Regional Cooperation in Central Asia: Viewpoint from Uzbekistan

Kakhkharov, Jakhongir

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Executive Summary

Central Asia is a region strategically located in a part of the world which had attracted constantly the attention of superpowers of the world as evidenced by the term the Great Game. The term usually attributed to Arthur Conolly, was used to describe the rivalry and strategic conflict between the British and Russian Empires for supremacy in Central Asia. The term was later popularized by British novelist Rudyard Kipling in his work “Kim”. The Silk Road turned the region into a bridge between Europe and East Asia, and between North and South Asia for many centuries. The region also had functioned as a hub for the religious, scientific and cultural development of the Islamic world for many years in the past.

As the UNDP (2005) report notes, during 70 years of Soviet rule, when the Central Asian republics were largely shut off from the rest of the world, their economies became closely linked with the rest of the union. Many analysts consider that during this period living standards improved as a result of heavy investments in physical infrastructure and human capital. However, these improvements were accompanied with some devastating impact on the environment and culture of the region.

The collapse of the Soviet Union in 1991 resulted in the creation of new countries in Central Asia—Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan—with a total population of almost 60 million. Independent states gradually began establishing real borders separating them. This process is not over yet. The borders, tensions between some of the countries, and security policies of the countries in the region disrupted trade links and weakened critical but vulnerable region-wide water and energy systems.

This report analyzes two important aspects of regional cooperation - trade in the region as a whole and electricity/power as a micro case study of cooperation between Uzbekistan and Tajikistan. The main research question of the report is “What are the main obstacles for greater regional cooperation in these two areas and how can these obstacles be removed?”

In general, there are many factors which, apparently, make regional cooperation necessary for the economic development of Uzbekistan and the whole Central Asian region in general. Factors that speak in favor of regional cooperation are the following: (a) the communication, transport and energy infrastructure created by the former Soviet Union as an integrated national system which makes necessary a single and regional approach (b) the presence of environmental issues which require a regional approach to their solution (c) the potential attractiveness of the region free of trade and transit barriers for foreign and local investors compared with the limitations of small economies (d) the utilization of the regional cooperation to overcome geographical deficiencies and to improve access to global markets, thus creating opportunities for the effective integration of the region into the world market.

Nevertheless, the research of the two aspects of regional cooperation mentioned above identified the following impediments for greater regional cooperation. In the area of regional trade:

- A country’s ability to cooperate with its neighbors depends on the level of development of the market economy and democratic governance mechanisms. These are not well developed in Central Asia yet, which has become a serious impediment for regional cooperation;
- The Central Asian leaders adopted diverse economic strategies which led to divergence in their respective trade policies and hindered harmonization of regional cooperation;
- Regional Trade Agreements involving the Central Asian republics generally have a narrow range and complex rules of origin and most of them have remained agreements on paper only.
- Existence of significant trade barriers and protectionist trade policies - while formal tariffs are relatively low, there are many other policy instruments that Central Asian countries use, often in a discretionary and non-transparent manner, to regulate trade. These include taxes on imports that are not levied on domestically produced goods or that have higher rates for imported than domestically produced goods, foreign currency conversion problems, export bans on some products, and crack downs on shuttle traders.
- Low degree of trade complementarity between Central Asian republics;

In the power sector between Uzbekistan and Tajikistan:
- The governments have had self-sufficiency as a policy goal totally ignoring possibility of cooperation. Past tensions between the governments were partly to blame for this;
- A distorted system of energy prices is a significant barrier for greater regional cooperation between Uzbekistan and Tajikistan. Primary energy sources for thermal power generation are frequently and grossly undervalued by the state policy. Also, there is no value attributed to water regulation for irrigation;
- Potential nonpayment across borders.

Chapter II of the report provides an overview of the benefits of regional cooperation in Central Asia. Chapter III reviews the present state of regional trade in the region as well as obstacles and barriers for greater regional trade. Chapter IV analyzes the micro case of regional cooperation in power sector between Uzbekistan and Tajikistan and Chapter V draws conclusions.

