

## REGIONAL COOPERATION OF THE CIS7: PAST EXPERIENCE AND OPTIONS FOR THE FUTURE<sup>1</sup>

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The basic goal of the CIS7 initiative gathering seven CIS countries<sup>2</sup>, the World Bank, the Asian Development Bank, the European Bank of Reconstruction and Development, the International Monetary Fund and bilateral donors is to combine efforts in order to enhance the economic growth and poverty reduction prospects of the seven poorest CIS countries. Several studies conducted within this initiative pointed to the significance of transit and trade as engines of economic growth in the CIS7. The expansion of trade in turn depends on regional cooperation in elimination of border delays, corruption and facilitation of transit across the region. The previous two conferences, in London and in Lucerne, highlighted also the need for regional cooperation in sharing the regional public goods such as water and energy, as well as cooperation in dealing with security issues. Despite many positive developments in these areas such as establishment of the regional TTF centers, it seems that the potential benefits of regional cooperation have not been yet fully appreciated and exploited.

The CIS7 belong to a number of regional integration agreements (RIAs). Most of them involve solely the members of the CIS block. All CIS7 countries except Tajikistan also signed cooperation agreements with the EU, while South Caucasus countries signed RIA with neighbors within the Black Sea basin; the Central Asian countries cooperate with China. However, over the 1995-2001 period none of the existing RIAs among the CIS countries has been successful in preventing the fall of share of intra-CIS trade in total trade of its members.

The aim of this paper is to present a framework for the analysis of regional cooperation, which will allow for the analysis of the reasons behind limited effectiveness of the existing arrangements and the incentives to improve their implementation. The goal of this paper is also to present the areas and the possible country groupings in which the expected benefits of cooperation are the highest.

The paper begins with a review of political and economic considerations in the formation of a RIA. The second part draws on the analysis of the first section to discuss the lessons for the CIS7. It discusses the options for further cooperation within the CIS block, with the EU and with other large economic partners. The third section reviews the existing RIA. It includes a brief discussion of the current level of implementation of each RIA and studies the likely political and economic benefits to be derived from increased integration of their members. In many cases further economic cooperation in terms of harmonization of external tariffs or harmonization of other policies does not seem to be a beneficial option at this time, however the cooperation in sharing the regional public goods is expected to leave all members significantly better off. Therefore the forth section shifts focus to the regional cooperation in sharing water resources, electricity and

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<sup>1</sup> This is a background paper for the CIS7 initiative and its completion was financed by the World Bank. The views expressed in this paper are solely those of the author.

<sup>2</sup> Armenia, Georgia, Azerbaijan, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan.

to transport and to security issues. The last sections contain the summary of findings and policy recommendations.

## **I. Regional Integration Agreements<sup>3</sup>**

This section discusses general considerations in formation of a RIA. The questions that arise are the following: should a country join a RIA or not, what partners should a country choose, what areas and how deeply should a RIA cover, what are the political and economic benefits and costs of each alternative? These arguments will serve as a background for discussion of the existing and potential RIAs involving the CIS7 countries.

### **1. Political arguments**

The political arguments are quite often the main reasons for joining a RIA. There are three major issues. The first is security. There may be perceived benefits from using a regional agreement as a basis for increasing security against nonmembers. In some instances, formation of a regional agreement may improve the security of its members in relations to other members. The increased security can be achieved through different mechanisms. Interlocking economies can make any potential conflict more expensive and regular contact can build trust and facilitate cooperation in other issues. On the other hand a regional agreement can create internal tensions, particularity driven by perceived unequal distribution of gains among its members. In the past, such tensions led to breakup of agreements and conflict.

The second source of political benefits is an increase in bargaining power when countries act on international forum together rather than individually. The small countries grouped in regional agreements can enter negotiations with bigger partners more effectively, they are more likely to “be noticed” and to strike good deals. These gains depend on the ability of members to agree on a common agenda.

The third potential source of political benefits is a “lock-in” effect, where participation in a RIA provides a commitment mechanism for trade reforms and other policy measures. The membership in a RIA rises the costs of and therefore decreases the likelihood of policy reversal. The effectiveness of a RIA in providing the guarantee for continuation of political and economic reforms depends on interests and a degree of involvement of other members.

### **2. Economic arguments**

There are two main sources of economic benefits from the formation of a RIA. The first are scale and competition effects. Reduction of barriers to trade is equivalent to market enlargement. Firms can increase their production and exploit economies of scale. Larger markets are more likely to attract foreign direct investment. Greater competition induces firms to make efficiency improvements. The design and implementation of the agreement are crucial for the realization of these gains. Some of these benefits can be achieved with unilateral liberalization, but this is not always politically feasible.

The second group of economic changes covers trade expansion and location of production effects. The reduction of barriers to trade within the block leads to trade

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<sup>3</sup> This section is based on “Trade Blocks”, World Bank, August 2000, Oxford University Press.

creation and trade diversion. The government loses tariff revenue and the overall effect may be positive or negative, depending on the block's policy towards the rest of the world and on the costs of alternative sources of supply.

Changes in protection may lead to relocation of production across members of the agreement. The shifts in location of production are determined by the comparative advantages of countries, by agglomeration effects and by possible technology transfer between the countries. The comparative advantage alone can explain the differing experiences of some RIAs. We consider two small countries having disadvantage in manufactures relative to the world average, but the disadvantage is less pronounced in one of them. Kenya and Uganda provide good examples. Kenya has little capital per worker and Uganda has even less. If both countries have disadvantage in manufacturing relative to the world average, before formation of a RIA they both have some manufacturing supported by relatively high tariff protection. If the two countries form a RIA manufacturing production is likely to relocate to Kenya taking it further away from its true comparative advantage and moving Uganda closer to its comparative advantage. However, this is going to bring gains to Kenya of a larger market protected by high tariffs from nonmember competition, while Uganda is going to suffer trade diversion. As a result the incomes of countries will diverge. In general countries further away from world average in terms of factor endowments do worse in a RIA.

In the case of high and low income countries forming a RIA the industry is likely to relocate in response to differences in factor prices. The benefits for a small country with relatively cheap labor are maximized if it enters into a RIA with an industrial and high wage economy.

Comparative advantage is not the only force that determines relocation of industry in a RIA. Another forces are the agglomeration economies, which are the strongest at high and low trade costs. At high trade cost the industry will locate in a larger market to benefit from the proximity to buyers and to exploit the economies of scale. At low trade costs the periphery might attract industry due to lower costs of production and serve the core market through exports.

The following statements conclude the arguments presented in the above sections:

1. South-South RIAs are more likely to lead to income divergence of its members and to generate trade diversion.
2. North-South RIAs are more likely to generate transfer of technology and to provide lock-in mechanism for political and economic reforms.
3. North –South RIAs may provide more benefits from deep integration and allow for the full exploitation of the comparative advantage by the smaller members.

### **3. External Trade Policy**

Some of the costs and benefits of a RIA depend directly on the level and structure of external protection. Several arguments point to the importance of low external protection. First, trade diversion is more likely and more costly to occur if external tariffs are high. It is more likely, because relative price differences created by preferential liberalization are greater. It is more costly, because higher external tariffs provide greater incentives for the expansion of inefficient sectors. In general, the gains that stem from competition from low cost suppliers may be forgone if competition is inhibited due to high external trade barriers. In addition, a closed RIA is more likely to result in agglomeration of activity in

one of the members, as the linkages between firms are stronger when firms need to rely on local suppliers and on local markets for their sales.

Another important question that countries forming a RIA need to consider is to whether set the external trade policy in a concerted manner. A customs union (CU) requires greater political commitment, as members need to agree on a common external tariff and on a distribution of tariff revenues. The advantage of a CU is that it allows for greater simplification or even abolition of internal borders. In contrast, a free trade area (FTA) allows members to set their external trade tariffs individually, but it involves the risk of trade deflection i.e. redirection of imports from outside world via the FTA member with the lowest external protection. If unconstrained, this reduces effective tariffs of other members to that of the member with the lowest tariff plus transport costs, which is a wasted real resource cost. The usual solution, the implementation of rules of origin is very costly. It means that internal border controls need to be retained to ensure compliance and to collect duties. In practice, implementation of rules of origin allows customs authorities a good deal of discretion and provides opportunities for corruption. In addition the rules of origin are complex and hard to negotiate.

