

Annex V. Economic Cooperation and Integration in the CCA

Economic cooperation and integration, within the CCA and with other regions, can help CCA countries leverage their comparative advantages, gain access to larger and faster growing markets, and reduce high trade costs. However, bilateral or narrowly focused initiatives risk diverting trade and weakening economic prospects of the region. CCA countries would benefit from liberalizing their restrictive trade regimes on a multilateral basis within the World Trade Organization (WTO) framework, while continuing to foster regional economic cooperation and integration. As CCA countries open up to trade, they may need to adjust their macroeconomic policies to make their economies less vulnerable to external shocks.

Rationale for Economic Cooperation and Integration in the CCA

Economic cooperation and integration can promote growth. CCA countries share many economic challenges: being landlocked, difficult terrain, underdeveloped infrastructure, and a legacy of extensive public sector involvement in their economies. However, there is also considerable diversity in economic size, development levels, energy and water endowments, and economic policy regimes. Diversity and heterogeneity across the CCA can be a source of dynamism for economic cooperation and integration.

Greater economic cooperation and integration have several potential benefits:

- **Lower trade barriers, by developing economic corridors and improving transport connectivity to reduce transportation and cross-border costs** would likely increase trade and expand product diversity, and encourage liberalization of markets for services.
- **Greater diversification and larger markets** would increase domestic competition, facilitate innovation, and contribute to building cross-

border production chains. These, in turn, would increase exports outside the region and enhance job opportunities.

- **Strengthened financial linkages** would provide better opportunities for consumption smoothing (trade finance), efficient capital allocation (foreign direct investment), and reliable financial services (international payments).
- **Resolution of regional issues such as labor migration and water access.** With a substantial number of migrants from the CCA region seeking employment in the better-off economies, both within (Kazakhstan) and outside the CCA (Russia), economic cooperation and integration could contribute to the reduction or removal of informal and institutional barriers to labor migration. Regional approaches to the water-energy nexus could also bring major benefits, reducing the potential for conflict through more efficient management and more reliable availability of these scarce resources.
- **Greater unification of standards and locking-in of structural reforms.** Economic and social benefits from economic cooperation could reinforce economic reforms and political commitment to anticorruption and good governance. This would, in turn, help generate the political momentum for further domestic reforms. Friendly competition and benchmarking among CCA countries would provide a further impetus.

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Status of Economic Cooperation and Integration in the CCA

In many respects, the CCA economies recognize that multilateralism formalized by WTO membership provides a strong framework for developing international economic relations. CCA countries have pursued accession to the WTO to gain better access to markets in developed countries, though progress has been slow. Armenia, Georgia, the Kyrgyz Republic, and Tajikistan are members of the WTO, and Kazakhstan's accession is expected soon. Azerbaijan's accession is advancing, while the accession processes of Turkmenistan and Uzbekistan are at an earlier stage.

Other efforts have been made to improve regional links, with signs that regional cooperation gained a new impetus in recent years.

- *Eurasian Economic Union (EEU)*. Comprised of Belarus, Kazakhstan, and Russia, the EEU will become effective in January 2015, building on the Eurasian Economic Community established in 2000 and the Eurasian Customs Union (ECU) formed in 2010. Armenia and the Kyrgyz Republic are expected to join in the near future. The EEU envisages the free movement of goods, services, capital, and labor among the member countries. The initiatives followed earlier efforts: the Eurasian Development Bank was established in 2006 to finance the development of regional resources and infrastructure, and the Anti-Crisis Fund was formed in 2008 to support efforts by countries in the region to address the fallout from the global financial crisis.
- *Central Asia Regional Economic Cooperation (CAREC)*. Emerging from a regional initiative in 1997, the current membership consists of Afghanistan, Azerbaijan, China, Kazakhstan, the Kyrgyz Republic, Mongolia, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan. Focused on the development of regional trade, transport, and energy corridors, CAREC aims at

promoting and facilitating regional cooperation. The participation of multilateral institutions, such as the Asian Development Bank, is a unique aspect of CAREC, allowing cooperation and coordination not only among the member countries but also among key international financial institutions involved in the region.

- *Shanghai Cooperation Organization (SCO)*. This organization was established in 2001 by China, Kazakhstan, the Kyrgyz Republic, Russia, Tajikistan, and Uzbekistan. Although principally focusing on regional security concerns, the SCO added regional economic development and cooperation to its goals in 2003.

