



Next Generation Democracy

Post-Soviet Eurasia

Track 2 - Business and the Economy

Regional Trends 2000-2015 & Projections 2015-2030



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NOTE TO THE READER

NGD regional reports for Track II, 'Business and the Economy', analyze trends and projections in democratic governance from a predominantly economic perspective, on the basis of a multidimensional template specifically formulated by the Club de Madrid and the Bertelsmann Stiftung for this purpose. These reports have been prepared by the Bertelsmann Transformation Index (BTI) team and complemented and fine-tuned as a result of extensive exchanges between International IDEA relevant staff, the CdM Secretariat and, more significantly, NGD regional partners and relevant stakeholders from each region, from sources such as the Round Table discussions that took place in the respective regions.

The template for NGD Track II reports is based on BTI and Bertelsmann Sustainable Governance Indicators (SGI) which provide an overview of the quality of the market economy (including both economic performance and social developments) as it relates to democratic governance. The BTI team has contextualized and interpreted other economic indicators, particularly those provided by the World Bank's Doing Business project. The assessment covers the past ten to fifteen years, and the projections sections, which have been drafted by NGD regional partners, represent an attempt to foresee key challenges and opportunities in the respective field for the next fifteen years.

The relevant BTI and SGI indicators for each section are as follows (see full range of indicators at <https://www.bti-project.org/en/index/methodology/>):

- **Economic competition:** 7.1 Market-based competition; 7.4 Banking system.
- **Legal certainty:** 9.2 Private enterprise – market principles; 9.1 Property rights; 3.3 Prosecution of office abuse.
- **Market Access:** 9.2 Private enterprise – protection of private companies and privatization processes; 7.2 Anti-monopoly policy; 7.3 Liberalization of foreign trade.
- **Inclusiveness & Non-discrimination:** 10.1 Social safety nets; 12.2 Education policy; Labor market policy – information from BTI indicators 6, 7.1 and 10.2.
- **Strategic capacity and Efficiency:** 8.1 Price stability/monetary policy, Macrostability, fiscal / debt policies; 12.1 Sustainability / environmental policy; 17.1 Effective use of support of international partners.
- **Consensus-building:** 16.1 Actor consensus; 16.4 Civil society participation in shaping economic policies.

These reports constitute the second major step of the NGD process following the discussions on Track I reports, which will progressively organize transformative practices and ideas, and will draft NGD regional agendas in reaction to signals of democratic decline, advancing democracy worldwide.



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Index

Introduction p. 4

I. Values and Institutions p. 5

1. Economic competition p. 5

2. Legal certainty p. 6

Projections p. 7

II. Access and Inclusiveness p. 10

1. Market Access p. 10

2. Inclusiveness & Non-discrimination p. 11

Projections p. 12

III. Management and policies p. 14

1. Strategic capacity & Efficiency p. 14

2. Consensus-building p. 15

Projections p. 15

Introduction

Market reforms in the region of **Post-Soviet Eurasia (PSE)** have been associated with considerable divergence in economic trends and in some cases with economic disjunction. The **Russian economy**, which accounts for three-quarters of the region's total GDP, continues to dominate the region. Nonetheless, and despite its importance to the Eurasian Economic Union, the Russian economy no longer constitutes the sole center of economic integration in PSE. In overall economic and trade terms, it is quickly losing ground to China and the EU, which have become the main trading partners for **Russia** itself as well as for **Ukraine, Moldova**, the Central Asian resource exporters and the Caucasian countries.

Each of the 13 countries comprising the PSE have chosen different paths of economic transformation. Whereas **Georgia, Armenia** and **Mongolia** have thus established solid institutional frameworks for a market economy, **Belarus, Turkmenistan** and **Uzbekistan** have largely retained their state-owned economies as well as price and trade restrictions for many goods. Russia has continuously extended the state's influence in strategic economic sectors, and Ukraine has launched radical economic reforms in the face of war and a looming financial collapse.

Gaps in national income levels across the region have widened significantly. Russia has the highest per capita gross national income and its income level of \$23,200 (PPP, 2013) is nearly ten times higher than that registered in **Tajikistan**, the poorest PSE country. The standard deviation of these income levels for all PSE countries have more than tripled between 2000 and 2013.

Natural resource exports, primarily oil and natural gas, but also minerals and rare earth elements, are key drivers of income divergence throughout the region. Natural resource rents have facilitated economic growth in **Azerbaijan, Kazakhstan, Mongolia, Russia, Uzbekistan** and **Turkmenistan**. However, such resources have also made these economies dependent on volatile world market prices and have undermined the competitiveness of non-resource sectors. Russia and other resource-exporting states are facing the challenge of diversifying their economies.

The opportunities inherent to such economic development have dissipated as falling oil prices have resulted in shrinking revenues. Economic sanctions imposed by **Canada, the EU, the United States** and other **NATO countries** in the wake of Russia's annexation of Crimea and the war in Ukraine, have also had a negative impact. The sanctions and general political uncertainties have prompted most companies based on PSE countries to cancel their investment projects, cutting Russia off from important technologies needed for economic modernization.