However, despite benefits of a CU the majority of RIAs are in fact FTAs. The costs of a CU are that harmonization of external trade policy means of loss of national autonomy. Secondly, it might lead to unequal distribution of wealth across countries. Thirdly, the members need to agree on a distribution of tariff revenues, which can also be divisive. In many developing countries difficulties of agreeing on a common external tariff and distribution of revenue led to delay in implementation of a common external tariff or ineffective implementation due to several exemptions. Finally, the formation of a CU involves adjustment costs and lobby opposition in the implementation of a CET. Schiff (2000) shows that the costs of a formation of a CU are minimized if countries are similar. He estimates that the ratio of FTAs to CUs is 6 to 20 times higher for North-South RIAs as compared to South-South RIAs.

#### **4. Market integration beyond trade barriers**

The gains from competition and scale effects may not be realized if markets remain fragmented by non-tariff obstacles to trade. However, the removal of remaining barriers may be costly. Several RIAs retain protection on internal trade in the form of antidumping duties, countervailing duties or “emergency protection” in the case of balance of payments crises or a surge in imports. Contingent protection provides a major barrier to trade, even if not actually applied its existence reduces trade flows. The threat of initiation of antidumping actions may result in the loss of markets for exporters, as importers seek to avoid the costs of possible action against them. Research shows that threatened exporters often agree to raise price and maintain market share, so that contingent protection leads to collusion between domestic and foreign firms.

There are several arguments that support the existence of contingent protection in RIAs. One is the often-mentioned threat of predatory behavior when foreign firms cut prices to drive out domestic producers from the market to raise the prices subsequently. This however is very rare in practice and can be dealt with by national antitrust authority. The second argument in favor of contingent protection is that if it was to be suspended, then other instruments would need to be put in place to ensure that other members do not subsidize production for export in a way that has a negative impact on domestic

production. This is very difficult to achieve. Finally, there might be strong opposition from lobby groups to abolition of these protective measures, which might lead to loss of political support for the RIA membership.

Further areas of integration include elimination of border delays, harmonization of product standards and reduction of administrative barriers to trade. Border formalities can be greatly reduced if countries decide to use standard procedures and employ good customs administration. Membership of a RIA may facilitate development of common approaches and institutions. Another area of greater integration is mutual recognition or harmonization of product standards. Compliance with different technical specifications and obtaining a separate certificate of compliance for each export market involves real costs that are a waste of resources. Harmonization of product standards is much more common than mutual recognition in the existing RIAs.

## **II. Lessons for the CIS7**

The CIS7 share several similarities. They all face transition from a former central planning system, they struggle with different security threats, some of them with internal conflicts, they share unfavorable geographical position, far from the economic core of Europe (except for Moldova), erosion of physical and human capital, corruption. Despite many similarities the CIS7 do not constitute a group of similar countries, which naturally should seek greater economic integration with each other. Various historical and economic ties as well as distance between the three sub-regions make the Central Asia, South Caucasus and Moldova drift towards different economic centers of gravity.

### **2.1. Integration within the CIS7**

Regional integration of two small low-income countries can offer some significant benefits of increased cooperation in areas other than trade, such as water management, development of infrastructure etc. Another political benefit is that of “being noticed” if the two countries can agree on a common stance on world issues. The “lock-in” effects are not likely to be present in this case.

RIA of small countries may lead to greater competition and scale effects in selected industries. This might lead to rationalization and elimination of unnecessary duplication of plants, which will result in more efficient allocation of resources. Market integration can attract FDI. However, as before these gains can only be realized if there are no other significant obstacles to trade and the extent to which opening of the markets increases competition on the domestic markets. In addition the size of the combined markets might be too small for scale and competition effects to operate. If external tariffs remain high, then trade diversion is likely. Also inward-FDI may be “tariff-jumping” and not necessarily beneficial. Both these effects will lower the tariff revenue, which is an important source of government income in many small countries.

It is also likely that a relatively closed South-South RIA will lead to agglomeration of production in only one region. In this case, the region with a head start, comparative advantage or better location will benefit, while the remaining countries may suffer income losses.

The above arguments suggest that greater economic integration among the CIS7 may not bring substantial benefits. There is clearly the case of integration among low-income countries, which are more likely to benefit from greater political cooperation, but

benefits from economic integration will probably be quite small. The reduction of trade costs within Central Asia and within South Caucasus (once it becomes politically feasible) could bring some economic benefits if scale and competition effects result in rationalization and removal of inefficient duplication of plants bringing efficiency gains and perhaps attracting FDI. However, given that the neighbors' markets are small the likely increase in trade and therefore the welfare gains are likely to be small too. This is not to say that the CIS7 have nothing to gain from increased trade with each other, but these gains will be tiny relative to potential gains from increased trade with the bigger partners. The CIS7 would benefit most from the cooperation in dealing with common issues, such as reform of their customs services, sharing the public goods such as transport, water, electricity, and security threats. The cooperation in areas other than trade will be the subject of section IV.

**Table 1: Geographical Composition of Exports and Imports of the CIS7 (in percent)**

	Armenia			Azerbaijan			Georgia			Kyrgyzstan			Moldova			Tajikistan			Uzbekistan			Total	
	1988	1995	2001	1988	1995	2001	1988	1995	2001	1988	1995	2001	1988	1995	2001	1988	1995	2001	1988	1995	2001	1995	2001
<i>Exports</i>	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Total CIS	98	48	30	94	39	10	93	63	23	98	73	48	95	63	61	86	34	32	85	33	35	42	28
CIS-7		1	7		10	5		21	4		20	21		2	1		18	14		7	6	9	7
Russia		25	18		18	3		31	13		24	15		48	44		13	16		16	18	21	15
Other CIS		21	5		12	1		10	6		29	12		13	17		3	3		10	11	12	7
Non-CIS	2	52	70	6	61	90	7	37	77	2	27	52	5	37	39	14	66	68	15	67	65	58	72
EU		22	22		17	69		5	40		12	27		12	21		46	33		15	16	18	37
USA & Canada		0	13		0	1		0	6		0	1		1	5		2	0		0	3	1	3
China		0	0		0	0		0	1		1	6		0	1		1	0		2	0	1	1
Iran		10	12		30	0		1	1		1	2		0	0		0	5		0	0	3	1
Turkey		1	0		5	3		23	20		4	2		1	1		1	12		0	1	2	4
CEE <sup>1</sup>		0	1		2	1		4	2		9	2		20	10		7	8		3	3	6	3
Other		19	22		6	16		5	7		0	12		3	2		9	10		47	41 <sup>2</sup>	28	23
<i>Imports</i>	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	104	107
Total CIS	82	48	17	75	34	31	80	40	27	79	69	53	82	68	38	87	59	78	86	39	38	49	41
CIS-7		9	4		5	1		15	14		21	17		1	0		32	28		3	3	9	7
Russia		19	11		13	11		12	6		27	17		33	16		17	19		25	20	24	16
Other CIS		20	3		16	19		13	6		21	19		34	22		11	32		11	16	17	18
Non-CIS	18	52	83	25	66	69	20	60	73	21	31	47	18	32	62	13	41	22	14	61	62	55	66
EU		15	30		13	19		16	27		2	12		14	28		26	6		17	21	17	23
USA & Canada		16	9		2	16		4	12		2	7		1	3		4	0		1	7	4	9
China		0	0		0	3		0	0		7	13		0	1		0	0		2	2	1	2
Iran		13	15		12	4		0	1		1	2		0	0		0	1		3	0	4	2
Turkey		0	0		21	10		21	16		1	3		1	2		0	1		3	4	5	6
CEE <sup>1</sup>		2	3		5	2		16	9		0	3		13	20		1	3		8	5	7	7
Other		5	25		13	14		3	9		19	8		3	8		9	9		27	24	17	17

1/ Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania & Slovakia.

2/ Gold exports are included in this category, since their geographical destination is unknown (estimated at about 25 percent of total exports).

Source: The IMF Directions of Trade Statistics for 1995 and 2001, "Vestnik Statistiki," No. 3, 1990, for 1988.

Freinkman, Polyakov, Revenco (2004), Table 1.5.

