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Libman, Alexander

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# **Regional Integration in Central Asia: A Firm-Centered View**

by

Alexander Libman,

CDSE Mannheim, IE RAS Moscow and ECNU Shanghai

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Regional integration remains among the main topics of international discourse in Central Asia, though the progress of international cooperation is very limited. Our aim is to understand the connection between the organization of economic institutions in Central Asia and the regional integration. The existing literature has explored the state level of integration in great detail: varying from rational choice explanations of security dilemma to the studies of social construction of the region in Central Asia. This paper, however, provides a firm-centered perspective on the regional integration. Thus, it first considers how varieties of political economies of Central Asian countries influence the regionalization process in the region through economic networks established by private actors, and how institutions are shaped by regionalization. Second, it considers how political institutions determine the impact of informal networks on formal regional integration initiatives, and looks at the potential effect of formal regionalism on regionalization process in Central Asia.

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## **1. Introduction**

Regional cooperation and integration remains among the main topics of international discourse in Central Asia. In fact, though the issue of the regional integration is perceived differently for different regions of the former Soviet Union, the overall consensus is that increasing regional cooperation could be helpful for Central Asia from the point of view of economic development and overcoming common problems. However, in spite of multitude of regional cooperation initiatives, both exclusively among Central Asian countries, and including both Central Asia and external actors – both post-Soviet and from other regions of the world, there is still no evidence of active intergovernmental cooperation in the region. Thus, regional integration in the Central Asia is still mostly a vague collection of “ink on paper” projects.

This paper, however, aims to consider a different perspective on the regional integration in Central Asia. It is well known, that the areas of relatively less effective regionalism could happen to be quite successful in terms of regionalization, i.e. interaction of economic and political actors beyond the formal intergovernmental cooperation across national borders. Main elements of the regionalization usually include stable trade networks, cross-border investments linking the countries through international chains of production and migration. The well-known case of “informal integration” is South East Asia, where foreign direct investments of Japanese corporations and cross-border Chinese ethnic business networks effectively substitute for lack of formal international integration (Peng, 2000; Kawai, 2005). In Africa cross-border trading networks play a similar role: while the official intraregional trade is estimated at the level of 6% of the overall foreign trade of the countries in the region, the informal trade flows not captured by statistics could reach the level of 30-50% (Meager, 1997). Similar processes are observed in Southern Asia, although they seem to be less developed (Taneja, 2001; Rafi Khan, 2007).

It is therefore interesting to check whether similar processes could be observed in the post-Soviet Central Asia. This paper focuses on a “firm-centered view” on regional integration, considering a firm the main agent of regionalization. We use a “broad” concept of firm, including e.g. international networks established by migrants or informal entities. Obviously, in this case the “borders” of the firm are weakly defined. Moreover, Breslin (2000) empathizes two important caveats with respect to the comparative analysis of regional integration of the dimension of “regionalization” is incorporated: first, the borders of regions

become fuzzy,<sup>1</sup> and second, focus on states as political entities to establish relevant integration areas is not necessarily correct – in particular, the so-called “microregionalism” and “microregionalization”, based on integration of subnational entities, can be very important. From the point of view of the first caveat, we define “Central Asia” as five former Soviet republics (Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan). On the one hand, this approach is reasonable because countries of the region share a relatively long period of common economic and political history and closed interconnections (one should be aware of the fact, that the very existence of the political entities and the nation-building in Central Asia is strongly influenced by the “national delimitation” policy of the Soviet Union in the 1920-1930s, see Abashin, 2007). However, on the other hand, Central Asia is still an “emerging region” (Kazantsev, 2005), i.e. its very concept, as well as structure of economic and political relations can be subject to re-definitions and turbulences. The second caveat is also ambiguous; all Central Asian countries are politically highly centralized (Ufer and Troschke, 2006; Leschenko and Troschke, 2006), and do not allow for active paradiplomacy of their regions. High political and fiscal centralization definitively does not support microregionalism: for example, in China, where microregionalism and microregionalization were quite important, they were also closely related to decentralization (Breslin, 2000a). In a similar way, Russia’s regions paradiplomatic activities emerged in an environment of high political decentralization (Magone, 2006). But on the other hand, geographical dimensions (especially in Kazakhstan) and poor quality of transportation (in all countries of the region), as well as internal differences (like those between northern and southern Kyrgyzstan) could theoretically contribute to clustering of economic activity on the subregional level.

The paper is organized as follows. In the next section it provides a short account of the regionalization process in Central Asia. The third section attempts to incorporate the analysis of the regionalization in a broader framework of the political economies of Central Asian countries, trying to understand, how their specifics influences the process of regionalization,

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<sup>1</sup> On the one hand, if one defines region as a cluster of economic and social ties, it obviously does not have any well-defined borders, unlike formal regionalism projects. On the other hand, public discourses and social sciences may represent the “mental maps” of “imagined” or even “invented regions” (Shenk, 2001; Miller, 2002). If the analysis of regionalization is focused on qualitative data (e.g. because the quality of statistics is low, what is quite likely to be the case for the post-Soviet space - as well as in the developing and transition world in general), the “mental maps” of *researchers* are likely to create biases for the research outcomes and especially for the claimed causal links. On the other hand, mental maps of *actors* (indirectly *influenced by academic discourse*) not only have an impact the *perception* of regions, but also *can* indeed influence the processes of regionalization and regionalism.

and to establish a link between regionalization and institutional reforms in Central Asia and between regionalization and regionalism. The last section concludes.

## **2. Regionalization in Central Asia**

### **2.1. Post-Soviet regionalization and Central Asia**

In spite of extremely weak intergovernmental cooperation in the post-Soviet space, the region currently exhibits a substantial degree of the bottom-up integration. Basically, there are four factors contributing to this process. First, Yudanov (2000), Vahtra (2005), Crane et al. (2005), Libman and Kheifets (2006), Kuznetsov (2007) and Kheifets and Libman (2008) show, that since early 2000s Russian corporations have been increasingly present in the post-Soviet countries through takeovers, joint ventures and – recently – greenfield investments. The investment expansion of Russian business is only partly registered by official statistics, since informal channels and offshore schemes are actively employed. Traditionally three main sectors of expansion are oil and gas, metals and mining and telecom, although currently a much larger diversification is observed (Libman, 2008). Second, post-Soviet countries are closely linked by migration flows: once again, the main destination for the labor migration is still Russia (Tyuryukanova, 2005; Ivakhnyuk, 2006). Third, the post-Soviet space is still connected through a unity of infrastructure, e.g. in railroad and power utilities sectors, created in the Soviet times. Finally, there is still a significant (though permanently declining) degree of social integration in the post-Soviet world, manifesting itself in interpersonal networks and, above all, Russian as lingua franca for communication (Nasledie Evrazii, 2007). Hence, the regionalization in the post-Soviet space seems to be driven partly by the Soviet heritage (which may happen to be a “disappearing reality”), and partly by the logic of regionalization common for a typical geographical strategy of emerging multinationals (Davidson, 1980, Bell and Pennings, 1996). The post-Soviet regionalization seems to be extremely asymmetric and clearly centered around Russia as the key market and key source of FDI in the region. Interestingly enough, there is no evidence of trade regionalization in the CIS (unlike, e.g., Africa, where informal integration is basically trade-driven), what can be attributed to the specifics of industrial structure of post-Soviet economies, where (mostly global) trade in commodities dominates the trade structure. Nevertheless, after significant decline of the 1990s the share of intraregional trade in the CIS reached a stable level; there is also evidence that the intraregional trade is still “too high” as opposed to gravity models predictions