Import substitution has provided an economic rationale for Russia's initiatives to create an internal market among PSE countries modeled on the example of the EU. Together with Armenia, Belarus and Kazakhstan, Russia established on 1 January 2015 an **Eurasian Economic Union** that is to be expanded to include Kyrgyzstan. In contrast, Georgia, Moldova and Ukraine aspire to join the EU and in 2014 signed Association Agreements with the EU that envisage free trade and far-reaching regulatory alignment through Deep and Comprehensive Free Trade Areas (DCFTA).

I. Values and Institutions

1. Economic competition (2000-2015)

Most of the region's countries have established market-based competition by liberalizing prices, removing restrictions to free trade, introducing convertible currencies and privatizing small state companies. However, the extent to which large state-owned enterprises have been privatized varies, and none of the PSE countries have sufficiently strengthened competition and corporate governance in both private and state sectors. Restrictions to free market entry and exit prevail in many countries, which only helps the emergence and persistence of private, oligarchic monopolies. Within PSE, **Georgia** has the most advanced market economy, followed by **Armenia** and **Mongolia**. Georgia has privatized most of its large state-owned companies, minimized corruption and fostered a business environment that has been rated as the best in the region according to the World Bank's Doing Business survey.

Most other PSE countries have adopted reforms to improve the conditions for foreign and domestic business. **Mongolia**, for example, enacted new investment and securities laws in 2013 and 2014 to improve the legal framework for foreign investment. Several countries introduced electronic systems for filing and paying taxes and social insurance contributions. In **Russia**, the public Agency for Strategic Initiatives published the first-ever comparisons of business climates across Russia's regions. **Ukraine's** new government has begun to simplify the tax system by reducing the number of taxes.

Belarus and **Turkmenistan** are the only countries that have not created the fundamental infrastructure needed for market-based competition. **Uzbekistan** has largely privatized its small companies, but continues to control many prices, exports and imports. In 2014, the Belarusian government exempted several basic products from price regulation, increased utility and transport prices, but also tightened regulations for the retail trade sector in order to constrain consumer goods imports.

Prior to the military conflict in **Ukraine** and the ensuing economic crisis, **Russia**, **Ukraine** and **Georgia** had the most stable banking systems within the region. The crisis and the abovementioned financial sanctions led to a reduction in foreign bank credit exposure in Ukraine, Russia and other PSE countries. The sanctions also deprived Russian banks from the option of refinancing their lending activities through international capital markets. In addition, domestic sources of refinancing became much more costly when the *Russian Central Bank* raised its interest rate to 17 percent in December 2014 in an effort to stop the depreciation of the ruble. As a consequence, the government had to provide approximately \$15 billion (RUB 1 trillion) in January 2015 in order to recapitalize *Vneshekbank*, *VTB*, *Gazprombank* and 24 other banks suffering the effects of sanctions and the economic recession.

Domestic capital markets are small and underdeveloped in all PSE countries except for **Russia**. Banking in PSE is generally characterized by high capital adequacy ratios on the one hand, and weak regulatory and supervisory frameworks on the other. High shares of non-performing loans (NPLs) pose risks to the financial stability of banks in several countries, including **Azerbaijan**, **Kazakhstan**, **Tajikistan** and **Ukraine**. Kazakhstan tried to reduce its large stock of NPLs (nearly 40 percent of total bank capital at the end of 2013) by merging *Bank Turan Alem*, the bank with the highest NPL ratio, with

Kazkommertsbank, the country's leading commercial bank. In addition, the government recapitalized the fund for problem loans and broadened its mandate.

High levels of dollarization entail significant credit risks, as most U.S.-dollar-denominated loans are not hedged against currency depreciations in the wake of the economic recession and the decline of the ruble exchange rate in Russia. Several governments and central banks throughout the region have sought to stabilize their banking systems. In 2013 and 2014, the Central Bank of Russia dissolved some 80 banks with intransparent corporate governance structures and financial problems. The *National Bank of Ukraine* in 2014 recapitalized the Deposit Guarantee Fund and organized asset quality reviews for major banks. **Tajikistan** introduced a law on the principles of Sharia-compliant banking in 2014 prohibiting the acceptance of specific interests or fees for loans.

2. Legal certainty (2000-2015)

Although all PSE countries share a legacy of state socialism and nationalized means of production, the private sector is now the largest economic sector in most countries of the region, except for **Belarus** and **Turkmenistan**, where it is estimated to produce less than half of the GDP. Turkmenistan initiated a privatization program in 2014, and Belarus and **Kazakhstan** resumed the privatization of major state-owned enterprises in 2014. Extractive industries forming core economic sectors in those PSE countries exporting natural resources (**Azerbaijan, Kazakhstan, Mongolia, Russia, Turkmenistan, Uzbekistan**) are predominantly controlled by the government directly or through capital owners who are linked to the governing elites. In the absence of overlap, informal links and networks are maintained by political and economic elites acting in their mutual interest. While these networks provide political elites with influence, rents and patronage options, business elites obtain political protection and secure lobbying channels. As a consequence, the formally private ownership of many large companies in natural resource industries (and in other sectors of the economy) does not necessarily imply an economy undergoing de-etatization.