## 2.2. Integration with the EU

This case represents an agreement between small low-income country and a high-income block. The most important political benefit is “policy lock-in”. The RIA will work as a commitment mechanism, if a larger country is willing to impose sanctions if the small country renegades on its commitments and the small country cares about the sanctions that the partner might impose. The larger partner due to its size is likely to account for a large share of trade of the smaller country, large enough for a small country to care about the sanctions. When countries are geographically close, the larger country is prepared to act to ensure the economic and political stability in the region. The agreement needs to be designed in such a way that it makes explicit the commitments to reform and states sanctions that are to be followed in the event of policy reversal. The benefits of this type of a RIA stem also from potential cooperation in several issues such as environment, technical assistance, fighting organized crime and others.

On the economic side, such a RIA might lead to trade diversion, loss of tariff revenue and relocation of production. Trade diversion is likely to be small if the larger partner has small external protection. However, if the larger partner is distant relative to other sources of supply, then a RIA might result in some trade diversion induced by transport costs. The issues of government revenue may be tackled within the agreement itself. The gains from scale and competition are likely to be significant for a small country. Access to a much larger market will allow for the exploitation of the economies of scale and induce productivity gains. However, the success of a small partner in supplying the larger market will depend on several factors. The lower costs of factors of production will be balanced against transport costs, quality of infrastructure and security of market access. This suggests that such a RIA needs to cover all those issues to overcome trade frictions and secure guaranteed market access.

For the majority of the CIS7 the EU is the major export market. Only in the case of Moldova and Uzbekistan, the share of Russia in total exports was higher. In 2001 Azerbaijan exported almost 70 percent of its goods to the EU (mainly oil), Georgia around 40 percent, Tajikistan, Kyrgyz Republic around 30 percent, Armenia, Moldova around 20 percent and Uzbekistan only 15 percent (see Table 1). The share of exports to Russia amounted to 44 percent in the case of Moldova and to 17 percent in the case of Uzbekistan. The EU is also a major source of imports for the majority of the CIS7. Only in the Kyrgyz Republic and Tajikistan the share of imports from Russia was higher than the share of imports from the EU.

All the CIS7 countries except Tajikistan signed the PCAs agreements with the EU. These agreements are similar for all the countries and stipulate the formation of a FTA given enough progress is made in reforms towards market-based economic system. Such a FTA is likely to result in trade expansion and growth of the CIS7 countries. All the political and economic gains identified above are likely to materialize in this kind of a RIA. The first gain comes from the “policy lock-in” argument. The association agreement with the EU could provide a good opportunity for the CIS7 to commit to economic reforms. Such a RIA might also provide the benefits of improved security. Moldova is crucial for the stability of the Balkan region. In the case of the South Caucasus, the EU relies on oil from Azerbaijan and gas transported via Georgia to Turkey. In addition the EU is concerned about the threat of terrorism that might spread from the South Caucasus. Therefore the EU is likely to be prepared to act if the economic and political stability of

the region is at stake. The EU is a major trading partner for the majority of the CIS7. This suggests that they are not likely to risk having any sanctions imposed by the EU on their exports and that the lock-in and security arguments seems to work in the case of these potential RIAs. Further, there is a large scope for cooperation in areas such as environmental projects and technical assistance.

Further integration with the EU is likely to bring substantial economic gains to the CIS7. The expansion of trade already mentioned above is one of them. Further opening of the CIS7 markets will result in greater competition and force domestic firms to restructure and become more efficient. Apart from the scale and competition effects, the potential gains stem from relocation of outward processing activities e.g. in Moldova, the process has already started to take place within the wearing apparel sector. The loss of tariff revenue is likely to be outweighed by assistance that the EU grants to its associated members. To avoid trade diversion the CIS7 need to keep their barriers to trade with the remaining regions, particularly the other CIS countries, low. However, external tariffs of the EU are very low, except for food and agricultural goods, so trade diversion in the case of industrial goods is not likely to take place.

Given that the CIS7 already enjoy the preferential access to the EU due to the GSP treatment of their exports, the scale and competition effects can only be realized if the non-tariff barriers to trade with the EU are also tackled under the agreement. This points to the importance of improving the trade-related infrastructure. Examples of issues involved include tackling the costs of border delays and controls, the establishment of a network of conformity assessment centers that would supply inexpensive certificates of compliance with technical standards and regulations or simplification of the procedures related to the satisfaction of the rules of origin and other.

### **2.3. Integration with the big partners**

The small countries might also benefit from greater integration with other medium-income or relatively large countries such as Russia (for all CIS7), Ukraine (Moldova), Turkey, Iran (South Caucasus) and China (Central Asia). The political benefits will vary with agreement, however none of the CIS7's other big trading partners, except for the EU, is likely to provide a "policy lock-in" mechanism. Increased political and economic integration is likely to bring in the long run increased security for the CIS7. The arguments of increased bargaining power or "being noticed" are unlikely to be important in this case. The WTO accession negotiations showed that the CIS7 are likely to be better off acceding individually instead of as members of a sub-block of the CIS countries<sup>4</sup>.

The economic benefits depend very much on the design of the agreement. The CIS7 need to ensure that obligations under different agreements do not contradict each other. Any reduction of real costs to trade with Russia or Ukraine due to elimination of tariff peaks, harmonization of customs procedures, reduction of border delays, elimination of illegal payments and other is likely to be very important to the CIS7. Russia is either the first or the second largest trading partner for the CIS7 and it supplies the CIS7 countries with energy at subsidized prices. Several CIS7 products that could not compete with the goods on the EU markets have their traditional customers in Russia or Ukraine. The reduction of real costs of trade with Russia could lead to realization of benefits of competition and scale effects. The technology transfer is unlikely to take

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<sup>4</sup> See section 3.3 for more detail.

place, as all CIS share similar level of technological development. Fiscal implications can be positive and significant if reduction of corruption leads to previously illegal payments ending up in government coffers. In the long run it is possible that some production from bigger CIS countries will be relocated to the CIS7. However, due to high transport costs this is unlikely to happen for some years to come. The potential for trade diversion is significant, this is one of the reasons why further formation of a customs or economic union with the remaining CIS countries is not likely to be a good option for the CIS7 at this stage (see discussion of the CIS FTA below).

The South Caucasus countries trade a lot with Turkey and Iran. Both these countries are middle income countries, which might be viewed as large partners for the South Caucasus. Turkey accounts for 20 percent of the Georgian exports and 16 percent of the Georgian imports. Only about 3 percent of Azeri exports is directed to Turkey, however, its share of exports for selected products is quite high e.g. 22 percent in the case of crude materials. About 10 percent of Azeri imports originate from Turkey. At the moment Azerbaijan does not have any FTA with Turkey. Armenia's situation is complicated by the border blockage with Azerbaijan and Turkey. If the political process leads to opening of the border with Turkey, Armenia could gain substantially from an increased trade with Turkey.

For the Central Asian countries China constitutes a large partner with whom they might seek greater economic integration. The share of Turkey and Iran in exports of Tajikistan and the Kyrgyz Republic is quite significant (17 percent and 4 percent respectively). However, the trade with China is almost non-existent in case of all the CIS7 except for the Kyrgyz Republic. Therefore it seems that trade with China is well below potential. For example only recently Tajik importers started to look for cheaper products that can be sold to the Tajik population and started to import certain goods from China instead of importing them from Europe. One of the main reasons is that non-tariff barriers and transport costs in trade between Central Asia and China are very high. The opening of the new border crossing between Tajikistan and China would greatly contribute to the exchange of goods between the two countries. At present road transport from China goes via Kazakhstan and Uzbekistan and is performed by Kazakh drivers who ask very high prices for their services.

### **III. Review of regional cooperation**

#### **3.1. Regional cooperation in trade and related issues**

The CIS7 are members of several multinational agreements. The majority of them created within the CIS institutional framework aims at greater economic and political cooperation between these countries, however their effectiveness remains limited. The following section reviews the free trade agreements concluded by the CIS7 with other CIS countries, as well as with the EU and other regions.

#### **The CIS Free Trade Area<sup>5</sup>**

Plans to establish a CIS free trade area were initiated in 1992. However, the main plurilateral agreement on the free trade area, signed by all CIS countries except

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<sup>5</sup> The description of CIS FTA draws on Evgeny Polyakov's section in Freinkman, Polyakov, Revenco (2004).

Turkmenistan in 1994, was of the framework nature and has never been ratified by the Russian Parliament and therefore remains ineffective. Most CIS countries have concluded FTAs among themselves. However, these FTAs include exemptions from the free trade regime. The core exemptions include sugar, tobacco and cigarettes, alcohol and (sometimes) non-alcoholic beverages. The driving force of the exemptions are the trading majors of the CIS – Russia, Ukraine, and Kazakhstan. Smaller countries introduce exemptions reciprocally in response to the exemptions of these countries. Nevertheless, exemptions currently account for only 0.2 percent of mutual trade in the CIS.