Advancement of economic cooperation and integration under existing international agreements, however, faces a number of challenges.

- EEU: Early evidence suggests that many challenges prevent member countries from reaping the full benefits of the customs union and enhanced economic integration, because of asymmetry in the economic size of the member states and high common external tariffs (CETs). Kazakhstan's GDP is about one-tenth of Russia's, and Belarus' GDP is one-third of Kazakhstan's. The significantly higher ECU CETs (the simple weighted average of 9.2 percent) could lead to a significant increase in the tariffs of prospective member countries, leading to trade diversion.¹
- CAREC: Despite some progress in physical infrastructure in the areas of regional connectivity and access to energy and water, progress has been slow in the areas of improving legal and regulatory aspects of trade, transport, and energy sector management. Moreover, links between the regional CAREC and national sector strategies have been weak.

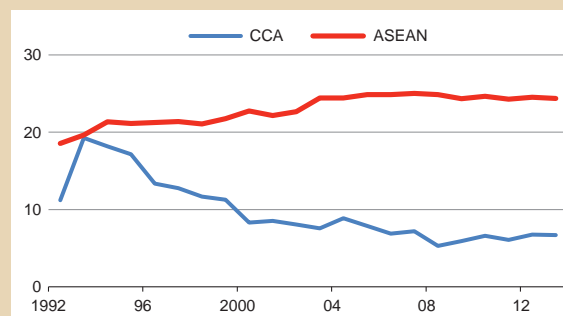
¹ Trade-weighted average tariffs at end-2011 were 3.6 percent for Armenia, 6.4 percent for Azerbaijan, and 3.8 percent for the Kyrgyz Republic. Data are not available for Tajikistan, Turkmenistan, and Uzbekistan.

- SCO: This organization deals primarily with regional security issues, while issues of economic integration receive less attention, a reflection of differing views and interests on key issues of regional oil and gas transit. The SCO's decision-making rule is based on principles of consensus and noninterference, which has its limitations in resolving conflicts among members, such as border crossing and regional water management issues.

In practice, gains from increased market size through economic integration are yet to fully materialize. Although the CCA has made significant progress in integrating with the rest of the world, intraregional trade has yet to catch up. The share of intraregional trade in the CCA relative to the region's overall global trade dropped significantly over the past two decades and did not keep pace with rapid economic growth in the region (Figures A5.1 and A5.2). Lower intraregional trade in the CCA contrasts with that of the rising numbers among the Association of Southeast Asian Nations (ASEAN) countries. CCA economies benefit from trade with two major trading partners, China and Russia (and for some CCA countries, the European Union), more than from trade within the CCA (Figure A5.3).

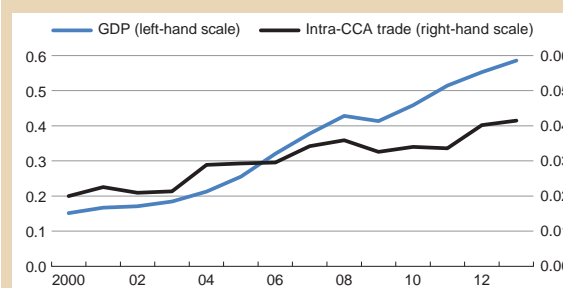
The CCA's trade with China has grown rapidly in recent years. China has become the main trading partner of the CCA countries, overtaking Russia and the European Union. China's economic growth and rising energy needs explain the expansion of Chinese engagement with the CCA countries, whose trade with China increased over the past decade, mainly reflecting increased exports of oil and gas, agricultural products, and raw materials from the CCA to China and increased CCA imports of manufactured, mostly consumer goods. Nevertheless, Russia remains an important destination for some goods, such as garments and spirits, from the CCA's job-creating manufacturing industries and a source of manufactured imports for the CCA (Table A5.1).