The **Russian** government has renationalized several large oil companies. For example, in 2014 the prosecutor general confiscated the majority share package held by AFK Sistema in Bashneft', Russia's sixth-largest oil company. This measure was preceded by the Investigative Committee's intervention against Vladimir Yevtushenkov, the owner of AFK Sistema (and Russia's 15th wealthiest businessman). The committee placed him under house arrest, accusing him of money laundering and theft of Bashneft' shares. The head of the Russian Union of Industrialists and Entrepreneurs compared the Bashneft' trial with the expropriation of the oil giant Yukos and the jailing of its CEO Michail Chodorkovski in 2004. Another major renationalization took place in 2013, when Russia's state-owned oil company Rosneft' acquired 100 percent of TNK-BP, Russia's third-largest oil producer, from British Petroleum and its Russian business partners.

Uncertain property rights have induced many Russian business leaders to establish and maintain their assets outside the country. From 2011 to 2013, the average annual net outflow of private capital was 3.3 percent of GDP, and reached \$151.1 billion in 2014, a figure 2.5 times higher than that in 2013. In order to reverse this trend, the government in 2014 expanded the tax base of Russian citizens and companies to include profits from

their foreign companies. President Putin also promised a tax amnesty to Russians who would repatriate their assets.

The crisis in Russia's relations with **NATO** countries has raised questions about the protection of foreign investment in Russia. In October 2014, the Duma discussed a bill that envisaged the expropriation of foreign property as a means of compensating Russian businesses for losses incurred as a result of EU, U.S. and other NATO countries' sanctions. Facing criticism from the government and the Supreme Court, the Duma suspended readings of the bill.

Apart from the capacity of government agencies in many PSE states to "capture" business, the uncertain prospects of litigation jeopardize property rights throughout the region. According to the World Bank's 2014 Doing Business survey, resolving a commercial dispute before a relevant court in PSE took 354 days on average, involved average costs of 26 percent of the debt value and required 36 procedural steps (unweighted average of 12 countries, excluding Turkmenistan). The best conditions for enforcing contracts existed in **Belarus, Russia, Georgia** and **Mongolia**, whereas the number of procedures in **Armenia** and the costs in **Ukraine** were much higher than elsewhere in the region.

In a representative survey conducted by the **European Bank for Reconstruction and Development** (EBRD) among 9,000 business managers in 12 PSE countries during 2012/2013 (excluding Turkmenistan), only 35 percent of the respondents considered their country's court system fair, impartial and uncorrupted (unweighted average). Managers in **Belarus** and **Georgia** had the most positive opinions about their country's court systems, confirming their integrity by 50 and 46 percent, respectively. In contrast, 72 and 87 percent of Moldovan and Kyrgyz managers viewed their judicial systems as unfair, biased and corrupted.

All PSE states have formulated anti-corruption policies, but low levels of elite commitment mean that implementation often lags behind. Moreover, these policies usually do not target corruption among ruling elites who often depend on maintaining patronage-based relations of exchange with their supporters in business and society. The EBRD survey found that for 21 percent of the managers in PSE, corruption represented a very severe or major obstacle to their business activities. **Kyrgyzstan** and **Moldova** emerge here as the two countries with the highest number of respondents noting corruption, whereas corruption appears to be the least relevant in **Belarus** and **Georgia**. In terms of perceived corruption and fair court systems, **Russia** places in the middle on both questions, though 24 percent of its business managers declared they frequently or very frequently make informal payments or gifts to get things done. This is the highest frequency reported in PSE, more than twice the region's mean share of 10 percent.

Projections (2015-2030)

Economic Competition

Trade barriers and technical hurdles to economic flows will likely remain a key feature of the PSE region. In particular, as the case of **Ukraine** has shown, signing a DCFTA with the EU is irreconcilable with belonging to the **Eurasian Economic Union**. This could potentially harden divisions and create further splits in Eastern Europe and the South Caucasus. In Central Asia, trade among the five republics is extremely low (for example,

Uzbekistan regularly blocks the transit of goods by rail to **Tajikistan**) and international links remain weak. The Central Asian countries, with the exception of **Kazakhstan**, are not considered business-friendly countries given the persistence of corruption and/or complex customs procedures.

It is difficult to project how external shocks and geopolitical challenges will affect the PSE region's economic outlook. It is still unclear how key factors such as the volatility of (currently low) oil prices and the Ukrainian crisis will evolve, but they will surely have long-term economic implications for many countries, including **Azerbaijan, Kazakhstan** and **Russia** which, until very recently, were experiencing steep growth. At best, these factors will cripple public spending and lead to more lost years in a region that has never fully recovered from the post-Soviet collapse with regard to infrastructures, social services, and education.