**II Benefits of Regional Cooperation**

Most economists specializing in international economics agree that there are gains from trade. When countries sell goods and services to each other, this exchange is almost always to their mutual advantage. In fact, Krugman and Obstfeld (2003) notice that “the range of circumstances under which international trade is beneficial is much wider than most people imagine.” Textbooks on international economics try to prove with zeal that two countries can trade to their mutual benefit even when one of them is more efficient than the other at producing everything, and when producers in the less efficient country can compete only by paying lower wages. This economic postulate could well be applied in case of Central Asia as well. The five Central Asian landlocked countries may yield significant gains and flourish if they remove the barriers to the cross-border movement of people, goods and knowledge, among themselves as well as with their neighbors and the rest of the world.

The UNDP’s report (2005) argues that increased cooperation among the Central Asian republics will produce large gains by reducing trade costs, increasing remittances from migrant workers, and improving water and energy use. The experience of other parts of the world show that regional cooperation will especially help the poor in the region. By the same token, the cost of non-cooperation will affect the poor most. As to the issue of regional trade, the UNDP report notes that opening borders or reducing trade costs is not enough. Much will also depend on the business climate and the quality of financial services in each country. International experience confirms that reforms also require measures to combat corruption, improve the civil service, and enhance the transparency and accountability of governments. Martin Spechler points out that the revival of civilian machine building would make sense in Central Asia only if its products gain access to nearby markets. The Asian Development Bank emphasizes that the Central Asian

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republics are all relatively small economies. Therefore, they need to promote trade and closely integrate into the international trading system to achieve sustainable economic development.\(^2\)

The importance and benefits of regional cooperation in Central are especially high compared to other regions of the world because Central Asia is a landlocked region located far away from major seaports.\(^3\) Given these circumstances, in many cases, Central Asian countries have to pass each others territory to gain access to major seaports or trade between each other more in order to save in significant transportation expenses associated with getting their goods to affluent but remote markets.

In addition to above mentioned economic factors, there are many “non economic” factors which seem to facilitate regional cooperation in Central Asia - the people of the region have very similar language and culture and majority of the indigenous ethnicities profess Islam. Before Soviet Union, territorial divisions between the “Stans” were loose, conditional, and fuzzy, which make the history of the region also common.

Multilateral institutions, donor agencies, bilateral aid programs and a number of regional organizations have been undertaking tremendous efforts to promote greater regional cooperation in the region. However, as many observers agree, the progress toward regional integration after the collapse of the Soviet Union has been very modest. Along with a number of specific barriers that impede trade in general and electricity particularly, which this report will review in the following chapters, there are also obstacles of “institutional” nature that hamper regional cooperation. In connection with this, the UNDP report (2005) notes that “a country’s ability to cooperate fully with its neighbors depends on the nature of its internal institutions, regulatory system and governance culture. A nation with sophisticated market institutions is better able to engage in regional economic integration. A country with a more open, pluralistic and democratic culture can build stronger cross-border ties than one with a less open, more autocratic political culture and institutions”\(^4\).

### III Regional cooperation in trade.

Before the collapse of the Soviet Union, the Central Asian republics had very high levels of trade within the union, but it was managed centrally via Moscow. Considerations (efficiency of allocation of resources, pricing, transportation costs) taken into account in trade in a regular market economy were neglected most of the time. Trade with the countries outside of the Soviet Union was conducted from Moscow. It was only after gaining independence that the Central Asian republics received an opportunity to access world markets with their own products directly. Thus, prior to gaining independence none of the Central Asian countries had exercised significant influence over their economy and foreign trade. For example, Kazakhstan’s government claims that before 1991, 90% of its industry was controlled from Moscow via all - Union Ministries. Therefore, at independence, there were no national institutions with experience of developing and managing industrial policy, supervising state owned enterprises, and conducting foreign trade.\(^5\) Before embarking on reform process and establishing their position in world trade, Uzbekistan, as well as other Central Asian countries, had to start with the formation of a sovereign state\(^6\), creating government

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\(^3\) See for analyses of the consequences of landlockedness for Central Asian countries Raballand (2005).

\(^4\) “*Central Asia Human Development Report 2005*” by the UNDP Regional Bureau for Europe and the Commonwealth of Independent States, page VI


institutions able to control fully the economy of the country. Furthermore, this process was constrained by a variety of factors, including the need to establish new transport and trade links, the limited competitiveness of Central Asian manufactured exports in international markets and the lack of hard currency. As some of these constraints were eased or removed, the share of the former Soviet countries in Central Asian countries’ trade significantly decreased (UNDP 2005).