The free trade agreements also stipulate the possibility of contingent protection – temporary protection, anti-dumping measures, and safeguard measures. Contingent protection measures are most pronounced in the Russia – Ukraine trade but the CIS-7 countries have been occasionally affected too, for instance, by Kazakhstan's use of temporary protection measures from 1999 to 2000 on a variety of products, including cement, metal pipes, agricultural products and foods and current Ukrainian anti-dumping measures against Kyrgyzstan.

The rules of origin applicable in the CIS free trade area were established by the Decision of the CIS Government Heads on the Rules of the Determination of a Country of Origin of Goods in 2000. According to the rules of origin, exports subject to the free trade treatment must be conducted by tax residents in the free trade area.

Another important multilateral agreement is the 1992 plurilateral Agreement on Mutual Policies in the Area of Standards, Metrology, and Certification and the 2000 Protocol on amendments to this agreement. The Agreement established the Interstate Council on Standards, Metrology, and Certification, which develops a system of harmonized standards. Within this system, the CIS members honor each other's certificates of conformity and quality. This is an important trade advantage for the CIS members since, despite their membership in the ISO, their national standards are not honored in the rest of the world.

Another problem of the CIS trade bloc is the weak administration of the free trade area and underdeveloped plurilateral institutions. Trade is only one of many activities of the CIS, and the departments of the CIS Executive Committee and Secretariat (the main bodies of the CIS) that deal with trade do not have strong administrative power and can hardly influence the policies of national trade agencies, especially those of the larger CIS members. As a result, trade relations among the CIS countries are determined mostly on the bilateral level.

The membership in a CIS FTA does not seem to have a potential of providing any significant political benefits to the CIS7 countries except for increased cooperation within the region and perhaps increased security. There are several reasons why there is lack of political will to improve the implementation of the agreement and the rules governing it. The main reason might be that the economic incentives for further integration have not been that strong. All CIS countries have been undergoing the process of liberalization of the foreign trade regime that has opened up national markets to non-traditional CIS suppliers. They rely on imports to provide intermediate inputs and physical capital. All CIS countries have big incentives to maintain good access to their export markets, but little incentives to grant preferential access to imports from other CIS countries on their markets. This is mainly due to the threat of trade diversion that is likely to be significant

in this case. Given that the competitiveness of several CIS products is still low and that trade within the CIS is expensive due to excessive border and transport costs, replacing lower cost non-CIS products with the higher cost CIS suppliers could have important welfare effects on consumers. Furthermore, the CIS countries want to attract foreign direct investment. Granting privileges to the CIS products might discourage investment from non-CIS countries.

Another argument is related to the process of the WTO accession. Moldova, Armenia, Georgia and Kyrgyz Republic are already members of the WTO. The remaining CIS7 also have entered the negotiations with the WTO. Countries linked by preferential trade agreements can negotiate their entry individually, but where commitments have been made to form customs or economic unions, there is a need to negotiate in collaboration. In the process of negotiation of accession Georgian government stated that while it had signed the Agreement on the Creation of an Economic Union and the Agreement on Creation of Free Trade Area within the CIS, it has no intention of ratifying them. On the other hand the Kyrgyz Republic set out in detail its commitments under EEU and the CIS customs union. Now if the EEU members want to proceed with the adoption of the common external tariff they either need to adopt the level of external tariff of the Kyrgyz Republic (which may be politically unfeasible) or other WTO members may seek compensation from the Kyrgyz Republic. This means that from the point of view of the WTO accession the membership in free trade agreements as opposed to the customs or economic unions facilitates negotiations. This reduces incentives for greater economic integration before joining the WTO.

In the case of all CIS7 countries except Azerbaijan substantial share of exports is directed to the CIS countries. The CIS account for about 30 percent of exports and imports of Armenia, Georgia and Uzbekistan. The level of exchange with the CIS countries is higher in the remaining CIS7. Therefore there is potential for scale and competition benefits from increased trade between the CIS7 and the remaining CIS countries. However, such benefits are unlikely to materialize as long as other obstacles to trade such as border and transport costs remain excessively high.

The CIS FTA stipulates formation of customs and economic union in the future. However, at present it seems that all CIS, including the CIS7 are likely to benefit more from a FTA with the remaining CIS countries and not from a customs union. This is mainly due to the arguments discussed above such as the likely trade diversion, increasing integration with the non-CIS countries and the WTO accession. The major disadvantage of a FTA is the issue of the rules of origin. The big differences in tariff levels create scope for trade deflection. To avoid trade and production deflection member countries of FTAs usually impose rules of origin. In practice, the costs and inefficiencies of transportation of products within the CIS probably reduce deflection effects. In addition, customs delays and problems related to the mutual recognition of customs documentation and certification further minimize the scope for deflection at present. The existence of so many bilateral FTAs between CIS countries makes the application of rules of origin difficult and costly.

### **Additional comments on the CIS FTA**

All CIS7 countries also signed bilateral FTA with several of the CIS countries<sup>6</sup>. The plurilateral and bilateral agreements have many overlapping and sometimes contradictory provisions. It is not clear how they relate to each other in practice. For example, in addition to being a signatory to the GUUAM agreement, Armenia has signed the bilateral FTA with Georgia, Moldova, Ukraine and Uzbekistan (the remaining GUUAM members). All countries have also signed the agreement on creation of a CIS Free Trade Area. Each agreement has its own list of exceptions and special provisions. Therefore traders and customs officials are often confused as to which rules apply in a particular case.

In practice the only way to figure out the right duty payment is on the basis of documentation presented at the border. However, since the customs authorities have not produced a standard set of operating procedures or documentation requirements, the customs officers have significant degree of discretion in deciding if a given shipment is accompanied by appropriate documents. This degree of discretion in making decision as to whether the duty needs to be paid or not leads to illegal practices by traders and customs' officials. The RTAs require clear rules on issues such as mutual recognition of product certification agencies and documentation, certificates of origin and the level of processing required to confer the origin.

The study by TACIS (2001) points to another disadvantage of multiple trade agreements. An example is provided by an attempt in 1996 to set up Tsentrzelectron, an electro-technical consortium of 29 enterprises within the CAEU. The establishment of the joint venture among firms of the member countries failed because Kazakhstan and Kyrgyz Republic could not offer preferential terms and duties to Uzbek companies, owing to their obligations under bilateral agreements with Russia and Belarus.

### **Central Asian Cooperation Organization (CACO)**

The Central Asian Economic Community was established in 1993 by Kazakhstan and Uzbekistan with the aim of providing a permanent mechanism for discussing and reviewing issues of mutual economic and political interest. Kyrgyz Republic joined the agreement in 1994 and Tajikistan in 1998. The CAEC held annual meetings at the presidential level and more frequent meetings on issues such as customs, tax policy, antimonopoly policy etc. The Central Asian Bank for Reconstruction and Development was established in 1994 to provide financing for development projects in the four member countries. Over 200 agreements and contracts have been signed on issues such as shared water use, improvement of transport infrastructure, migration, military-technical cooperation and others. In 2000 the presidents of the four member countries signed an agreement that aimed at the creation of a common market in four stages by 2002. These included the creation of a free trade zone, followed by customs union, monetary union and common labor and capital market. In 2001 the CAEC was transformed into CACO to reflect the broadening of cooperation beyond economic policy to include security cooperation.

Currently the organization mostly serves as a vehicle for multilateral discussion of regional issues. In July 2003 during the Almaty Summit, heads of the states have agreed to strengthening co-ordination of actions in struggle against terrorism, extremism and

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<sup>6</sup> For the list of bilateral FTA within the CIS see Freinkman, Polyakov, Revenco (2004).

illegal drug trafficking, to the creation of a uniform cultural - information and humanitarian space, implementation of telecasting in territory of all members. The CACO heads of state issued a statement on speeding up the creation of several interstate consortiums under CACO, which would deal with the use of water and energy resources, implementing communications projects, and ensuring the food supplies of member states.

CACO member countries have historic, ethnic, geographical, cultural, and linguistic unity. However, all these are small countries and from the theoretical point of view their greater economic integration is not going to bring significant economic benefits. This in part might explain why the initial aims of creating economic union seem to have been abandoned. The political cooperation in water and energy management or building of infrastructure and trade facilitation has the potential of bringing substantial benefits to the countries involved (these issues will be discussed further in section IV).