In this context, the risk of a systemic banking crisis will also remain for some time. Several countries might look for alternatives to prevailing OECD banking systems. Central Asia is likely to seek further Chinese loans and credit projects, as well as funds from Muslim countries perceived to be more stable and secure.

On the other hand, the potential long-term decline of Russia's economic attractiveness for PSE countries and the limitations of Russia-backed regional integration projects might lead PSE governments to turn to the EU and other international investors. This could help improve their economic governance frameworks, particularly if there are sustained demands of European governments (as well as the United States, Japan and others) in this sense.

The stalemate may have consequences in terms of popular support for the regimes in the medium term. In various PSE countries, a new generation of middle-class elites – trained abroad and more conscious of rules-based reforms – is emerging. This is the case in countries that have the capacity to send their young bureaucrats and students abroad (**Kazakhstan**, for instance, through its Bolashak program) or those that have close links with the EU and the United States (**Moldova** and especially **Georgia**). International exchange programs beyond the region remain essential in training bureaucrats and professionals. International donors need to emphasize this aspect in relevant cooperation frameworks. Some of these programs, however, are being suspended by PSE countries.

Legal Certainty

Business-friendly rule of law reforms will conflict with the informal clientele and patronage systems underpinning authoritarian rule. Shortcomings in the rule of law in many PSE countries will continue to affect the potential for attracting foreign companies and foreign direct investment (FDI). Over the medium term, continuity seems likely in the approach to reform in various countries throughout the region. There are four basic models most likely to be pursued: There are those countries that will progressively improve the rule of law by aligning their system with liberal democracies' norms and practices (**Moldova, Georgia**, possibly **Armenia** and **Mongolia**); some will only implement reforms that are directed at creating a business-friendly environment without detracting from increasingly cemented authoritarian rule (**Azerbaijan** and **Kazakhstan**); others will institute only artificial changes that are not implemented in practice and will remain risky for investors (**Turkmenistan, Uzbekistan**). A fourth group of countries will also see little improvement, with economic prospects heavily dependent on the maintenance

of a balancing act between powerful neighbors: Belarus between the EU and Russia; and Kyrgyzstan and Tajikistan between China and Russia. Ukraine will continue its EU-targeted approach, with little prospects for membership in the short to medium term or the situation in Crimea being settled.

Corruption is deeply ingrained in all levels of society and is likely to remain the biggest obstacle to economic development – one with broad-based benefits for society – in PSE countries. The corruption of elites will probably remain the most severe threat to the impact of development aid, too. In this sense, only **Georgia** and much less likely **Belarus** may eventually take advantage of positive policies to counter corruption, which would benefit the population at large.

Regarding prospects for transformation, many of those engaged in providing democracy support are already very active in programs targeting the rule of law and anti-corruption, encouraging reforms in different sectors and across various institutions (such as the judicial and prison systems), all of which have resulted in little change thus far. Whereas legal frameworks are reasonably up-to-date, practice is lagging behind. International donors have not been able to inspire transformation in this sense, and weak civil societies and media systems in PSE countries are not able to exert a watchdog function. The same applies to national audit institutions. Relevant reforms and control mechanism would not only create trust among traditional foreign investors. **China** and other countries such as **Turkey** are indeed affected by legal uncertainty, weak rule of law and corruption while doing business in PSE countries, including ongoing large investments in Central Asia.

II. Access and Inclusiveness

1. Market Access (2000-2015)

All PSE states recognize the importance of private entrepreneurship and have sought to provide conditions enabling the creation of small and medium-sized enterprises (SME). In its 2014 Doing Business survey, the **World Bank** found that establishing a business in PSE takes 11 days and requires four procedures and four percent of the respective country's per capita income (unweighted averages, missing data for Turkmenistan). These figures are lower than the means of most other world regions. Within PSE, registration procedures are the least bureaucratic in the three Caucasian countries and **Kyrgyzstan**, while the procedure is most time-consuming in **Tajikistan** and **Ukraine**.

According to national data sources, SMEs account for more than 90 percent of all companies and for 40 to 80 percent of total employment in most PSE countries. However, their importance for national economies in terms of employment and GDP shares is still far below the levels of the more advanced transition economies. Most SMEs are clustered in trade rather than in industrial production or skill-intensive services. SMEs lack capital and have limited access to finance since banks associate them with higher credit risks due to information asymmetries and lacking collaterals. As a consequence, average annual private investment in fixed capital has been below 20 percent of GDP in most PSE countries during the period from 2011 to 2013, except for **Mongolia** (43%), which benefitted from a mining boom, **Belarus** (34%) and **Armenia** (21% of GDP) (World Bank data).

According to the **U.N. Conference on Trade and Development**, the stock of FDI in PSE formed 47 percent of the region's GDP in 2013 (unweighted average of 13 countries). **Mongolia** has been the most attractive destination for FDI (134% of GDP), followed by **Georgia** (72% of GDP) and **Kazakhstan** (59% of GDP). In contrast, the stock of FDI in **Uzbekistan** comprised only 15 percent of GDP in 2013, indicating the limited openness of the country's economy (inward FDI has also been below 20% of GDP in **Azerbaijan** and **Tajikistan**, if for reasons respectively related to exhaustion and lack of possibilities).