The UNDP report (2005) points out that the decline was especially swift and dramatic in Uzbekistan, reflecting the fact that it was relatively easy for Uzbekistan to reorient exports of internationally marketable commodities, such as gold and cotton, from the former Soviet countries to international markets. The reorientation of trade in Central Asia away from the former Soviet countries and towards the rest of the world was, however, partly reversed in recent years.

It is believed that among the most important benefits of cooperation, ones that would touch every country, could be those that come from harmonized trade and customs regulations, open borders, and enhanced cooperation on energy production and natural resource use. During the interviews conducted by the author with a number of existing and potential foreign investors in Uzbekistan, many of the interviewed expressed the opinion that the attractiveness of Uzbekistan and the whole of Central Asia as a recipient of foreign investments would have been much higher had the region been a single economic area without borders, visa requirements, and customs barriers. Interviewees noted that, currently, trade within Central Asia and the trade relations of the region with the rest of the World is obstructed by serious barriers, such as, protective trade policies, difficulties in crossing the borders, visa requirements, transportation issues. Interviewed businessmen noted that 60 million consumer market size would make much more sense from the view point of economies of scales compared to individual market of each Central Asian country taken separately.

The ADB report (2006) also notes that given their landlocked status, the liberalization of trade policy and regional cooperation in transport and customs transit are closely interlinked for the Central Asian republics. Progress in any of these areas will have a limited positive impact on trade if there is no progress in the others. For example, liberalization of trade policy by a CAR and its nonadjacent trading partner will not boost their bilateral trade much if movements of transport equipment and goods through connecting countries remain difficult or impossible due to deficiencies of transport infrastructure or restrictive transit systems in those countries.

The table below shows that it constitutes a small percentage in the foreign trade of Central Asian republics. However, it should be noted that major part of trade in Central Asia goes unrecorded. Table below illustrates what percentage of foreign trade in each Central Asian country is intra-regional trade.

**Share of intraregional exports and imports of the Central Asian Republics, 1999-2004**

(in per cent of total merchandise exports/imports)

<table>
<thead>
<tr>
<th>Country (exports/imports)</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kazakhstan (exports)</td>
<td>3.4</td>
<td>3.3</td>
<td>4.3</td>
<td>3.8</td>
<td>3.7</td>
<td>4.2</td>
</tr>
<tr>
<td>Kazakhstan (imports)</td>
<td>3.6</td>
<td>2.3</td>
<td>2.0</td>
<td>2.1</td>
<td>2.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Kyrgyz Republic (exports)</td>
<td>22.6</td>
<td>26.6</td>
<td>20.1</td>
<td>16.6</td>
<td>16.2</td>
<td>17.5</td>
</tr>
<tr>
<td>Kyrgyz Republic (imports)</td>
<td>27.1</td>
<td>24.6</td>
<td>32.2</td>
<td>32.4</td>
<td>29.8</td>
<td>27.4</td>
</tr>
<tr>
<td>Tajikistan (exports)</td>
<td>27.5</td>
<td>13.6</td>
<td>14.2</td>
<td>10.9</td>
<td>9.5</td>
<td>8.1</td>
</tr>
<tr>
<td>Tajikistan (imports)</td>
<td>55.2</td>
<td>50.2</td>
<td>40.6</td>
<td>34.8</td>
<td>36.1</td>
<td>37.8</td>
</tr>
<tr>
<td>Uzbekistan (exports)</td>
<td>9.7</td>
<td>8.3</td>
<td>9.2</td>
<td>8.0</td>
<td>6.6</td>
<td>10.6</td>
</tr>
</tbody>
</table>
Uzbekistan (imports) | 6.7 | 11.7 | 8.8 | 8.3 | 8.1 | 7.5

Source: Governments of Central Asian Republics and Asian Development Bank

As we see from the table smaller Central Asian economies (Kyrgyz Republic and Tajikistan) are more dependent from regional trade than larger economies (Uzbekistan and Kazakhstan).