### **Eurasian Economic Community (Evrazes)**

The CIS Customs Union was created in 1995 by Russia, Belarus and Kazakhstan. The Kyrgyz Republic joined in 1996, followed by Tajikistan in 1999. The Customs Union was transformed in 2000 into Evrazes. The new structure aimed at creation of a common market, with a common tariff and non-tariff policy. It also aimed at the creation of a harmonized legal system, of a more integrated education system and provision of access to any country health facilities for citizens of the participating countries etc. However, at present there is free trade among the participating countries, but their external tariffs diverge substantially. The members stated their intention to set up a customs union with a common external tariff by 2005.

The harmonization of external tariff with the Russian tariff level is mostly based on unilateral decision of countries. Countries tend to keep a certain level of harmonization, however the Agreement on Common Customs Tariff signed in 2000 allows for transition periods during which each country can establish a list of sensitive goods for which it can set up its own rates. This agreement established the transition period until full harmonization at 5 years, however it was ratified only by Russia, Belarus and the Kyrgyz Republic.

The countries agreed to apply to join the WTO individually, which meant that they recognized the fact that there was no common external tariff in place, as required in the customs union. The unilateral character of the WTO accessions and the little progress made so far in the creation of the customs union indicate that Evrazes will not be fully operational over the medium term. Following Kyrgyz accession to the WTO and likely accession of Russia in the next year, followed by Kazakhstan, harmonization of the external tariffs has to be put on hold until after the member countries join the WTO and will then have to follow the rules of the WTO. This will involve much more complex and lengthy negotiations, as the weighted average tariffs in a newly formed customs union can not exceed the pre-joining tariffs.

The Evrazes member countries signed also the "Agreement regarding unified conditions of transit through the territories of the countries-members of the Customs Union". It provides for unrestricted transit of the member countries' goods through the territory of the customs union by ensuring equal treatment of their own and their parties' importers/exporters, exemption from payment of any customs fees, charges and tariffs and bans imposition of economic barriers to transit. This potentially very beneficial

arrangement has not been fully implemented and did not facilitate the transit of goods from the Kyrgyz Republic or Tajikistan through Kazakhstan, who treats the freight forwarders from these countries differently than those from Russia.

Overall it seems that Evrazes failed to provide any significant economic benefits to its members, however it is a forum of regular meetings of commissions (on customs, tariff and non-tariff regulations) and premiers on the various trade issues. The commissions discuss a number of issues, however they fail to tackle the issues of high importance such as mutual recognition of certificates, harmonization of transit requirements and charges. Despite slow and partial implementation of the agreements, Evrazes is the most active among all the regional arrangements in terms of holding regular meetings at the high level and within working groups.

The plans to form the customs union have been put on hold due to the WTO accession of members. With the partial exception of Belarus, the Evrazes members' economic interests lie in trading with countries outside the CU and encouraging investment from the West. The Central Asian countries often invoke the CU when criticizing Russia for imposing protection on their traditional exports to Russia. However, they are not themselves ready to grant privileges to the Russian goods on their markets. Overall, the problems of integration within Evrazes are similar to those accompanying integration within the CIS FTA.

Moreover, the Kyrgyz Republic, Ukraine and Kazakhstan have often criticized Russia for erection of tariff and other barriers, in the name of the customs union, which undermine trade between Ukraine and the two Central Asian members of the Evrazes. Such problems could easily undermine the formation of the CU in the future.

It seems that at this stage countries can gain most from increased cooperation in trade related issues. The implementation of the agreement that provides for unrestricted transit of the member countries' goods through the territory of the customs union by ensuring equal treatment of their own and their parties' importers/exporters, exemption from payment of any customs fees, charges and tariffs and bans imposition of economic barriers to transit could bring substantial increase in trade and welfare gains. The countries would also benefit from pursuing the initially planned increased integration of the education systems and provision of access to any country health facilities for citizens of the participating countries.

### **Partnership and Cooperation Agreements (PCA)**

Between 1997-1999 the EU reached agreements with 11 CIS countries (except Tajikistan) on the mutual granting of the MFN status, the removal of quantitative restriction and formation of the free trade area given enough progress is made in reforms towards market-based economic system. The agreements cover also modalities of political dialogue, provisions concerning payments, capital, competition, intellectual property rights, as well as economic and financial cooperation. The aim of the PCAs is to promote trade and investment and harmonious economic relationships between the countries. Promoting regional cooperation is one of the main routes envisaged towards amicable relations and sustainable development of their economies - particularly via the EU TACIS program of assistance, and initiatives in the framework of TRACECA and INOGATE. Particular attention is promised to the Basis multilateral Agreement on International Transport for Development of the Europa-The Caucasus-Asia Corridor

signed at Baku on 8 September 1998, to developing the INOGATE Umbrella Agreement for pipeline networks, initiated in Brussels on 17 February, and to the Energy Charter Treaty.

In terms of further trade liberalization the EU might consider several issues. The treatment of the CIS7 products under the GSP grants very low tariffs on the EU markets. However, in several instances the CIS7 producers need to compete with the producers from countries which have signed a free trade agreement or customs union with the EU and who enjoy a larger margin of preference. In addition the exclusion of processed agricultural products from the GSP treatment constitutes a major obstacle to the CIS7 agricultural exports. The application of the rules of origin for clothing products results in only partial utilization of the GSP preferences by Moldova.

Further integration with the EU is likely to bring about significant political and economic benefits if the remaining obstacles to trade are reduced. This issue was already discussed in detail in section II.2.

### **The Shanghai Cooperation Organization (SCO)**

The SCO, which was established as the Shanghai Five by China, Russia, Kazakhstan, Tajikistan, the Kyrgyz Republic in 1996, admitted Uzbekistan in 2001 and shifted focus to combating terrorism. This grouping had a wholly security-oriented agenda, however at a meeting in July 2000, the group considered expanding its mandate to incorporate an economic union. The proposals from the meeting in September 2003 include promotion of trade and investment in a bid to realize the smooth circulation of goods within the framework of the SCO as well as to reduce and eliminate non-tariff barriers like those in customs service, quarantine, standards and transportation. The member states intend to set up projects on economic and technological cooperation and give priority to those in transportation, energy, telecommunication, agriculture, home appliances, light industry and textiles. The group has a long-term objective for regional economic cooperation that would gradually result in a set up of a free trade zone within the SCO.

The three Central Asian CIS7 members of the SCO would gain from the creation of a free trade zone with China, Russia and Kazakhstan. Many traders and transport operators in these countries have high hopes related to the opening of their countries towards China and vice versa. Again this is the case of integration between small members and large countries, which might bring several benefits to the Central Asia. Improved access to the Chinese market may lead to significant expansion of exports and imports in the long run. Trade diversion is not likely to happen as long as the commitments with respect to the EU and other partners are adhered to. Several firms in China are more advanced technologically and the Central Asian producers might benefit from cooperation with them.

### **GUUAM**

This grouping covers Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova. The presidents of the four member countries (except Uzbekistan) met in 1997 and stated their mutual interest in developing a bilateral and regional cooperation in the areas of European and regional security and establishing political and economic contacts. The most important plans of future cooperation included establishment of the Trans-Caucasus corridor (TRACECA), settling all issues related to the oil and gas resources of the

Caspian Sea region and creation of the multiple pipeline system to the world markets. Building pipelines, railways and trade routes from Central Asia and the Caspian Sea across the Caucasus through Moldova and Ukraine to Europe would bypass Russia and allow the GUUAM members to reap the benefits without relying on Russia.

Some of the GUUAM member states see the GUUAM as a precondition to a future strategic goal of integration in the European Union. This is the case, for instance, for Moldova and Georgia.

So far however, the countries failed to establish the transport corridor to Europe. Their GDP has also decreased significantly as a result of ongoing transition and the 1998 economic crises. They GUUAM members are heavily indebted and suffer energy shortages. Therefore the envisaged independence from Russia has not been achieved as Georgia and Azerbaijan turn to Russia for relief from energy shortages, while Ukraine and Moldova turn to Russia for relief from debt re-payment. The countries continue to cooperate on bilateral rather than multilateral level and the GUUAM agreement has not been notified to the WTO.