With the exception of **Turkmenistan**, all PSE countries have created competition legislation and agencies. But these agencies lack enforcement powers, and in some Central Asian countries they are confined to address exorbitant prices for basic consumer goods, whereas they do not intervene to break up oligopolies or other forms of rent-seeking. **Georgia, Moldova** and **Ukraine** have committed themselves to establish independent and stronger competition agencies, EU-type state aid control and public procurement systems in their Association Agreements with the EU. Similarly, **Armenia, Belarus, Kazakhstan** and **Russia** agreed to introduce a joint competition policy in the Treaty on the **Eurasian Economic Union** (EAEU) that took effect on 1 January 2015. The Treaty obliges the member states to codify common principles of competition policy in their national legislation and delegates supervisory and regulatory functions to the **Eurasian Economic Commission**, a supranational agency charged with implementing the EAEU Treaty.

Both the Association Agreements and the EAEU Treaty are aimed at introducing trade and the free movement of capital, services and the freedom of establishment, although they are clashing with each other in practice. In addition, the PSE states participating in

the **Commonwealth of Independent States** (CIS) in 2011 agreed to establish a free trade zone. However, these economic integration projects have been questioned by protectionist actions in conflicts between PSE states, and they have also been associated with new trade barriers between **Russia** and the EU. In August 2014, Russia imposed a one-year import ban on EU food products in reaction to economic sanctions in the wake of the Ukrainian crisis. Russia also banned imports of certain food products from **Ukraine** and **Belarus** in 2014, and there have been several WTO dispute procedures between Russia, the EU and other countries. It is worth noticing in this regard that **Armenia, Georgia, Kyrgyzstan, Moldova, Mongolia, Russia, Tajikistan** and **Ukraine** are **WTO** members; **Azerbaijan, Belarus** and **Kazakhstan** are close to accession.

In geo-strategic terms, Russia views the EAEU as a framework to re-connect former republics of the **Soviet Union** and to facilitate more competitive and diverse economies in EAEU member states by protecting domestic industries and substituting imports. However, intra-PSE trade has declined significantly, while the EU and, increasingly, China have become the main trading partners for most PSE countries. At present, only Belarus and Kyrgyzstan conduct more than half of their foreign trade with the CIS.

2. Inclusiveness & Non-discrimination (2000-2015)

In 2011/2012, total public expenditure on social protection was more than 15 percent of GDP in **Belarus, Moldova, Russia**, and **Ukraine**, but less than ten percent of GDP in **Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Mongolia** and **Tajikistan** (ILO data). It is noticeable that the level of social protection is not associated to income level, since Moldova is in the first category and Azerbaijan and Kazakhstan in the second. In fact, countries willing to get closer to the EU are the ones making more efforts in terms of social protection.

Expenditure shares rose in most countries during the period from 2000 to 2009 and fell afterwards. **Belarus** maintains a relatively inclusive social protection system as part of its “Soviet-retro” welfare state model. In the poorer Central Asian countries (**Kyrgyzstan, Tajikistan, Uzbekistan**), pensions, unemployment benefits, social assistance and social services are less developed, and needy persons often have to rely on family or community support on family or community support, including Islamic civil society associations which work informally in the field of social assistance and justice. In the course of the last decade, most PSE countries have adopted policies that focus social benefits on the most vulnerable strata of population. These policies and the period of economic growth until 2014 have helped reduce poverty rates and income inequality in many countries. Several states have recently raised pensions and minimum wages to protect low-income groups against inflation.

Prior to 2014, most PSE states were able to broaden the scope of employment and thus the revenue base of social insurance systems, although employment rates in most countries improved only by a few percentage points. **Kazakhstan** had the highest employment-to-population ratio in PSE (69% in 2013, up from 65% in 2007). In contrast, **Moldova**’s ratio decreased from 42 (2007) to 39 percent (2013), which was by far the lowest ratio in PSE. Sustained economic growth also contributed to reducing the high shares of long-term unemployed in several countries (among others, in Russia and Ukraine), although shares

continue to be more than 30 percent in a number of countries. Unemployment benefit schemes cover only a small fraction of the unemployed. According to the International Labor Organization, only 21 percent of Russia's and Ukraine's unemployed received periodic unemployment benefits in 2012. These shares had decreased from 28 percent (**Russia**) and 34 percent (**Ukraine**) in 2007, and they were even lower in several other PSE countries. Most PSE states lack active labor market policies and broader employment promotion policies aimed at overcoming the segmentation of labor markets along regional, urban-rural and skills-based lines.