(Fidrmuc, Fidrmuc, 2001; Djankov, Freud, 2002; Elborg-Voytek, 2003, de Sousa and Lamotte, 2007).<sup>2</sup>

From the point of view of this asymmetry regionalization in Central Asia seems to be a complex phenomenon. Theoretically, extraregional actors (like Russian corporations) could act as a driving force in the regionalization process. For example, in East Asia Japanese and (partly) U.S. multinationals seem to contribute to the development of informal regional structures (Dobson and Yue, 1997). However, it requires two additional conditions: first, companies are present in several countries of the region, and second, their businesses are linked to each other. To our knowledge, there are extremely few areas where both conditions are satisfied. Two fields where Russian FDI could potentially increase the degree of regional interdependence in the Central Asia are telecommunications and power utilities. Currently, the “Big Three” Russian mobile service providers are present in all five countries of the region (VimpelCom/Altimo in Kazakhstan, Kyrgyz Republic and Uzbekistan, MTS in Uzbekistan, Kyrgyz Republic, Turkmenistan and Tajikistan, and Megafon in Kyrgyz Republic) and have already been engaged in tough competition for the most attractive assets. In the power utilities the major player is the state-owned RAO UES, which is present in Kazakhstan and Tajikistan, as well as potentially in Kyrgyz Republic. Given the fact that the energy systems of the post-Soviet countries are still intervened, common actors in energy sectors can significantly contribute to regionalization. However, one should be aware of the fact that the energy trade in the post-Soviet space decreased in the last few years, and that the modes of organization of power utilities in individual Central Asian countries differ substantially. A third field where Russian extraregional actors could potentially become agents of regionalization, is oil and gas; however, currently the presence of Russian corporations in this sectors is quite limited (although growing).

Finally, regionalization through external actors - like in the “Greater China” area - is sometimes explained by the “intermediary function” accepted by certain regions and countries “canalizing” foreign investments and trade in the region (Breslin, 2004). However, developed bilateral ties between Russia and post-Soviet countries make the use of these “intermediaries” less important. The situation is not unambiguously clear; for example, in October 2006, president of the Association of Kazakh investors in Kyrgyzstan Bakhtybek Zheldibaev

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<sup>2</sup> It means that the counterfactual trade between the countries of the region estimated according to the size of their GDP and geographical distance is lower, than the actual trade flows. This, however, still does not imply that the intraregional trade is dominant in the trade structure.

claimed, that, as opposed to foreign investors from other countries, companies from Kazakhstan

“... are in a more attractive position. First of all, Kyrgyz and Kazakhs have similar language, traditions, beliefs, psychology, reason and think in a similar way. Second, we do not need intermediaries. This is our advantage as opposed to European, Chinese and Russian investors. Actually, the latter also feel quite good [in the Kyrgyz Republic], but we do not feel their pressure now” (Kuz'min, 2007).

Hence, Russian investors are probably not as close to Kyrgyzstan, as those from Kazakhstan, but the “distance” is still relatively small. However, as we will show below, Kyrgyzstan and Kazakhstan seem to develop deep economic relations, which are not present elsewhere; in Tajikistan Russian investors are more important, than those from Kazakhstan. One could of course speculate as whether increasing presence of Chinese investors will contribute to establishment of the “gate regions” to support regionalization through external forces, but the outcome is yet to be seen.

## **2.2. FDI**

A more interesting question is whether one could expect any regionalization driven by the intraregional actors. It is clearly not the case in other regions of the CIS (for example, there is only vague evidence of some Ukrainian investment activity in Moldova – in particular, in Transdnistria, and of Azerbaijan – in Georgia). However, Central Asia is quite different, mostly because of the activity of private and semi-private businesses from *Kazakhstan*, which actively explore the Central Asian countries. Though main direction of investments for Kazakhstan is still Russia, it is increasingly present in the Central Asian region. As of September 30, 2007 Kyrgyz Republic ranks 13 in the overall outward investments of Kazakhstan with about 1.3% of total foreign investments of the country (US\$ 481 mln., including US\$ 240 mln. FDI). Uzbekistan ranks 20 with US\$ 199 mln. (FDI: US\$ 109 mln.), and Tajikistan ranks 21 with US\$ 188 mln. (FDI: US\$ 24 mln.). Hence, the countries seem to be of minor importance for the outward investment activity of Kazakhstan, with Russia, US, UK and British Virgin Islands (BVI) being the main targets for outward investments. However, one should take into account, that the Central Asian economies are relatively small, and hence even limited investment activity of Kazakhstan can become crucially important. Indeed, according to the investment statistics of the Kyrgyz Republic,

Kazakhstan is currently the dominant source of FDI for Kyrgyzstan, accounting for about 50% of the total investment inflow (see *Figure 1*). Unfortunately, we do not have data on the FDI structure for Tajikistan and Uzbekistan. However, applying the Kazakhstan data on FDI and total investments and national data from the balance of payment, one could establish, that for Q1-Q3 2007 Kazakhstan accounted for about 21% of total investments and about 4% of FDI inflow in the economy of Tajikistan (with Russia being the main investor accounting for about 40% of capital inflow).<sup>3</sup> One should, however, be aware of the presence of indirect investment channels (e.g. via the BVI investments), which have not been captured by the statistics above.

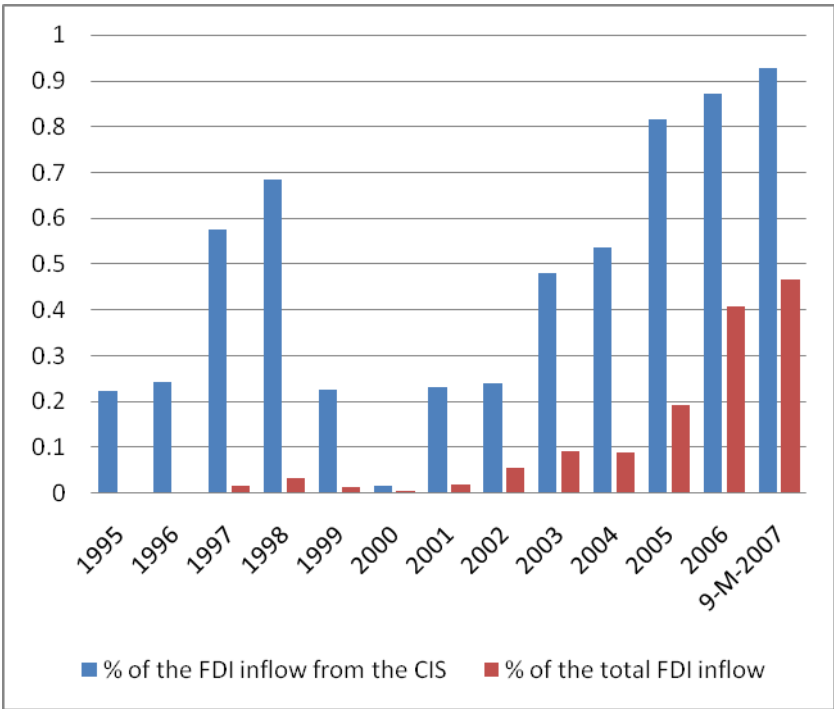


Figure 1: Share of Kazakhstan in the FDI inflow to Kyrgyz Republic

Source: governmental statistics of the Kyrgyz Republic

The low quality of statistical data makes the discussion of case studies of investment activity in the region necessary. In what follows we list the main investment projects of Kazakhstan in other countries of the region. Most projects we are aware of are implemented in Kyrgyz Republic; it could represent the quality of data bias, however, from our point of view, reflects the true predominance of Kyrgyzstan-Kazakhstan connection in the regionalization processes in Central Asia.