Over the recent years the main focus of the grouping has been on security issues. During the last summit in July 2003 the member countries have agreed to activate their cooperation in combating terrorism, separatism, extremism and other challenges to international security. The GUUAM members cooperate in this respect with the US within the "GUUAM-US Framework Program", which includes a Virtual Center to combat terrorism, drug trafficking and other dangerous types of crime, an Interstate Information Processing System (IIPS), as well as border security and customs control projects aimed at TTF. The member states also expressed their intention to establish a free trade area and signed a number of bilateral documents in the field of border and customs control and TTF. The GUUAM member states convene regular summits at the level of Heads of State at least once a year, and meetings at the level of Ministers for Foreign Affairs at least twice a year. The Committee of National Coordinators (CNC) holds regular sessions on a quarterly basis.

This is the case of integration between the small countries, although Ukraine is a relatively bigger market, especially important to Moldova. The political benefits of such integration mainly derive from increased security. Once the GUUAM members establish the transport corridor to Europe, the benefits of improved access to the European markets are going to be significant, as discussed already above in the case of PCA. These include exploitation of the economies of scale, increased competition on the domestic market, which will drive out the inefficient firms, relocation of production might also take place together with the FDI inflow. Facilitation of trade among the GUUAM members themselves will strengthen the above effects. Whether the GUUAM members will be able to develop effective export activities depends on several factors. The costs of transport, border crossing and compliance with technical standards and regulations need to be reduced significantly, while domestic production requires improvements in quality and productivity, so that the GUUAM members can successfully compete on the EU markets.

### **Economic Cooperation Organization (ECO)**

The ECO was created in 1985 by Iran, Pakistan and Turkey with the aim of promoting regional cooperation in trade, transportation, communications, tourism, cultural links and

economic development. In 1992 five Central Asian republics, Azerbaijan and Afghanistan joined the organization. The main aims of ECO are to promote development of transport and communications infrastructure, facilitate trade and investment and effective use of the vast energy resources. In the context of trade facilitation the ECO members established a preferential trade agreement between Pakistan, Iran and Turkey. It provides for 10 percent reduction in tariffs on a list of specific items. Within its framework, it is being endeavored to gradually reduce tariffs and non-tariff barriers as well as expand the list of commodities for preferential treatment. In addition the members signed the ECO Transit Trade Agreement and the Agreement on Simplification of Visa Procedures for the Businessmen of ECO countries.

This is an example of cooperation between Central Asia and bigger regional partners, which was already discussed in detail in section 2.3.

### **Black Sea Economic Cooperation Pact (BSECP)**

The BSEC, established in 1992, is comprised of Russia, Ukraine, Turkey, Georgia, Romania, Bulgaria, Albania, Armenia, Azerbaijan, Moldova and Greece. The members have committed themselves to improving economic and technological cooperation, to encouraging social interaction and free circulation of private enterprise. However, the BSEC has failed to achieve most of its original goals. The intra-regional trade, for instance, has remained below the level that had been initially considered to be achievable. The current activity of the BSECP covers issues such as promotion of cooperation in science and technology, combating of organized crime, discussions on energy transit potential, exchange of economic data and information, facilitation of agricultural trade between members. The limited potential of the BSECP is mainly due to lack of political will, economic stability and mutual trust. The obstacles to fruitful cooperation include unresolved border and territorial disputes, numerous ethnic problems, hostile military posturing and religious rivalry among some member states, serious economic and financial problems suffered by most of the BSEC member states.

The BSEC is an initiative that lacks political support. It is viewed by all members as a second rate partnership and not an alternative to the EU or NATO. Bulgaria, Romania and Albania have consistently played down the significance of the BSEC out of fear of infuriating the Western world. Russia seems to view the BSEC as some way of restoring the old partnerships under the Warsaw Pact and Comecon. The two largest and oldest states, Turkey and Russia, do not see the Black Sea as the realm of common economic interests and so far the Russian-Turkish rivalry has been undermining the opportunities offered by the BSEC.

Overall, it seems at this stage that cooperation within the BSEC is in contradiction to other political and economic processes that are taking place in the Black Sea, such as integration with the EU or economic transition. The member countries do not see large economic benefits stemming from such integration and therefore devote very little effort to making this agreement successful.

### **3. 2. Examples of regional cooperation in other areas**

The TRACECA project aims at creating a transit corridor, that parallels the old Silk Road, and links Central Asia and Europe through Caucasus. The project, which was launched in May 1993 with support of the EU, includes Armenia, Azerbaijan, Georgia,

Kazakhstan, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan. The project works at establishing a route that would provide good quality infrastructure (roads, ports), but also will facilitate trade through a simplified customs procedure. The customs component includes TA assistance as well as small technical grants available for technical modernization of the customs points participating in the project. The ongoing projects include the harmonization of border crossing procedures, implementation of unified policy on transit fees and tariffs and supply of optical cable for communication and signaling to the railways of Armenia, Georgia and Azerbaijan.

The Turkish-Armenian Business Development Council (TABDC) was established in 1997 to promote and facilitate cooperation between the Armenian and Turkish business communities. The TABDC works on establishing direct trade and business links in various sectors. It also provides support for the border opening and the establishment of interstate relations between Armenia and Turkey by maintaining close ties between both governments and by lobbying activities on the international forum (e.g. European Parliament). The activities of the TABDC include organization of business trips to Armenia and Turkey, cultural and academic exchange programs and the preparation of regional business conferences in Anatolia with the participation of businessmen from Armenia and Diaspora.

The International Committee for the Protection of Taxpayer Rights provides another example of regional cooperation. This Committee was established by taxpayers in several ECA countries at the International Taxpayers Conferences in February 2002. The aim of the Committee is to serve as a vehicle for cooperation and experience exchange among taxpayers association in promoting taxpayer voice and rights. The members include taxpayers associations from Belarus, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Russia and Ukraine.

#### **IV. Sharing the regional public goods<sup>7</sup>**

Countries that share common rivers, hydroelectric power or rail connections can benefit greatly from cooperation. However, there are several reasons why countries do not reach agreements on shared public goods. They include political tensions, lack of trust and asymmetric distribution of costs and benefits. A major obstacle is the absence of higher authorities to which to appeal in case of conflict, as the enforcement of property rights at the international level is weak. This is where the role of international organizations is important in creating institution that foster trust, provide expertise and financing.

Secondly, RIAs can facilitate cooperation on non-trade issues. To be implemented effectively, the cooperation agreements require specialized institutions, including mechanisms that enforce the provisions, deal with disputes over the distribution of costs and benefits and with situation that require re-negotiations of the agreements. Incorporation of agreements on shared natural resources into a wider set of agreements could be cheaper and more effective. Negotiations on a set of issues can lower the size of compensatory transfers and make enforcement more effective. The frequent collaboration on various regional issues can generate practice in shared problem solving and generate trust among members of the RIA. Below we discuss issues related to cooperation in sharing the regional public goods among the CIS<sup>7</sup> and provide positive examples of joint

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<sup>7</sup> This section relies heavily on Schiff and Winters (2002).

actions in other parts of the world that could serve as motivation for increased cooperation among the CIS7.

#### **4.1 Water**

The most common subject of international cooperation agreements are the water resources. This is the area where externalities are omnipresent, while property rights are not clearly assigned and their international enforcement is close to impossible. Without cooperation everybody tries to maximize their own welfare without paying any attention to the impact on other users. As a result every party is left worse off. Over-exploitation leads to environmental disaster with low water levels, high pollution, depleted fish stocks and costs on other sectors of the economy.

In the case of the Aral Sea Basin, the regional cooperation is crucial in solving the problem of river water diversion and extreme environmental degradation. The Aral Sea Basin extends over 690,000 km<sup>2</sup> and covers five Central Asia republics. Water is critical resource in Central Asia. It is used for the generation of electricity in the small upstream states (the Kyrgyz Republic and Tajikistan) and for irrigation by the downstream states (Kazakhstan, Turkmenistan and Uzbekistan). However, the lack of multilateral management of water supplies resulted in environmental disaster.

The draining of the sea, once the world's fourth largest lake, destruction of the ecosystems and pollution of surface and groundwater due to inefficient irrigation, inadequate drainage, and excessive use of chemicals in the production of cotton and rice have caused serious environmental and health problems. The World Bank, UNEP and UNDP engaged in building regional institutions to stabilize the environment of the sea, rehabilitate the disaster zone around it and undertake comprehensive management of the waters. The five republics established the Inter-Disciplinary Coordinating Water Management Commission, which directly manages water resources. The Commission draws up yearly water consumption shares for each of the states and the entire region. (Schiff and Winters, 2002). However, it seems that so far the cooperation under this agreement has not been very successful in rehabilitating the Aral Sea.