Armenia, Azerbaijan, Moldova and **Ukraine** have recently envisaged or implemented reforms of their pension systems that introduce, among others, private pension funds. **Kazakhstan** in 2013 decided to merge its private pension funds and to use some of the pension savings to finance credits to national companies. Generally, PSE states possess relatively inclusive education and health systems, but the quality of services is low. Most PSE states have been able to make their health care systems more effective insofar as they improved their performance on two important aggregate quality indicators during the last decade, life expectancy at birth and infant mortality rates. Georgia, the most advanced health care reformer in PSE, increased the coverage of its state medical insurance in 2013. **Azerbaijan, Belarus** and **Uzbekistan** have succeeded increasing the enrolment and completion rates of girls in secondary and tertiary education.

One of the most worrying features in the PSE region is the state of educational and health care systems. This is especially worrying in the poorest countries, many of which are in Central Asia. But also countries like **Moldova** and **Armenia** are affected by a downward spiral. In Central Asia, Islamic solidarity mechanisms are on the rise (alongside conservative values) and provide social safety nets in rural areas.

Projections (2015-2030)

Market Access

The present stalemate is likely to continue in the short to medium term unless there is commitment to work towards increasing compatibility of both free trade areas, which would not entail such difficult choices for countries in the region (e.g., **Serbia** has free trade agreements with both the EU and Russia). However, competition between the EU's DCFTAs and the Eurasian Economic Union, compounded by political tensions between the EU and Russia, is likely to result in further trade barriers. The countries that have signed an AA with the EU but also are still partly dependent on **Russia** for imports and exports will likely continue to suffer from Russian trade embargos and insecure energy deliveries. Meanwhile, the EAEU members will be confronted with fewer options to export outside the EAEU area and be affected by Russia's economic decline. An increasing economic split would indeed entail higher risk of localized conflict and geopolitical competition. Some small steps could contribute to easing tensions, starting with possibilities for SMEs of different countries cooperating particularly in border regions. In the case of Eastern Europe and the South Caucasus, the EU's Eastern Partnership Business Forum might play an initiating role in such direction.

Inclusiveness and Non-Discrimination

The crisis in **Ukraine**, the decline of oil revenues and the economic recession in Ukraine, **Russia** and other PSE countries will burden social security systems and increase risks of poverty and unemployment. These developments will also affect the poorer Central Asian countries since their economies depend on remittances from labor migrants who predominantly work in Russia and face uncertain employment prospects due to the recession. Social and economic precarity will indeed favor increasing conservatism on values and family norms, including gender roles, which will in turn affect the economy. Labor migrations are likely to continue to play a key role in the national incomes of many PSE countries. The number of East Europeans but especially Caucasus people and Central Asians that work in Russia is extremely high. The current economic difficulties of Russia have resulted in many labor immigrants returning home, giving rise to unemployment and social tensions. Over the coming decade, PSE nationals will increasingly look to other countries for work besides Russia: East Europeans to the EU; Caucasus nationals to the **EU, Turkey** and **Gulf States**; and Central Asians to Gulf States.

Meanwhile, Russians are also leaving their country. Five times as many Russians are emigrating now, during Vladimir Putin's third term, than in the early 2000s: 86,382 Russians left the country in 2013 and 122,751 in 2012. These numbers represent a significant increase over the 36,774 that left in 2011 and the 33,578 in 2010. The difference between Russia and PSE countries is that Russia's migrants are often educated workers from the new middle class that will not return, while PSE migration, mostly to Russia, concerns low educated workers that send remittances home.

Number of Foreign Citizens engaged in Legal Labor Activities in the Russian Federation

	2011 (fourth quarter)	2012 (fourth quarter)	2013 (second quarter)
Total	1,192,000	1,325,000	1,573,000
CIS countries	1,024,000	1,135,000	1,374,000
Azerbaijan	36,000	33,000	33,000
Armenia	53,000	97,000	77,000
Kyrgyzstan	77,000	87,000	93,000
Moldova	55,000	59,000	54,000
Tajikistan	198,000	218,000	271,000
Uzbekistan	476,000	554,000	702,000
Ukraine	117,000	134,000	117,000

Source: Russian Federal Migration Services, Quarterly Reports (<http://www.fms.gov.ru/about/statistics/data/>)

Only economic development, the strengthening of local industries and agriculture, and education can help remedy the negative consequences of labor migration. More broadly, structured support is needed for the educational system at all levels (basic education, higher education, vocational training) as well as for health care systems and other social welfare mechanisms in Eastern Europe and the South Caucasus. In Central Asia's

case (excluding **Kazakhstan**) only a sort of “Marshall Plan” could help develop public educational and health care systems.

III. Management and policies

1. Strategic capacity & Efficiency (2000-2015)

Azerbaijan, Kazakhstan and **Turkmenistan** have stabilized and pegged exchange rate arrangements anchored to the U.S. dollar. The other PSE countries maintain more flexible exchange rate and monetary policy frameworks. The war, falling oil prices, sanctions and the accelerating capital flight in 2014 caused the Russian ruble and the Ukrainian hryvnia to lose nearly half of their values against the U.S. dollar. In order to stabilize the exchange rate, the **Central Bank of Russia** in December 2014 raised its policy rate to 17 percent. The ruble depreciation has also put the currencies in **Armenia, Belarus, Kyrgyzstan** and other PSE countries under pressure and has increased inflation rates.