<sup>3</sup> Surely, this indicator is extremely questionable. It is well known that direct comparison of outward and inward investment flows data from different statistical authorities of the CIS yields substantially different results (Vahtra, 2005); moreover, one faces the challenge of separating balance of payment statistics and methodology of statistical authorities, which also happen to be different.



While distinguishing among the areas of FDI activity of Kazakhstan in the region, one should point out the *banking sector*. Successful economic reforms fostering market discipline and high standards allowed Kazakhstan to establish a well-functioning banking sector outperforming that of most other CIS countries (including, to a certain extent, Russia), allowing the banking sector to pursue an active expansion strategy abroad. Currently the main holdings of the banks of Kazakhstan in Central Asia include *Nacional'nyi Eksportno-Importnyi Bank* (Kyrgyz Republic) owned by *TuranAlem* (originally purchased by *Temirbank*), *Kazkommerzbank Kyrgyzstan* (Kyrgyz Republic) and *Kazkommerzbank Tajikistan* (Tajikistan) owned by *Kazkommerz*, *ATF Bank Kyrgyzstan* (Kyrgyz Republic) owned by *ATF Bank*, *FinanceCreditBank* (Kyrgyz Republic) owned by the *Seimar Alliance Financial Corporation* and *Khalyk Bank Kyrgyzstan* (Kyrgyz Republic) owned by *Kazakhstan People's Bank*. Investments from Kazakhstan account for about 30% of the capital of the banking system of Kyrgyzstan being the sole major foreign investor (Abalkina, 2007:43), and the share of the banks controlled by Kazakh banks may reach 50% of the market for banking services (Kuz'min, 2007). Nevertheless, the presence of the banks of Kazakhstan in other countries of Central Asia seems to be fairly limited. The state-owned *Development Bank of Kazakhstan* has a representative office in Uzbekistan.

There are several other sectors where investors from Kazakhstan achieved relative success. In Kyrgyz Republic one should definitively mention the tourist industry, in particular the recreation facilities in the Issyk-Kul region (UNDP, 2006:28). The data regarding this sector is fragmentary at best; however, the number of objects controlled by Kazakhstan could be significant. The most well-known deal is the agreement to pass four facilities to Kazakhstan signed in 2001 and ratified in 2008. Nevertheless, it probably covers only the top of the iceberg. In March 2008 Kazakhstan and Kyrgyz Republic announced its plan to construct a new road connecting Almaty and Cholpon-Ata at Issyk-Kul, which, however, is still very far from implementation. For sure a clear advantage is the geographic proximity of the region to Almaty, increasing the potential market for the tourist services for customers from Kazakhstan.

Further sectors of the investments from Kazakhstan include mining, construction and media industries, as well as real estate. In Kyrgyz Republic Kazakh companies control the Kant Cement and Slate Plant, maize syrup plant, two concrete plants, Tokmok Brick Plant, Kadamjai Stibium Plant, Tokmok Wool Processing Plant, *Kyrgyzenergoremont* in Bishkek, and participate in the development of gold deposits at Jeruy (*Visor Holding*) and Taldy Bulak (*Sammergold*). In Tajikistan *KazInvestMineral* acquired the Adrasman mining complex in

2006 for US\$ 3.2 mln. In the field of gas supply Kazakhstan's state owned *KazTransGaz* and Kyrgyz *Kyrgyzgaz* established a joint stock company *KyrKazGaz* in 2004 to operate the gas pipelines to the North of Kyrgyzstan and the South of Kazakhstan. As in the CIS in general, the dominant instrument is still acquisition of existing assets, though there is increasing presence of greenfield investments (like the recently initiated project of a ferrosilicoaluminium plant in Tash-Kumar (Kyrgyz Republic) for US\$ 100 mln.) Finally, Kazakhstan seems to be extremely interested in power utilities in Kyrgyz Republic and Tajikistan (in January 2008 Kazakhstan declared its plans to participate in the reconstruction of the Kambarada Power Plant in Kyrgyzstan, and in February – in the reconstruction of the Rogun Power Plant in Tajikistan); however, any perspectives in this field are still vague, especially given active position of Russian *RAO UES* in the area. The investment activity seems to be driven by both relatively cheap labor (as opposed to Kazakhstan) and access to natural resources. Access to markets seems to be less important in this sector (unlike banking services).

The opposite direction of investments from Uzbekistan, Tajikistan and Kyrgyz Republic to Kazakhstan seems to be insignificant. In the first 9 months of 2007 Uzbekistan accounted for about 0.004% of total FDI inflow to Kazakhstan (or 11% from the CIS),<sup>4</sup> and Kyrgyz Republic for .008% (or about 22% from the CIS). There is no data on investment activity of Tajikistan, as well as cross-border investments in Central Asia beyond Kazakhstan. To conclude, it looks like the Central Asian regionalization is as asymmetric, as the regionalization process in the CIS in general, with Kazakhstan as the main source of outward investments and Kyrgyz Republic as the main recipient of FDI. In Tajikistan investments from Kazakhstan are important but less active, than those of Russia (in the Kyrgyz Republic the situation is exactly the opposite). Uzbekistan and (especially) Turkmenistan are much less active in the development of intraregional investment ties.

### **2.3. Intraregional trade and migration**

In case of the intraregional trade the situation is similar to the CIS in general. Regional concentration of exports is characteristic to a certain extend for the Kyrgyz Republic mostly because of its closed economic ties to Kazakhstan. On the other hand, Tajikistan and Kyrgyz

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<sup>4</sup> There are currently 96 enterprises with Kazakh investments functioning in Uzbekistan, including trade, construction, light industry, metals and food industry, and 715 small and medium enterprises with Uzbek investments in Kazakhstan, including trade, manufacturing, food industry, construction materials, glass, services and real estate operations (RIA Novosti, 2008, April 21). However, the quality of these data is very low and is hardly helpful for understanding the scope of international cooperation.

Republic experience a certain degree of concentration of imports in the region (see *Table 1*). However, a slightly different result follows from the cluster analysis based on dissimilarity matrix (*Figure 2*). While Kazakhstan seems to have higher degree of market integration with Russia, than with the rest of the CIS, Kyrgyz Republic and Tajikistan indeed belong to one cluster. An additional factor potentially supporting the regionalization is that Central Asian countries share a number of common problems of infrastructure, in particular for energy trade and water supply, where their economies are closely linked to each other (Vinokurov, 2007). Even if the value of trade is small, its importance for the development is crucial.

