit countries are involved, and implementation would require endless oscillation within the public-private interface. On top of that, the project has encountered not only political, but also bureaucratic procrastination on the part of the European Commission.

Transit problems, of course, are not only of a technical nature. Turkey, for example, is currently in breach of the transit provisions of the Energy Charter Protocol which it signed and ratified. Here again, posturing seems to be part of the game. "If Turkey is difficult on transit, the European Union may have to take the country more seriously."

Does it matter if the intended Nabucco hub in Baumgarten (Austria) is being built by OMV and Gazprom? In other words, does it make sense for the European Union to import Azeri gas to a hub which is co-run by a Russian company? The experts amongst us are not impressed by these arguments. "The role of OMV and Gazprom is less of a concern, because technically, a hub is still a hub." Thus diversification would be achieved regardless of ownership. On top of that, OMV is a company regulated by internal market legislation of the EU, a fact that further hedges against the abuse of dominant positions. The same is not, of course, true for Gazprom.

What will eventually decide the fate of Nabucco? Political considerations on the one hand or sober economic calculation on the other? A majority of discussants tend to emphasize the latter. "This is about business, so do forget James Bond." In other words: While bureaucratic obstacles may impede progress, while games and posturing may occur at the political level, what really matters at the end of the day is the economic viability of a multi-billion-dollar investment. And commercially, Nabucco clearly seems more viable than its rival South Stream. "From all we know, Gazprom could afford South Stream only at oil prices of approximately \$140 per barrel, not at \$70 under any circumstances. Gazprom, on the other hand, does not depend on a decision by the European Commission."

Obviously, Gazprom operates under conditions that are entirely different from the European context—and clearly with lesser constraints. The same goes for Chinese players. Much like the European Commission, the Chinese leadership started to worry about energy supply in 2006 when it dawned on everyone that pipelines from Russia were not going to work anytime soon. Alternative sources of supply had to be found.

But what a difference in terms of speed! "Whereas the Europeans started to talk, the Chinese governments would strike one deal with Uzbekistan and another deal with Turkmenistan in a matter of months and start building pipelines. As a result, a pipeline from Turkmenistan will be operational anytime soon and may begin to supply Chinese markets as early as 2010. Remarkably, the Europeans want much the same, but they are still just talking."

Clearly, there is no level playing field—but who is to blame? The Europeans seem to be trying harder than they used to. In fact, they may be doing the best they can in putting a coordinated policy together. The European Investment Bank's ability to invest in Central Asia looks like a good step forward. However, the best may still not be good enough. Human rights and governance issues, above all, continue to undermine the European Union's ability to engage with countries such as Turkmenistan and Uzbekistan.

On many accounts then, Gazprom and Chinese companies seem better equipped to operate in the former Soviet republics—at least at certain levels. "While they are used to push and go through with big projects, they find it much harder to do the smaller, incremental optimizing steps. This is why Russian gas production is in decline." If neither China nor Russia is able to cope with maintenance and more refined technological issues, one question is to what extent Western companies can accommodate to Uzbek or Turkmen realities.

University of St.Gallen
Graduate School of Business Administration, Economics, Law and
Social Sciences (HSG)

M.A.-Program in International Affairs and Governance

Varnbuelstrasse 19
CH-9000 St.Gallen
Switzerland
Tel. +41 71 224 31 33
mia@unisg.ch
www.mia.unisg.ch

St.Gallen 2009