Further the UNDP (2005) points out that today, notwithstanding the recovery compared to the first years of independence, Central Asian countries trade relatively little among themselves. There may be a statistical bias - as mentioned above in this report, since local trade is more likely to go unrecorded than long-distance trade. But even allowing for this, trade within the region is probably low. The ADB (2006) explains this with the low degree of their trade complementarity and the existence of trade barriers. Although Kazakhstan can potentially absorb a relatively large proportion of the Kyrgyz Republic, and Tajikistan’s exports and supply a substantial proportion of their imports, the latter can potentially absorb small fractions of Kazakhstan’s exports and supply small fractions of its imports. Further, there is a little overlapping between the profile of the Kyrgyz Republic’s imports and the profile of Tajikistan’s exports. These countries will ultimately find greater opportunities for trade with dissimilar and hence complementary economies farther away, provided they overcome the barriers that stand in the way of access to world markets. Both trade within the region and with the rest of the world, however, will depend on regional cooperation to reduce trade costs.

IV Micro case study of cooperation between Uzbekistan and Tajikistan in electricity sector

Currently, Uzbekistan is the largest electricity producer among the Central Asian republics and a net exporter of electricity. The country has a total installed generation capacity of 12,300 MW. Uzbekistan achieved self-sufficiency in energy after gaining independence in 1991. Today, about 50% of power generating facilities of the Central Asia Integrated Power Grid is located in Uzbekistan. This power grid also incorporates the power systems of Turkmenistan, Tajikistan, Kyrgyzstan and southern Kazakhstan.

However, maintenance of Uzbekistan’s power systems has deteriorated over the past years. Much of the equipment in generation, transmission and distribution systems is outdated. At present it needs serious renovation and upgrading to meet the growing demand of the economy.

The Tajikistan Energy System’s installed capacity is 4,354.5 MW. The annual average power generation of the hydropower plants is 15-17,000 GWh. The Nurek hydropower plant of 3,000 MW installed capacity is the biggest in Central Asia. It has the seasonal-storage reservoir of $10.5 \times 10^9$ m$^3$, and it regulates the Vaksh flow for the irrigation needs in the Amu Darya basin countries. The Nurek hydro structure operates in the irrigation regime at the beginning and in the middle of the growing season (June - July) to meet the interests of the Republic of Kazakhstan and Uzbekistan. Therefore, Tajikistan has to buy power in Uzbekistan, Turkmenistan and Kyrgyzstan, and pay for it hard currency. The power system of Tajikistan experiences shortages in winter and surpluses in summer within the range of 1 to 1.5 kWh. The Soviet period electricity transfer system was destroyed. During the Soviet period, the republics sharing the Amu Darya were also involved in water-energy transfers directed from Moscow. Tajikistan received Turkmen and Uzbek gas in return for electricity produced to power irrigation pumps in summer. Tajikistan also received electricity from Uzbekistan during winter. After the Soviet collapse, bilateral trade replaced this arrangement. Tajikistan, for instance, unable to cover domestic energy demand through hydropower production, continues to import Uzbek electricity and gas. The latter is used in Tajikistan’s thermal power plants. The UNDP (2005) notes that given the diverse national interests, the post-independence years have seen a serious weakening of the
longstanding Soviet water and energy exchange arrangement among the republics. Kyrgyzstan and Tajikistan, the upstream countries along the two main rivers of the region—the Amu Darya and the Syr Darya—prefer to maximize the use of the water for generating electricity for export and to meet domestic energy demand, especially in the winter. The downstream countries, Kazakhstan, Turkmenistan and Uzbekistan, prefer to have maximum access to water for irrigation during the summer months, while also avoiding the floods caused by winter water releases. To cope with these interrelationships in regional trade, the Central Asian governments have resorted to bilateral and multilateral agreements that determine the quantities of water and energy (coal, electricity, and gas) that are exchanged between the countries and the values at which they are exchanged. The ADB report (2002) notes that pricing is the key to providing incentives for power trade. Regional approaches to the water-energy nexus in Central Asia would bring large benefits in terms of more efficient management of these scarce resources, a greater potential for exports of electricity, more reliable availability for communities and a reduction in the potential for conflict. However, such regional solutions would require compromises involving each country’s interests and principles, and a fundamental trust that agreements once entered would actually be implemented.

Bilateral trade is not without its problems, though. Uzbekistan has several times cut gas supplies to Tajikistan due to the latter’s inability to pay in cash, and Uzbek gas supplies are often unreliable due to low pipeline pressure.