Table 1: Structure of interregional and intraregional trade in Central Asia, 2006

From (exports), to (imports)	Indicator	To (exports), from (imports)					Total Central Asia
		Kazakhstan	Kyrgyz Rep.	Turkmenistan	Tajikistan	Uzbekistan	
<b>Kazakhstan</b>	Share of total exports		0.700%	0.054%	0.412%	1.006%	2.171%
<b>Kazakhstan</b>	Share of CIS exports		4.804%	0.371%	2.824%	6.902%	14.901%
<b>Kazakhstan</b>	Share of total imports		0.587%	0.560%	0.117%	1.348%	2.611%
<b>Kazakhstan</b>	Share of CIS imports		1.255%	1.199%	0.250%	2.884%	5.589%
<b>Kyrgyz Rep.</b>	Share of total exports	20.476%		0.264%	3.010%	3.513%	27.264%
<b>Kyrgyz Rep.</b>	Share of CIS exports	42.902%		0.554%	6.306%	7.361%	57.124%
<b>Kyrgyz Rep.</b>	Share of total imports	11.628%		0.105%	0.163%	3.783%	15.679%
<b>Kyrgyz Rep.</b>	Share of CIS imports	20.161%		0.182%	0.283%	6.559%	27.185%
<b>Tajikistan</b>	Share of total exports	1.987%	0.801%	0.007%		4.818%	7.613%
<b>Tajikistan</b>	Share of CIS exports	14.938%	6.018%	0.054%		36.217%	57.227%
<b>Tajikistan</b>	Share of total imports	10.838%	1.631%	3.501%		10.223%	26.193%
<b>Tajikistan</b>	Share of CIS imports	16.976%	2.555%	5.483%		16.012%	41.026%

Source: CIS Statistical Committee, 2007

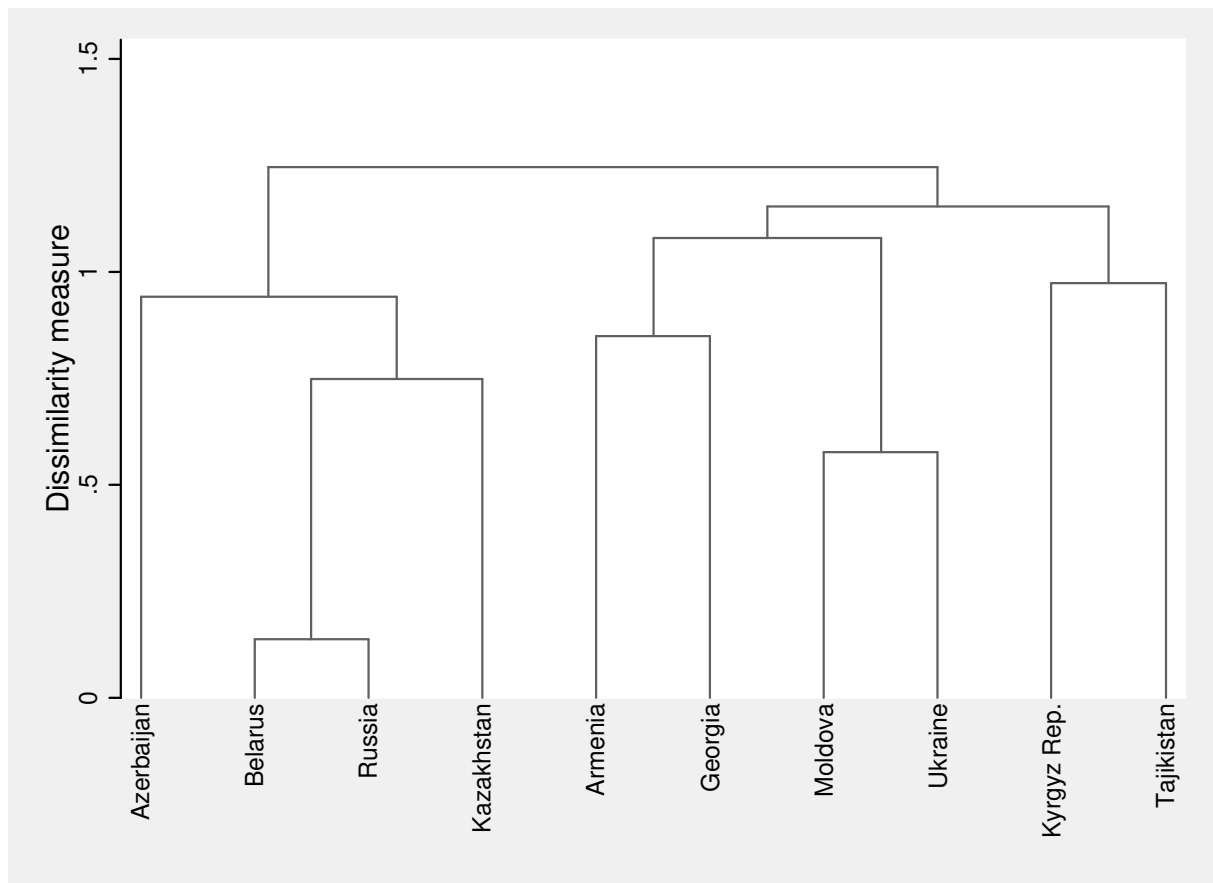


Figure 2: Clusters of intraregional trade in the CIS, 2006

Notes: cluster analysis using Ward clustering method. Dissimilarity matrix defines dissimilarity as 1 minus share of trade turnover between countries  $i$  and  $j$  in the overall trade turnover of the country  $i$  in the CIS, prices of export applied

Source: own calculation based on CIS Statistical Committee database, 2007

However, in spite of relatively low international trade, it seems likely that individual markets for consumer goods in the region are highly integrated. Grafe et al. (2005) show that the impact of border on price variation between Kazakhstan, Kyrgyz Republic and Uzbekistan is relatively small and practically equivalent to the intranational price variation between individual regions. It, however, does not imply that internal markets are integrated – only that the border effect for disintegration is less relevant. Therefore one could probably assume that the integration on the level of small business networks is much higher, than for commodities (which play the crucial role in determining the structure of trade statistics presented above). Spechler (2000:7) claims that “with all the problems, informal trade among the Central Asian countries appears to be working reasonably well”. Informal trade seems to be important for countries like Tajikistan (Olimova et al., 2006) and even Turkmenistan in spite of strong trade restrictions (in particular across the border with Uzbekistan) (Badykova, 2006). One should

however bear in mind, that the emerging informal trade networks often span outside the Central Asian region over the whole Eurasian continent (Evers and Kaiser, 2000; Kaiser, 2002).