Ukraine has experienced a dramatic decline of macroeconomic stability. According to the Ukrainian government, the occupation of Crimea and the Donetsk/Luhansk areas equaled a loss of approximately 20 percent of Ukraine’s GDP. Between 2013 and 2014, Ukraine’s GDP fell by nearly ten percent, the public debt increased from 40 to 70 percent of GDP, the inflation rate jumped to 25 percent and the country’s official reserve assets sank from \$20.4 to \$7.5 billion. The general government deficit is expected to reach ten percent of the country’s GDP in 2015. In March 2014, Ukraine and the **IMF** concluded a two-year Stand-By-Arrangement that provides approximately \$17 billion support which is far from sufficient to cover Ukraine’s financing needs.

Over the longer period between 2000 and 2013, **Armenia** and **Georgia** managed to retain average annual inflation rates below six percent, while these averages exceeded ten percent in **Russia, Moldova, Tajikistan** and **Ukraine** (IMF data). Inflation reached the highest levels in **Belarus**, where consumer prices increased by more than 50 percent in 2011 and 2012.

Rents from natural resources have contributed to relatively higher growth rates, positive general government budget balances, current account surpluses and lower debt-to-GDP ratios in the resource-exporting economies. The salience of these rents ranges between 19 and 39 percent of GDP in the two PSE resource exporters with the lowest and highest rents, **Russia** and **Azerbaijan**, respectively (World Bank estimations for 2012). **Mongolia** deviates from this general pattern, since it has generated successive twin deficits in its current account and its general government balance. Since lower FDI inflows in 2013 no longer fully covered the current account deficit, Mongolia had to raise more debts than admitted by its 2013 law on fiscal stability.

Most governments in PSE have tended to subordinate environmental protection to their priority of higher economic growth. Governments in several resource-exporting countries have formulated ambitious development goals, such as Kazakhstan’s aim of joining the 30 most developed economies of the world in 2050. Kazakhstan has also been comparatively open to liberal democracies’ advice and support in its efforts to upgrade its education and research systems. Among the resource-importing PSE countries, **Georgia** has more effectively used foreign and international support to curb

corruption and to draft institutional reforms although implementation, especially in the judiciary, remains fragile.

2. Consensus-building (2000-2015)

Political actors in all PSE countries agree that market mechanisms and private property rights are necessary tools in motivating economic actors, avoiding supply shortages and overcoming economic stagnation. Opinions vary regarding the reach and scope of state involvement needed. As a matter of fact, liberal economic reformers have lost much of their previous political influence in **Russia** under Vladimir Putin's current presidency. Policymakers in all resource-exporting PSE countries largely agree that the state should retain controlling stakes in major oil, gas or mineral industries. The prevailing view welcomes foreign investors to import advanced technologies and management knowhow, but refuses granting them exclusive rights to exploit the country's wealth.

To legitimize broad and active state involvement, ruling political elites in **Kazakhstan** and **Russia** have referred to successful East Asian "developmental states," such as **South Korea** and **Taiwan**. Seeking to emulate policies of these states, governments identified strategic industries and supported them.

Although majorities of the **Georgian**, **Moldovan** and **Ukrainian** citizens support closer relations with the EU and the approximation of its economic model, opposition groups in Moldova and Ukraine have advocated a closer orientation towards Russia. This minority position has also been justified by economic arguments that suggest protecting local industries against ruinous competition from foreign companies. Elite skepticism towards an unfettered market economy resonates with popular attitudes. Citizens of eight PSE countries, polled by the World Value Survey in 2011, considered competition more harmful and preferred more state ownership of business and industry, than, for example, respondents in China.

Governments in several PSE states have established channels of consultation with civil society organizations (CSO), such as in the case of **Moldova** (CSO). However, authoritarian political regimes such as **Azerbaijan**, **Belarus** or **Russia** have clearly limited such civil society participation to issues and policy areas that do not fundamentally question the existing monopoly on political rule. Moreover, these regimes have also tried to create pro-regime CSOs in order to tighten their control over civic activism. Civil society in Central Asia is either largely non-existent (**Turkmenistan**, **Uzbekistan**) or under threat (**Kazakhstan** and **Tajikistan**). Only **Kyrgyzstan** remains a positive example.

Projections (2015-2030)

Strategic capacity and efficiency

The economic foresight for the region remains bleak for the coming decade. National policies diverge enormously, but all PSE countries are very dependent on economic ties with the EU, China and/or Russia. In the case of **Russia**, a drastic reform of the state administration and an end to micro-management and hyper-centralization are needed to stop the country's economic downward spiral. Russia desperately needs to diversify its economy and make headway in modernization, though these measures seem impossible under the current leadership.