In an attempt to reduce its energy dependence on Uzbekistan, Tajikistan is currently contemplating how it can exploit its huge hydropower potential—only 10 per cent of which has been developed. Tajikistan is actively pursuing the completion of two hydropower schemes initiated during the Soviet period. According to the former minister of energy of Tajikistan Nurmakhmatov, capital investments to the tune of $2 billion into the Rogun and Sangruda in the course of 5-7 years, the country may generate electricity for exports minimum 10 billion kWt/h a year. When these stations become operational power generation in Tajikistan will reach 31-33 billion kWt/h a year. Tajikistan’s plans for expanding upstream hydropower capacity have roused concern in Uzbekistan because this would mean possibility of decrease in irrigation water in Uzbekistan.

In this light, increased intra-regional trade could provide benefits by allowing individual countries to meet future demand at a lower cost than if they were to rely solely on their domestic resources. For example, Kazakhstan and Uzbekistan could both benefit from importing hydroelectricity from existing hydropower stations in Kyrgyzstan and Tajikistan during the summer, rather than generating power in their own thermal power stations. The exploitation of differences in the marginal cost of production across countries and seasons, however, requires a much greater level of transparency in the electricity sectors of the various countries.

Central Asia has considerable electricity export potential. Possible markets such as Pakistan and Iran have the added attraction of experiencing their peak demand in the summer, when the largest electricity surpluses exist in Central Asia. Access to these markets will particularly benefit Kyrgyzstan and Tajikistan, since they could develop the capacity to export significant quantities of electricity. Uzbekistan and to some extent Kazakhstan could export thermal power in the winter, and also serve as transit countries and power traders. According to World Bank (2004a), the Central Asian Republics will need to get an intra-regional agreement on electricity transit in place for having access to export markets including Pakistan, Iran and some other countries. Major new power generation projects in Central Asia will only be feasible if there is assured access to export markets outside the region. Western investors currently view the new generation projects as high-risk ventures. Pakistan and Iran have the added attraction of experiencing their peak demand in the summer when the largest potential electricity surpluses
exist in Central Asia. Once agreements are in place they will then have to be carefully managed to ensure the benefits from intra-regional trade are optimized. Access to these markets like Afghanistan, Pakistan, Iran, China and Russia will particularly benefit the Kyrgyz Republic and Tajikistan since they are the countries with the potential to export significant quantities of electricity. Uzbekistan (and to some extent Kazakhstan), have the potential to export thermal power in the winter and also benefit in their role as prospective transit countries and as potential power traders.

In order to promote regional cooperation in the power sector the ADB allocated a loan for a Regional Power Transmission Modernization project in 2001. One of the important conditions of the loan was signing of the new type of power trade agreement between Uzbekistan and Tajikistan market players. However, this agreement was not approved and the loan was cancelled.

The main reasons for not signing the power trade agreement and abandoning this loan which would definitely contribute to regional cooperation between Uzbekistan and Tajikistan in power sector were the following:
- The financial framework didn’t not exist that would allow an efficient settlement of transactions in those cases where they are not barter-based and are dollarized.
- Potential problems of currency convertibility and absence of bank guarantees easily available, if at all, for such transactions.
- Potential nonpayment across borders.
- The desire to preserve energy security on both sides.

V Conclusion

The UNDP (2005) argues that developing a consensus and implementing follow-up action for regional cooperation and integration cannot happen overnight. In view of the many obstacles of history, current politics and institutional weaknesses, and bearing in mind the slow progress with similar efforts elsewhere in the world, one must realistically expect that serious progress with regional cooperation and integration will take years, and even decades.

The efforts to improve regional cooperation in Central Asia in the area of trade should focus on improving trade regimes in the countries in coordination with the WTO entry process, developing market economy and democratic institutions, harmonization of trade and customs policies, removing significant trade barriers such as taxes on imports that are not levied on domestically produced goods or that have higher rates for imported than domestically produced goods, export bans on some products, and crack downs on shuttle traders.

In the power sector between Uzbekistan and Tajikistan there is a need for strong negotiator/broker to mediate the negotiation process inductive to greater cooperation in this important sector. Russia might be suitable for this role provided they prove to be fair to both sides. Cooperation between Uzbekistan and Tajikistan could bring sizeable gains for both countries but this also means that the governments should curtail energy self-sufficiency as a policy goal, tackle a distorted system of energy prices, and deal with potential nonpayment problems across borders.

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