Finally, the last issue to be considered is the labor migration in Central Asia. Once again, Kazakhstan acts partly as a regional leader attracting migrants (although Russia still remains the most important partner for the majority of the CIS countries from the point of view of migration – although there is an increasing evidence of competition between these two countries for the labor force). As in case of the FDI activity, increasing labor migration in Kazakhstan is also a relatively recent phenomenon, directly related to the economic success of the country in the last half decade. The main countries of origin for labor migration to Kazakhstan are Uzbekistan and Kyrgyz Republic; the migration is partly driven by a relatively large ethnic Kazakh minority in Uzbekistan. Although Kazakhstan implements a policy of privileged ethnic immigration of the *oralman* (ethnic Kazakhs), there seems to be a significant flow of illegal labor migration exceeding the official migration. The number of labor migrants from Uzbekistan in Southern Kazakhstan (which seems to be the most attractive region for migration inflows) varies between 200,000 and 1 million; however, the any data is likely to be extremely biased and is to be considered with great caution. Some authors point out the existence of labor migration from Uzbekistan to Kyrgyz Republic, generating a remittance flow, but it seems to be relatively small (Mogilevsky, 2004:27). The migration flows have a heavy impact on both legal and illegal monetary flows of migrant remittances (Sadovskaya, 2005, 2006). In case of Tajikistan Russia remains the absolutely dominant country from the point of view of labor migration. Hence, for informal trade and migration the “microregionalization” involving selected regions and areas of the countries is probably relevant (however, one should not forget, that Southern Kazakhstan is not only geographically close to other countries of the region, but has also a relatively high level of economic development).

#### **2.4. Preliminary conclusions**

To conclude, one indeed can observe certain features of regionalization in Central Asia, but their impact is rather limited. There is some evidence of increasing presence of business groups from Kazakhstan in Kyrgyz Republic, which increased dramatically in the last years. The main driving force of regionalization is the banking sector; recently public structures (like *KazTransGaz* or *Kazyna*, currently developing a joint investment fund with

Kyrgyzstan<sup>5</sup>) also became increasingly important. Even as opposed to the regionalization via FDI of Russian corporations in the CIS, which basically started in 2000, the regionalization via FDI of businesses from Kazakhstan in Central Asia is still a very recent phenomenon with only few years of experience and strongly depends on economic performance of Kazakhstan. However, a significant driving force for integration seems to be formed by informal networks interconnecting Kazakhstan, Kyrgyz Republic and Uzbekistan and only partly visible for official statistics. In this case regionalization is a much older phenomenon embedded in the traditional economic ties in the region. Moreover, it seems to be by far more developed, than in the CIS in general (with only few exceptions involving separatist regions like Transdnistria, Abkhazia, Southern Osetia and Nagorny Karabakh, which also rely on informal trade). Thus, Central Asia combines both “investment regionalization model” of South East Asia and the CIS (Kazakhstan and Kyrgyz Republic) and “informal trade regionalization model” of West Africa and South Asia (Kazakhstan, Kyrgyz Republic and Uzbekistan). Given the significant size of the shadow economy in Kazakhstan (Schneider (2007) estimates it at 44.6% of official GDP for 2004/05), Kyrgyz Republic (40.6%) and Uzbekistan (35.4%), the role of informal trade can be significant, though diminishing given rapid economic growth in the region (especially in Kazakhstan). Less reliable estimates of shadow economy in Tajikistan exceed 60% of official GDP (Lenta.ru, 2007, June 27); however, the participation of the country in the regionalization processes is significantly smaller and the relative impact of Russia as an extraregional economic partner higher than for other countries. The role of Turkmenistan in the regionalization processes is negligibly small.

The development of regionalization definitively exceeds that of regionalism and “top-down” integration. The investment-led regionalization, however, is as asymmetric, as in the CIS in general with Kazakhstan being the main actor in the system. Finally, both investment-led and informal trade regionalization processes should be rather interpreted as collection of (probably) interrelated “microregionalization processes” connecting individual countries and even region rather than a unified process spreading out all over the Central Asia.

However, the most important problem is not just to establish the existence and forms of regionalization, but also to understand its interconnection with the institutional development in the region. Regionalization often occurs at the corners of development spectrum: it can become crucially important for economies at the low level of development, substituting for the deficit of the rule of law, but it can also follow from high development,

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<sup>5</sup> A similar fund was established with Tajikistan

with high governance capacity of non-governmental agents. In both cases effects of regionalization on institutions can differ. For example, in Medieval Europe merchant guilds effectively supported the de-facto integration of the economic space and overcame the low development of formal institutions (Greif, 2006), but also engaged in redistributive activities and market monopolization (Ogilvie, 2007). In what follows we are going to consider three channels of interaction between institutions and corporate integration: (1) how the forms of the informal integration depend upon the institutions of Central Asian countries; (2) how does the regionalization process influence the institutional development and (3) how does the regionalization relate to the development of regionalism in the region. The following section discusses these three questions extensively.

### **3. Regionalization and institutions: channels of interdependence**

#### **3.1. Regionalization and reform strategies**

In spite of economic and political similarities, the countries of Central Asia experienced a variety of alternatives of economic and political reforms. It seems to be reasonable to assume that the paths of these reforms (and, hence, of established political economies) have a significant impact on the patterns of participation (or non-participation) of individual countries in the regionalization process.<sup>6</sup> From the point of view of different patterns of regionalization the most interesting distinction is that between *Kazakhstan* and *Uzbekistan*. Both countries from the point of view of their economic potential, resource endowment and position in traditional economic ties in the region could theoretically act as a center for emergence of regional multinationals as the driving force for “investment-led” regionalization. Uzbekistan actually outperformed Kazakhstan in the early 1990s, giving rise to the discussions of the nature of an “Uzbek paradox” (Spechler et al., 2004). However, since early 2000s Kazakhstan performs significantly better, than Uzbekistan, in terms of economic growth. So why did Kazakhstan, and not Uzbekistan turn into the main driving force of the regionalization in Central Asia?

Basically, Kazakhstan and Uzbekistan implemented substantially different reform strategies. Kazakhstan followed the path of relatively fast transformation establishing market institutions. Major economic reforms implemented in the country include i.e. extremely favorable policy towards foreign investors (in fact, Kazakhstan remained an absolute leader from the point of view of per capita inward FDI in the CIS until recently), liberalization of

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<sup>6</sup> Obviously, a detailed discussion of institutions in individual countries of the region goes far beyond the objectives of this paper; therefore we will provide only stylized facts regarding this issue.

energy market, privatization of housing and communal sector and reforms of the pension system. However, in the mid 2000s Kazakhstan moved towards a more protectionist policy, including severe restrictions on FDI for foreign companies (and resulting into the de facto nationalization of several assets) and establishment of more active industrial policy in form of the so-called “cluster initiative”. However, one should not forget, that in spite of the advancements in the field of the *formal institutions*, the *informal power structures* in the economy in Kazakhstan, as in other CIS countries (like Russia and Ukraine) supported the development of privileged business groups with strong ties to the government and political support as the main source of competitiveness, with the family of the president in control of the most attractive assets (Olcott, 2002). Uzbekistan, on the other hand, followed a more gradual approach to economic reforms, resulting into persistence of significant public sector, strong governmental interventions and low development of formal market institutions. The privatisation in Uzbekistan was limited, and the government maintained strict control over international economic relations (see also *Figure 3* for some indicators of institutional quality in both countries).