A positive example of regional cooperation in sharing the water resources is provided by Thailand and Laos. The international community brought Thailand and Laos together to share the hydropower resources of Laos' Nam Ngum River despite poor relations between the two countries. The Mekong Secretariat established a forum in which Laos and Thailand were able to agree on the division of river's hydro potential. The project proved to be financially viable and provided Thailand with cheap power and Laos with substantial foreign exchange earnings. Another example is provided by the cooperation of India and Pakistan over the sharing of the Indus River. The intervention of the World Bank helped overcome the political conflicts and provided the funds needed to build a system of canals and storage dams without which it would have been impossible to resolve the dispute among the two countries.

#### **4.2 Transport sector**

Cooperation in transport and transit issues is the only way for several landlocked countries to gain access to the world markets as was stressed in the TTF studies.

Kazakhstan and Turkmenistan are critical transit routes for the rest of the Central Asia, while for Moldova the natural transit route to its main trade partner, Russia, runs through Ukraine. Larger countries have little incentives in facilitating transit through their territories, as a result the amount of transit permits is often insufficient, which results in the secondary markets for permits and significantly higher than officially stated transit fees. The gains from cooperation for a small landlocked country are large, as it relies on the transport corridor to ship its exports and imports. However, the larger partner will benefit from cooperation as well, as the transport corridor is going to enhance the larger partner's access to its internal market.

In all CIS7 countries problems are mainly related to road transport. Railways in the Central Asia use the same rolling stock, track standards and there appears to be a significant degree of cooperation between them. In the Caucasus, the major obstacles to the functioning of the transit routes derive from the Armenian-Azerbaijan conflict and the closure of the Turkish-Armenian border. Moldova faces delays at the Ukrainian border, its road operators are constrained by the insufficient number of permits to/through Ukraine, Hungary and the EU. In addition Transnistria creates constraints on transit through Ukraine and within the country.

The asymmetric externalities and differences in need and outside options make cooperation in transit area more difficult. The cooperation in this area is often complicated by internal or border conflicts. Countries of Sub-Saharan Africa (SSA) face similar problems. Almost a third of the countries of the SSA region are landlocked. Finding the ways to facilitate transport to the outside world is crucial for their development. A WB review of 42 completed SSA transport projects aimed at improving international transit between eight landlocked and seven coastal countries showed mixed results. The main problems were those typical for developing countries i.e. inadequate ports legislation, poor cost accounting for railways and poorly organized highway agencies.

In the case of a direct railway between the capitals of the Cote d'Ivoire and Burkina Faso the lack of cooperation, poor management and declining reliability drove business from railways to the already over-stretched roads. The governments finally split the railways into two separate national companies. This led to even further inefficiencies, even higher costs and even faster loss of business to the advantage of road transport. After three years of separation the Burkinabe and Ivoirian governments decided to seek greater efficiency by turning the line over to a private concessionaire. The winning bidder – SITARAIL - was the consortium that joined the two major regional freight forwarders, and international shipping line and a railway engineering consulting firm. The two national railway companies were replaced by corporations that own tracks and rolling stocks and lease them to the SITARAIL. Handing over the enterprise to the private sector eliminated the political tensions surrounding the operations of railways. A private company was also able to achieve significant efficiencies by cutting costs and introducing better management. This example points out that cooperation between small, symmetrical countries may bring substantial benefits to both sides by reducing the cost of transit. The cooperation of countries in completion of the TRACECA project could lead to materialization of such benefits.

### 4.3 Energy

Central Asian republics have significant energy resources and infrastructure. Uzbekistan and Turkmenistan produce gas, Kazakhstan produces coal and the Kyrgyz Republic and Tajikistan have hydro-power assets. Regional trade in energy is linked to the use of water for irrigation. Water is used for the generation of electricity in the small upstream states (the Kyrgyz Republic and Tajikistan) and for irrigation by the downstream states (Kazakhstan, Turkmenistan and Uzbekistan). Water is supposed to be stored during the winter season (mainly in the Kyrgyz Republic) and released for irrigation during the growing season. At this stage there are several bilateral agreements negotiated annually. The bilateral agreements include electricity swaps between Tajikistan and Uzbekistan, electricity/water agreements in exchange for natural gas between the Kyrgyz Republic and Uzbekistan, and water/electricity in exchange for coal between the Kyrgyz Republic and Kazakhstan. The agreements are negotiated annually.

Since the collapse of the Soviet Union the price of energy increased significantly. For net energy importers this meant an accumulation of foreign debt to net energy exporters. The cross-border payment problems have led to numerous confrontations and several stoppages by one or several countries. The politics of confrontation hurt the smaller and weaker upstream states, which are dependent in many ways on the bigger neighbors. The failure to adjust domestic energy prices resulted in the lack of resources for investment and degradation of the system. In addition water resources have not been used efficiently. Upstream states might be using too much hydropower in summer than is economically efficient. The move towards tariffs consistent with cost recovery would create a basis for realization of the gains from trade, unlock necessary investments in the power systems and if combined with introduction of water charges could lead to more efficient use of water resources as well as energy.

The revival of trade in Central Asia and South Caucasus would bring about several benefits. When resource endowments are heterogeneous across the countries, trade might lead to substantial system costs reduction. This in turn will allow for lower tariff rises necessary to reach the cost recovery. The rise in domestic tariffs is a precondition for the realization of gains from regional trade, as they will enable the countries to cover import costs. In addition in an integrated system the costs of generation additional supply in case of demand peaks are lower.

The study by Kennedy, Frankhauser and Raiser (2003) suggests that in the Central Asia the Kyrgyz Republic and Tajikistan could export hydropower and provide power to the system in the peak periods. A closer investigation might reveal that even though from the point of view of power usage hydropower should be used to generate energy in winter, if water is more efficiently used in irrigation, then hydropower should be used in the summer to replace some of the thermal energy generation at this time. In the South Caucasus a possible option for the regional trade would be for Georgia to export hydropower to Armenia in peak times and to import thermal generated power from Armenia, Azerbaijan or Russia to meet the base demand. At present Georgia covers the base demand with hydropower.

The establishment of regional trade in energy would require institutional reforms. The participating countries would need to agree on a grid code. Development of such technical terms and conditions for market participants could be coordinated by a regional

regulators association. Secondly, the cost reflective transmission tariff methodology would need to be developed in cooperation. Also a mechanism for coordination of investments in a regional context should be in place.

The box below discusses an example of regional trade in energy in the South Africa. The factors key to the success of a similar cooperation include the availability of complementary power sources, and active regional organization for economic cooperation and the political will to support increased regional energy trade. In the case of the Central Asia or the South Caucasus the first condition seems to be met. In the Central Asia a forum in place that could deal with the sustainable management of energy resources is provided by the CACO. However, the lack of political will has so far precluded any lasting solutions in this area.

The experiences from other regions suggest that RIA can help in power cooperation. In Southern Africa the key factor in this cooperation was the institutional base provided by the Southern African Development Community (SADC), which served as a tool for promotion of regional integration and facilitated the implementation of the needed inter-connection projects.

The Southern African Power Pool (SAPP) was established in 1995 to take advantage of the distribution of power sources in the region. The 12-country region has a large reserve of low-cost hydroelectricity in its north, large reserved o cheap coal in South Africa and the Kariba dam in the middle of the region. The SAPP was the first international power pool outside North America and Europe. It covers 6 million square miles and 200 million people. The utilities in the region have been exporting and importing electricity through bilateral contracts, these proved to be difficult to administer. The objective of shifting to the pool was to create a more efficient regional market.

Each member of the pool must have a capacity to cover its forecast monthly peak, it is obliged to cover emergency energy up to six hours, to provide automatic generation control and other facilities in the control area and to allow transmission of sales between two other partners if feasible. The pool's potential benefits include reducing or postponing new requirements for generation of new capacity and reserves, lower fuel costs, more efficient use of hydroelectricity. So far the system covers only a small proportion of production, however, it is expected to bring a saving of 20 percent in costs over 1995-2010 period.

#### **4.4 Security**

Terrorism, drug trafficking, organized crime, human trafficking and illegal immigration require organized information collection and operations together by all countries affected by these illegal activities. The major problem involving Moldova and Ukraine is the human trafficking and illegal immigration. Illegal immigrants who want to reach Western Europe choose to cross Romania from Moldova via the river border between these two countries.