In Eastern Europe, the major uncertainty is **Ukraine's** (economic) survival, which will depend both on Russia's degree of acceptance of a genuinely independent and increasingly democratic Ukraine and the EU's readiness to invest massively in Ukraine's economy and reform efforts. Meanwhile, **Moldova** will likely continue to slowly shift from dependence on Russia to increased trade with the EU, as it has done over the last decade. **Belarus** under Lukashenko will remain close to Russia in the EAEU but will seek to play Russia against EU member states, which includes attempts to circumvent EAEU trade rules (or EU sanctions for that matter).

In the Caucasus, **Georgia** will seek to gain maximum benefits from the DCFTA with the EU while also leveraging its role as an energy transit country, with regard to oil and gas either from **Azerbaijan to Turkey** or through Georgia's Black Sea coast. **Armenia** runs the risk of remaining isolated and dependent on **Russia**, although the EU and Armenia will probably seek possibilities to increase mutual trade levels. Azerbaijan will try to increase its energy exports to Europe but will remain highly dependent on commodity exports. The end of sanctions on **Iran** can bring new tensions with neighbors but also create new trade lines from which Armenia and possibly Georgia could benefit.

In Central Asia, **Kazakhstan** could face instability if the current economic crisis is not effectively addressed. The legitimacy of the regime rests on a social contract centered on improving the population's living standards. Kazakhstan's budget is based on the exploitation of the Kashagan oil fields (beginning in 2017), which will be vital to its continued economic growth, as well as on the price of oil. **Kyrgyzstan** and **Tajikistan** are likely to remain highly dependent on Russia, while China's economic clout in both countries will continue to rise. **Turkmenistan** and **Uzbekistan** will continue to rely on specific sectors (gas in Turkmenistan and obsolete industry and cotton in Uzbekistan) and are unlikely to achieve much in the way of economic diversification.

Consensus building

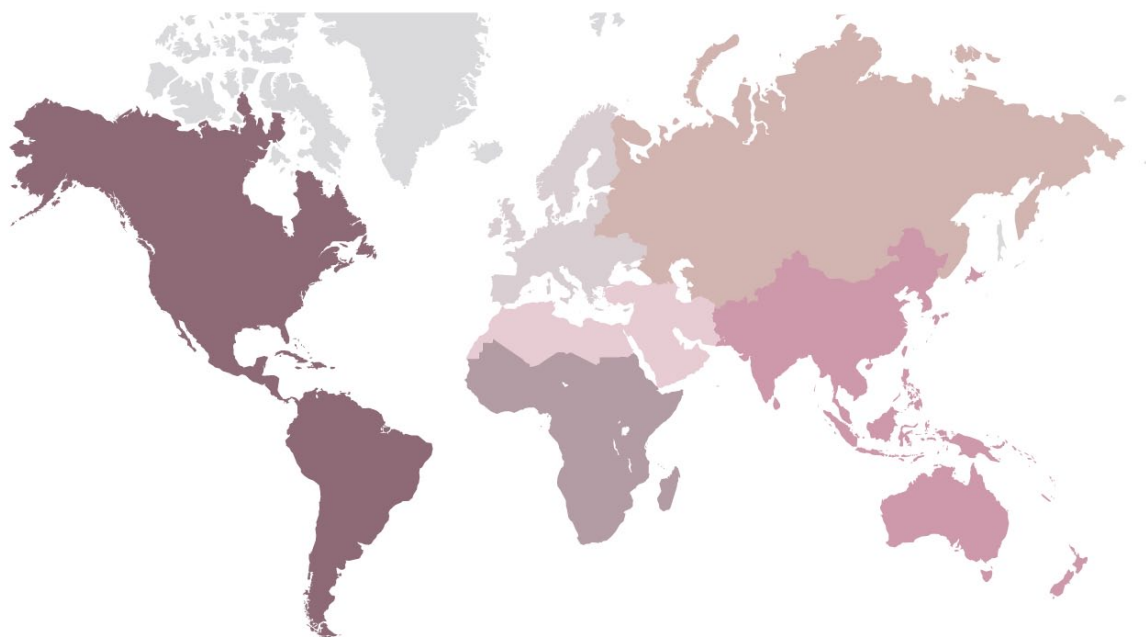
Anti-EU sentiment will tend to prevail among the population under the circumstances already mentioned. The fact that the EU, and particularly the Eurozone, may continue experiencing serious problems also contributes to the EU's waning attraction among PSE populations.

The EU has sought to establish modernization agreements, notably with **Russia** and **Azerbaijan**. Clearly, the diversification and modernization of PSE economies is essential but rent-seeking elites of oil and gas-producing PSE states have not been able to make use of the EU's offer to help as differences on reforms and values continue to stand in the way of true cooperation. As long as the EU and other donor countries incorporate democratic reform and values in their economic cooperation and development package

offers, they will meet with little interests among the regimes of **Central Asia** and **Russia**. Meanwhile, genuine reform is also resisted by countries that have chosen to establish closer ties with the EU such as **Moldova** and **Georgia**, as they also meet difficulties in breaking through the vested interests of elites.



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