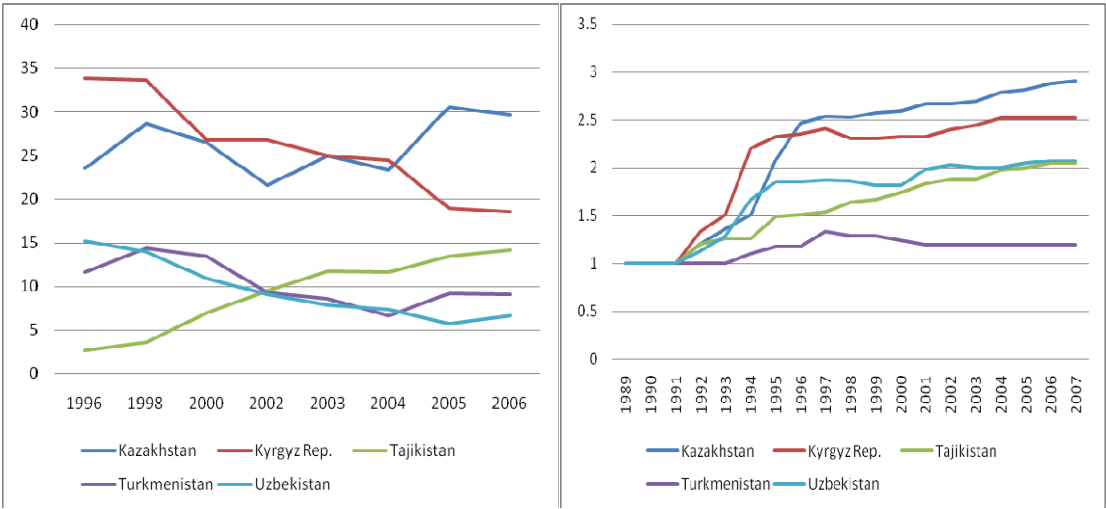


Figure 3: Average governance indicators (right) and average transition indicators (left) in the Central Asian countries

Source: for governance: World Bank Governance indicators; reported is the unweighted average of six indicators calculated by the World Bank on the scale from 0 (bad governance) to 100 (good governance); for transition: EBRD Transition Report 2007; reported is the unweighted average of ten indicators calculated by the EBRD on the scale from 1 (no transition) to 4 (successful development of market institutions)

So, the model of institutional development in Kazakhstan seems to form a better foundation for regionalization, than in Uzbekistan. One should mention three main “channels” of influence of the institutional reforms in Kazakhstan on the regionalization model:

1. Kazakhstan carried out a very successful banking reform, including the privatization of practically all banking structures, the improvement of quality of the banking system



leading to significant reduction of number of banks (by four times from 1993 to 2002), a relatively early introduction of the IFRS/IAS, deposit insurance system (1999) and opening the financial services market for foreign investors. On the other hand, unlike Russia, banks still control substantial industrial business groups. Successful development of private banking sector allowed the banks of Kazakhstan to initiate the international investment expansion, and become important forces for the regionalization.

2. In the political-economic environment like that of the Central Asian countries, successful regionalization basically requires two contradicting conditions. On the one hand, one of the problems of the state-led economies in a region with a very low level of political cooperation is that political difficulties actually prevent the development of economic ties. So, if the connection between economic and political actors are *formal* and *too strong* – like in case of the state-owned economy of Uzbekistan – political differences can effectively block any economic cooperation. On the other hand, an environment with poor protection of property rights is problematic for small private companies with substantial public support. The model of large privileged business groups implemented in Kazakhstan seemed to be quite successful from this point of view.<sup>7</sup> Moreover, the businesses of this group are large enough to successfully establish their presence in neighboring states, but also have experience of turbulent economic environments, which gives them a unique advantage vis-à-vis multinationals from developed countries.

3. The timing of development seems to be crucial. Gradual reforms are likely to reduce pressure at the stage of recession, but rapid reforms and development of market institutions could lead to better performance *after* the recession stage. However, any regionalization in the post-Soviet space became possible only after a certain period of time, when the initial problems of nation-building preoccupying political elites became weaker. From that point of view Kazakhstan also had better chances to become leader of the regionalization in Central Asia, than Uzbekistan.

The transition strategy of the Kyrgyz Republic was quite similar to that of Kazakhstan (see also *Figure 3*): in fact, Kyrgyzstan was considered an “exemplary” case of market reforms in the early 1990s (being one of the first countries in the post-Soviet region to enter the WTO). However, economic reforms in the country seem to be far less consequent and persistent. Kyrgyz Republic also developed the power-property system where the family of

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<sup>7</sup> It should be noted, that the links is more complicated than a simple statement that “market reforms ensure leadership in the regionalization process”. In fact, it was the exactly the combination of reforms with the development of large business groups which had a positive impact.

the president seemed to control the main assets in the republic (Spector, 2008). However, the last several years were characterized by increasing political instability with negative effects for the economic development. Generally speaking, economic development in Kyrgyzstan have been by far less successful, than in Kazakhstan and Uzbekistan; according to the Conference Board and Groningen Growth and Development Center, Total Economy Database (2007), Kyrgyz Republic belongs to the main losers of transition, with GDP per capita in 2005 accounting for only 66% of the GDP per capita in 1974 (the second worst performance after Moldova).<sup>8</sup> On the one hand, lack of natural resources seems to have contributed to economic decline, on the other hand, however, economic reforms were, though large (as opposed to other post-Soviet countries), still limited, also probably *because* of deficit of resources and economic decline. From the point of view of this paper to aspects should be pointed out. First, bad economic performance significantly contributed to the persistence of “informal trade” regionalization and development of labor migration: similar forces were at work in Uzbekistan, Tajikistan and partly Turkmenistan. Second, although the political and economic instability seemed to have a negative effect on the FDI inflow per se (and also is an important problem for Kazakhstan), Kazakh investors were *relatively* less affected by the problems, than multinationals from developed countries and probably even Russian investors (who, however, were quite successful in using the “turbid water” environment). Hence, the instability, while having an *absolutely* negative effect on the investors from Kazakhstan, increased their *relative* weight.<sup>9</sup> Moreover, similarities in the institutional structure may also enhance the presence of investors from Kazakhstan.

In case of Tajikistan the implementation of economic reforms was also delayed; however, unlike other countries of the region, the main reason for low quality of governance was the civil war of the early 1990s and the consequences of this conflict. It seems possible to argue, that Russia’s position during the civil war ensured the current status of Russian investors as the dominant group in Tajikistan; however, recent developments indicate, that strengthening the stability of the current political regime in the country at the same time weakens the unambiguous support for Russian investors (Abalkina et al., 2007), and therefore opens a window of opportunity for other players, including Kazakhstan. Finally, in Turkmenistan economic and political reforms have been negligible; on the contrary, the

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<sup>8</sup> All data refers to the GDP in PPP.

<sup>9</sup> It is not impossible that there is also some *absolutely* positive effect; for example, in several regions of the CIS several groups of Russian investors were able to enter the markets *because* of low quality of institutions (Libman, 2007), and similar logic may be present here. However, we do not have any (even anecdotal) evidence for this hypothesis.

current regime effectively restricted any contacts with foreign actors (even at the personal level). Hence, the only form of participation in the regionalization processes, both possible and – given the low quality of livelihood – necessary was the informal trade, which, as indicated, seemed to have at least a certain impact.