Central Asia remains attractive for international drug dealers. The heaviest Afghani drugs traffic goes through Tajikistan to Kyrgyzstan and on to European

countries; some drugs are transported via Uzbekistan and Kazakhstan. To strengthen the efforts in this area the Cabinet of Ministers of Uzbekistan passed a resolution in 2002, which comprises a program to combat trafficking in illicit drugs and psychotropic substances as well as drug abuse; it aims to fight the drug industry and to enroll the entire community to help suppress this crime. The program will host conferences and workshops for Asian countries and the CIS helping them to join forces to disrupt trafficking of illicit drug and psychotropic substances.

Another pivotal area in combating drug trafficking is the control of chemicals, which are used in illicit drug manufacture. Several CIS States in Central Asia are increasingly being used as alternative sources for the supply of chemicals. Some of them are, or have the potential to be manufacturers of key chemicals required for the manufacture of heroin and methamphetamine. Those countries are also used as transit countries for smuggling chemicals, in particular, acetic anhydride into Afghanistan and other countries in south-west Asia out of industrial establishments in the Russian Federation, as well as out of other European countries.

The main security threat in the Central Asia remains due to unstable situation in Afghanistan, the presence of Afghan refugees and the possibility of a military conflict within the country. The drugs industry and arms trafficking provide the financial base of terrorism. Any efforts to crack down on drug trafficking in the Central Asia will be unsuccessful if they do not include Afghanistan. To stop large production of drugs in Afghanistan it would be necessary to offer assistance to the government of Afghanistan to help re-orient its agriculture away from opium poppy to agricultural cultivation.

The major threats to security in the South Caucasus and Moldova originate from the ongoing conflicts in Transdnistria, in Nagorno Karabagh and in Abkhazia. The virtual blockade of Armenian border with Turkey is another factor affecting negatively the security of the region. In addition there are serious concerns about the threat of terrorism spreading from the South Caucasus to Europe. Russia maintains that Georgia supports activities of the Chetchen fighters, which is a source of ongoing diplomatic conflict between Russia and Georgia. These political obstacles served to constrain the cooperation in several areas and they require high level diplomacy to bring lasting solutions.

This section highlighted the security threats faced by the CIS7. The countries lack financial resources and technical expertise to fight organized crime. It is in the best interest of the international community to provide them with all the necessary financial and technical assistance in these areas. The CIS7 themselves could attempt to use the domestically available resources more efficiently and adapt the national regulation to allow for the effective fight with drug, arms and human trafficking.

## 5. Summary

1. There are no strong economic incentives to pursue greater economic integration among the South Caucasus or Central Asian countries. However, within these country groupings the likely benefits of cooperation in transit and trade facilitation, in sharing water, energy resources, dealing with security issues are great.
2. In terms of economic development the CIS7 **are likely to benefit most from integration** with large economic partners, such as the EU, Russia (all CIS7), Ukraine

(Moldova), Turkey (South Caucasus) and China (Central Asia). The political arguments in favor of such RIAs include “policy lock-in” and cooperation in issues such as security, technical assistance, environment and others. Trade creation and income growth generated by greater economic integration with large partners are likely to be significant. This however depends on the design of the agreement, on the external policy and elimination of non-tariff barriers to trade.

3. **Improved access to regional markets** via facilitation of trade and transit might also lead to significant economic benefits. Market enlargement might result in rationalization of production bringing efficiency gains and perhaps attract FDI. Given that the neighbors’ markets are small the likely increases in trade and welfare gains are likely to be small too. However, lower costs of transit across neighboring countries may also lead to higher exchange of goods with the larger partners.
4. Over the 1995-2001 period **none of the existing RIAs among the CIS countries has been successful in preventing the fall of share of intra-CIS trade** in total trade of its members. The reasons behind the lack of strong incentives to deeper economic integration include the likely trade diversion and increasing integration with the non-CIS countries. The need to attract non-CIS FDI also discourages the CIS7 from making any further concessions to their immediate neighbors. In addition, falling real income levels feed the national pressures for protection of domestic producers. Another factor discouraging greater integration among CIS countries is the WTO accession negotiations, which are easier to conduct when countries are acceding individually and not as members of a regional block.
5. **Cooperation in sharing of the public goods** such as water, energy, transport corridors and security issues is expected to yield the highest gains for the countries involved and joint action is often vital for success of the individual countries’ initiatives.
  - In the case of the Aral Sea Basin, the regional cooperation is crucial in solving the problem of river water diversion and extreme environmental degradation.
  - Cooperation in transport and transit issues is the only way for several landlocked countries to gain access to the world markets.
  - The revival of trade in energy across Central Asia and South Caucasus would bring about several benefits. When resource endowments are heterogeneous across countries, trade might lead to substantial system costs reduction and allow for lower tariff rises necessary to reach the cost recovery.
  - Terrorism, drug trafficking, organized crime, human trafficking and illegal immigration require organized information collection and operations together by all countries affected by these illegal activities.

## 6. Policy recommendations

1. The CIS7 could **pursue further integration with larger countries** such as the EU, Russia (all CIS7), Ukraine (Moldova), Turkey (South Caucasus) and China (Central

Asia). The CIS7 countries, which are covered by the PCA, could press for further trade preferences (e.g. trade in agricultural products, application of the rules of origin). The Central Asian republics would be likely to gain significantly from further opening of their economies towards China and vice versa. Azerbaijan could seek a creation of a FTA with Turkey. Armenia's situation is complicated by the border blockage with Azerbaijan and Turkey. If the political process leads to opening of the border with Turkey, Armenia could gain substantially from increased trade integration with Turkey.

2. **A reduction of excessive transport and transit costs** by the establishment of efficient, safe and competitive transport routes and transit condition within the region is the prerequisite for sustained economic development and access to foreign markets. It is also a precondition for the revival of regional trade in goods and services.
3. **A reduction of logistical costs** involved in engaging in trade activities would contribute to increasing competitiveness of small and medium enterprises for which the burden of involving in trade activities is often the highest. To accomplish this goal the international donors must emphasize the importance of facilitation of legitimate trade in the mission of border agencies by elimination of duplicative requirements, computerization of the customs operations and monitoring of border agencies' performance. The donors might also need to provide technical and financial aid in development of multi-modal logistic services that would reduce the costs of exports.
4. The local authorities could also **eliminate excessive fees and fight the cases when unofficial payment has been requested**. The elimination of corrupt activities, including smuggling would create a level-playing field for all companies and increase revenue collection. The necessary actions would involve improved transparency of requirements for all agencies, the harmonization of trade and transport practices and charges with neighboring countries and the strengthening of post release checks and of mobile preventive and enforcement units.
5. It is also important **to improve the working of the financial and specially the banking sector** that would reduce the transaction costs for exports. This would require technical assistance in the establishment of standards and norms that would facilitate the flow of credit between the countries.
6. The **regional cooperation in sharing the public goods** is hindered by the lack of mutual trust among the members, political tensions, lack of trust and asymmetric distribution of costs and benefits. A major obstacle is the absence of higher authorities to which to appeal in case of conflict, as the enforcement of property rights at the international level is weak. This is where the role of international organizations is important in creating institution that foster trust, provide expertise and financing.
7. It is necessary to **raise awareness of the benefits** stemming from joint actions of the neighbors to build consensus for cooperation. The lack of support for regional cooperation in dealing with environmental problems or transport development is often

due to the perception that benefits of such cooperation are small or that the costs and benefits will not be equally distributed. There is a need for quantification of the implications of increased investment in capacity expansion in infrastructure in sectors like energy, transport and telecommunications or environment.

8. At present regional cooperation does not have strong support among population or commercial groups in the region. **Building support for joint regional actions** requires the establishment of a regional network of business entities that could benefit directly from strengthening of regional ties. This would lead to intensification of involvement of the private sector in the dialogue on regional issues.
9. Some issues can not be tackled without **involvement of the neighbors beyond CIS7**. The examples include fighting drug trafficking in Central Asia that cannot be achieved without Afghanistan's engagement or development of transit corridors for Central Asia that cannot be achieved without cooperation of Kazakhstan. Involvement in cooperation on securities issues, environment or trade and transport facilitation of Russia, Ukraine, China, Iran or Turkey could improve substantially the payoffs from regional cooperation. .

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