### **3.2. Impact of Regionalization on Economic Institutions**

Regionalization is not only a strategy used *because* of a certain system of institutions, but also a factor *influencing* the development of institutions. The effects of regionalization can be both strengthening the market-enhancing institutions and conserving the inefficient institutional structure. However, these effects also differ for the “investment driven” regionalization and “informal trade” regionalization. From the point of view of the investment driven regionalization two arguments should be mentioned. First, investment driven regionalization (as well as developed labor migration) strengthens institutional competition, i.e. competition between countries for mobile factors of production by establishing legal environment and economic policies. Institutional competition is often considered to be an efficient tool of taming the Leviathanic rent-seeking government and of revealing the preferences for institutions through the evolutionary learning process (Vaubel, 2007). Second, multinationals are likely to act as channels of transmission of best practices and knowledge between countries, thus supporting the diffusion of efficient institutions. In a similar way, best practices can be important through the networks of labor migration.

Unfortunately, both positive effects are not unambiguous. On the one hand, institutional competition is not necessarily driven by demand for good institutions. In fact, the literature on the post-Soviet transition established a variety of factors leading to inefficient equilibria supported by the demand for bad institutions. Reasons for these “institutional traps” include redistribution effects, learning costs, deficit of trust, as well as interaction between formal and informal institutions (for a survey see Libman, 2007). This is definitively related to the emergence and stability of the “clan capitalism” (Kosals, 2006) in the post-Soviet world. The main question is actually not whether demand for bad institutions really exists, but rather whether it is permanent (i.e. constitutes a stable equilibrium) or temporary (and after a certain period of development should be replaced by demand for good institutions). Havrylyshin (2007:17) refers to this discussion as “transition inevitable” and “transition frozen” school of thoughts and claims, that “the debate ... will certainly go on for some time to come”. From the point of view of regionalization in the CIS space the results are

ambiguous: both factors of demand for good institutions and demand for bad institutions seem to be present (Libman, 2007).

From the point of view of the Central Asian countries the problem is as ambiguous, as in the CIS in general. Actually, it receives an additional dimension given relatively high degree of political instability in several countries of the region (like Kyrgyz Republic and Tajikistan). It is clear that the increase of investments from Kazakhstan and Russia does not necessarily coincide with stronger demand for transparency and general rules in the Hayekian sense. In fact, demand for privileged relations with regional authorities may be more important, and the “threshold level” of demand for institutions necessary to enter the market for the post-Soviet companies is not so high anyway. Hence, foreign investments may well support inefficient equilibria. For sure they support the semi-authoritarian regimes in the countries of Central Asia, which, in turn, are one of the main factors of the existing low quality of governance (Libman, 2007a).<sup>10</sup> However, the alternative to this support may be not market-enhancing reforms (like in the countries of the Western flank of the CIS), but chaos and disorder. The second channel of the impact of informal integration on economic institutions seems to be even more important in the region. In fact, in spite of its own institutional deficits, Kazakhstan can become an important source of “good practices” for the countries of the region. Once again, unlike the Western flank of the CIS, there are hardly any viable alternatives (like investments of multinationals from developed countries). Nevertheless, this transmission of good practices is per se limited by the quality of institutions in the country of origin of investments, making the very issue of institutional advancements crucially dependant from reforms in the leading country. Given the extremely short experience of the investment led regionalization in the region, it is still difficult to make any conclusions.<sup>11</sup>

The effects of informal trade regionalization are also not unambiguous. As already mentioned, most forms of the informal regionalization appear in an environment of weak formal institutions; to a certain extend, they serve as an instrument of overcoming this problem. From this point of view informal trade networks serve as a natural instrument of establishing an order for economic transactions. However, in this case their advantages and disadvantages are similar to the general discussion on the role of informal economy: on the

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<sup>10</sup> Moreover, as already noticed, strengthening these regimes can effectively result in a hold up of foreign assets and decline of regionalization in general.

<sup>11</sup> It is definitively necessary to differentiate between different groups of businesses and their strategies. The shift from demand for bad institutions to demand for good institutions is likely to depend upon these differences. Similar points are valid for Central Asia. Our paper therefore provides a rather simplified view, which is, however, helpful for the basic hypotheses development.

one hand, it overcomes the deficits of formal rules and makes economic transactions possible, but on the other hands, informal rules are less efficient (e.g. because of their personalized nature vis-à-vis formal abstract rules) and, more importantly, establish behavioral patterns preventing introduction of formal rules in the future. A possible strategy in line with the ideas of Hernando de Soto is to develop formal rules consistent with informal rules, but it is always a difficult task (also from the point of view of incentive-compatibility for political decision makers). Therefore the existence of informal trade regionalization may constitute a constraint optimum in a given environment, but is able to become an obstacle for the development of efficient reforms in the future.

### 3.3. Regionalization and regionalism

The last point we address in this paper is the relation between regionalization and regionalism. As already noted, there have been numerous attempts of top-down integration in Central Asia, mostly without any visible results. Even the most basic form of regional cooperation – the FTA – is quite problematic. Although there exists a (highly incomplete) network of bilateral trade agreements in Central Asia (see *Table 2*), there are huge implementation problems; countries quite often act unilaterally, restricting the trade relations in case of economic or political turbulences. Economic interdependence in the area of water or energy resources has also caused permanent redistribution conflicts over the common pool. Multilateral integration has been even more problematic. Basically, it is reasonable to distinguish between three main groups of regional projects: special projects for the Central Asian region, participation of the countries of the region in the post-Soviet integration and participation in larger integration projects, where countries of Central Asia form a substantial group of participants. In this paper I focus on the first group, where the interaction between regionalization and regionalism is the most relevant issue.

Table 2: Bilateral FTA in central Asia

	Kazakhstan	Kyrgyz Rep.	Tajikistan	Turkmenistan	Uzbekistan
Kazakhstan	X	1995	yes		1997
Kyrgyz Rep.	1995	X			1998
Tajikistan	yes		X		1996
Turkmenistan				X	1996
Uzbekistan	1997	1998	1996	1996	X

Source: Kort and Dragneva, 2006: 9

The first project involving the countries of Central Asia was the Central Asian Union, established by Kazakhstan, Kyrgyz Republic and Uzbekistan in 1994. In 1998 Tajikistan was

formally admitted to the Union, and in 2001 the structure was renamed as the Organization of Central Asian Cooperation (OCAC). In spite of declarations of the organization to develop a regime for a full-scale economic and political cooperation, OCAC remained a more or less vague forum without any results (Kuz'min, 2008), finally leading to the integration of the organization in the Eurasian Economic Community (EAEC). However, the idea of a Central Asian Union is still part of the agenda of the main players in the region. While the old OCAC failed to function also because of the rivalry between Kazakhstan and Uzbekistan, in the new round of negotiations Kazakhstan became the main promoter of the institutionalized regional integration. In 2007 Kazakhstan and Kyrgyz Republic agreed on establishing an institutional framework for the bilateral agreement between these two countries – an initiative considered to be the first step towards a new regional integration project. Tajikistan is also considered to be a potential partner in the new structure (Zhugan, 2007). Nevertheless, it is still very difficult to assess the potential viability of a new structure.

Once again, investment led and informal trade regionalization can have different influence on the regionalism in Central Asia. From the point of view of the former, the most often stated argument is that economic dominance of Kazakhstan based on the investment expansion of its corporations can become a factor supporting formal regionalism in its current form (once again, with Kazakhstan as the main actor). Regionalization can become an additional leverage mechanism. The increasing attention of the Kazakhstan government to the FDI activity in the Kyrgyz Republic confirms that at least these expectations are present at the level of the political decision makers. Nevertheless, international experience shows, that the asymmetric regionalization can have different impact on regionalism: while in Mexico the development of *maquiladoras* actually supported the formation of NAFTA, in the CIS significant presence of Russian investors in Ukraine did not support any formal integration between these two countries.

Considering the link between investment-led regionalization and regionalism, one should not forget the potential importance of political institutions in the regional integration processes. As noted, most countries of the region are semi-authoritarian regimes, where governments use the design of economic institutions to restrict potential opposition. It is well known in the literature on international integration, that non-democracies are less likely to participate in the regional economic integration than democracies (Mansfield et al., 2002). In fact, that is what one can observe in Central Asia: in fact, the less democratic countries of the region (Turkmenistan and – to a lower extent – Uzbekistan) are also less likely to become part of integration agreements. The main problem is the issue of commitment: in a political

system based on informal power balances it is extremely difficult to provide any commitment to an external actor, yet alone to give up part of the sovereignty (what is per definition implied by the regionalization). A question is of course whether regionalization can overcome these obstacles. Basically, there are two factors to be taken into consideration. First, regional cooperation can take form of the development of *international hierarchies* (Lake, 2007), and in this case is less dependent from the issue of democracy. An important aspect from this point of view is not just the *existence* of asymmetries, but the *scope* of asymmetries. Weak asymmetry can in fact be even quite dangerous for regionalism: it increases mistrust, but does not provide any instruments for leverage. In fact, the political elites in Kyrgyz Republic have been quite cautious with respect to any potential integration with Kazakhstan. However, high political instability is a clear factor increasing the asymmetries and also the demand for international hierarchies. Second, the question is whether there is a clear link between investment expansion and governmental policies. Once again, in case of Russian investments in Ukraine businesses basically ignore the regionalism dimension. However, given a relatively high influence of consolidated political leadership in Kazakhstan on its business groups, one could in fact expect that the government will be able to influence the investment decisions following the logic of international politics. Hence, one can actually expect that in case of Kazakhstan and Kyrgyz Republic *regionalization could support formal regionalism*.<sup>12</sup>

Obviously, the scope of these projects mostly covers Kazakhstan and Kyrgyz Republic, and maybe Tajikistan (where the position of Russia is crucial). Uzbekistan has been quite reluctant to support regionalism in Central Asia (Bohr, 2004; Kuz'min, 2008), and in the current situation seems to prefer Russia to Kazakhstan as the main source of FDI, designing its investment policies respectively (Abalkina et al., 2007; Kheifets and Libman, 2008). The latter fact raises an important issue of *competition between Central Asian regionalism projects and broader projects* (with participation of Russia – EAEC – or China – Shanghai Cooperation Organization). And in this context development of regionalization can also be quite important: on the one hand, strong economic interconnections can make regional integration within Central Asia a priority; but on the other hand, it is possible, that at least some actors try to off-balance economic influence of Kazakhstan by the political influence of

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<sup>12</sup> It is important to notice, that the main players in the economy of Kazakhstan are, though highly connected to the government, still *private businesses*. There is no trend towards wide-scope nationalization in Kazakhstan, as it was observed in Russia. This is an additional argument in favor of the regionalism projects: in case of dominance of state-owned enterprises regionalization can effectively become just another form of intergovernmental contacts, making any form of further cooperation meaningless (Vinokurov, 2007a).

other actors (e.g. Russia). Theoretically, it is also reasonable to claim that *the development of Central Asian regionalism is able to reinforce the regionalization*, reducing the degree of political uncertainty and removing existing borders. The crucial factor is here whether the regionalism will move from rhetoric to implementation. The effects of pure rhetoric (as it has been so far in the field of regionalism in Central Asia) are ambiguous: it can both create necessary framework for public support of investment expansion (what seems to be the case for Kazakhstan-Kyrgyz Republic dyad (Kuz'min, 2008)), but also introduce political tensions in purely economic relations.

From the point of view of informal trade one can hardly expect any clear effects of regionalization on regionalism and vice versa. Informal trade supports the persistence of social integration and cross-border interpersonal networks, necessary for any integration project. On the other hand, increasing intergovernmental cooperation could theoretically shift the patterns of informal trade to formal trade by creating well-protected property rights and restricting rent-seeking of public officials through removing additional options for their decision-making (it is actually implied by any economic liberalization). From this point of view the very existence of *informal trade* is based on the lack of *formal framework for cooperation* – once again, very similar to the issue of the informal economy in general. Whether this degree of cooperation (and of quality of governance in general) can be achieved, is questionable. A reasonable point often mentioned by sociologists is that the real puzzle is not why some people prefer *informal structures*, but why there are people choosing the *formalization* of their transactions (Paneyakh, 2008). In a region with decades-old traditions of informal economy (in fact, flourishing even under late Soviet regime) even changes of formal institutions may have no effect on behavioral patterns for the actors.

#### **4. Conclusion**

In spite of the widely recognized need for cross-border cooperation in Central Asia (Gleason, 2001), the last fifteen years provided evidence for extremely low degree of top-down regionalism. Although integration rhetoric has been used quite often (especially in Kazakhstan), there is no sign of any more or less important integration achievements. Most countries prefer designing their policy unilaterally, leading to numerous conflicts, especially in the field of common pool resources (like water or energy). That is why it is interesting to look at yet another dimension of regional cooperation, which allows for independent action of non-state agents. In fact, we have tried to show that there are at least some elements of regionalization present in Central Asia. Basically, regionalization takes two forms. First,



countries of the region seem to be interconnected by the networks of informal trade, based on the long-term past experience. Second, recent economic success of Kazakhstan has allowed this country to become an important center for development of regional multinationals and FDI, particularly important for Kyrgyz Republic, as well as act as a center of attraction for labor migration.

The patterns of regionalization seem to be heavily influenced by the development of institutions in Central Asian countries. In particular, the model of more liberal reforms combined with still-persistent links between influential business groups and politics seems to be a “success combination” for the multinationals from Kazakhstan (as opposed to Uzbekistan). The impact of regionalization on institutional development is, however, ambiguous: on the one hand, it can serve as a link for transmission of “best practices” and reinforce better property rights, but on the other hand, the positive impact is limited by institutional deficits for the economy of Kazakhstan. Finally, in Central Asia regionalization *could* potentially support the regionalism development, though the expectations are also unclear.

Since we are dealing with a relatively recent process, it is difficult to make clear predictions regarding the future of the regionalization in Central Asia. Probably, there is no reason to expect any decline of cross-border informal trade, given lack of reforms in poor quality of governance in most countries of the region. It is the economic prosperity and freedom which could effectively shift the patterns of trade to the formal sector – but there is no reason to expect these changes. On the other hand, the development of other forms of regionalization – FDI expansion from Kazakhstan and increasing labor migration to this country – crucially depends on economic performance of Kazakhstan. Recent turbulences related to the global financial crisis, which seem to have a significant impact on the banking system of Kazakhstan (the driving force of FDI regionalization!), raise some questions regarding the viability of the model. Therefore the coming few years could be quite interesting from the point of view of informal regional integration in Central Asia.

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