Figure A5.1
Intraregional Trade
(Percent of total trade)



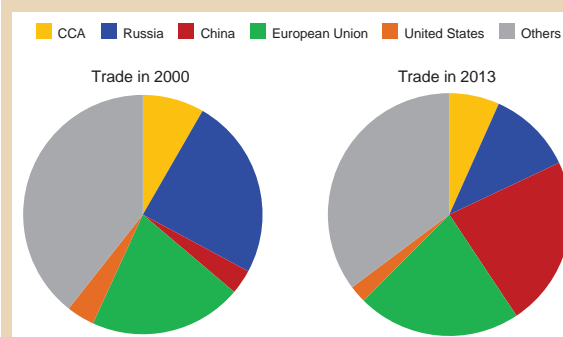
Sources: IMF, Direction of Trade Statistics database; and IMF staff calculations. Note: ASEAN = Association of Southeast Asian Nations.

Figure A5.2
CCA's Share in the Global Economy
(Percent)



Sources: IMF, World Economic Outlook database; and IMF staff estimates.

Figure A5.3
CCA: Trade Composition Change Between 2000 and 2013
(Percent of total)



Source: IMF, Direction of Trade Statistics database.

Table A5.1. CCA: Trade Shift from Russia to China
(Percent of CCA GDP)

	2000	2012
Oil and Gas Exports to China	0.3	2.6
Oil and Gas Exports to Russia	4.6	0.2
Agricultural and Raw Material Exports to China	0.8	3.3
Agricultural and Raw Material Exports to Russia	4.7	0.8
Manufactured Goods Imports from China	1.3	6.2
Manufactured Goods Imports from Russia	14.5	8.5
Manufactured Goods Exports to China	2.7	3.3
Manufactured Goods Exports to Russia	5.5	3.0

Sources: Comtrade database; and IMF staff calculations.

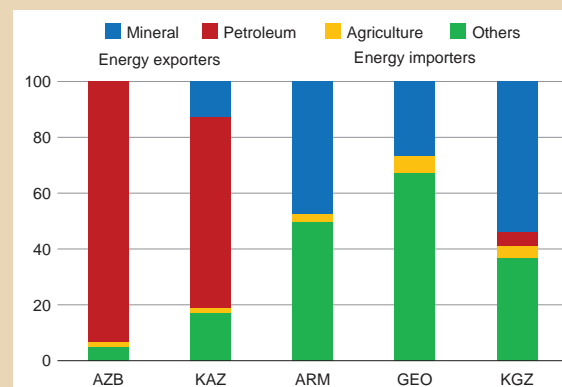
Several Factors Explain the Slow Pace of Regional Integration

- **CCA economies have similar product structures.** CCA countries in each subgroup export roughly the same set of goods, and most of these goods are either commodities or minerals. Exports are also concentrated on a few destinations (Figures A5.4 and A5.5). By contrast, in the ASEAN region, intermediate goods account for as much as 40 percent of intra-ASEAN trade, with a high degree of product chain dependence on Japan and China.
- **Intraregional trade costs remain high.** Most CCA countries face difficult geographic and climate barriers, leading to high cost of transportation and communication, as well as extended transit and delivery times, including time waiting at borders. In addition, limited and poor physical infrastructure adds to the cost of trade (Table A5.2).
- **Progress in removing cross-border obstacles has been slow.** The 2014 World Bank Doing Business Indicators rank most CCA countries, with the exception of Georgia, near the bottom on indicators of barriers to cross-border trade.² This ranking reflects cumbersome procedures and red tape in the processing of import and export documents.

² Armenia was ranked 117th, Azerbaijan 168th, Georgia 43rd, Kazakhstan 186th, the Kyrgyz Republic 182nd, Tajikistan 188th, and Uzbekistan 189th out of 189 countries.

Figure A5.4

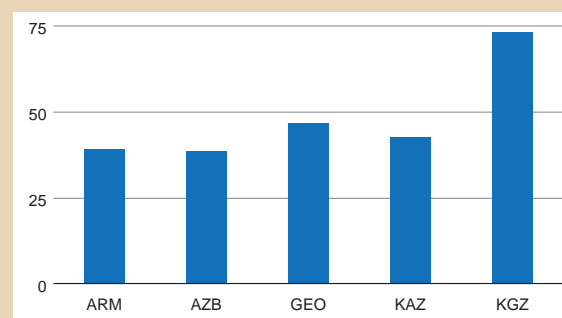
Selected CCA: Export Composition (Percent)



Source: United Nations Comtrade database.

Figure A5.5

Selected CCA: Export Share to Top Three Trading Partners¹ (Percent of total exports)



Source: United Nations Comtrade database.

¹Top three trading partners vary across countries.

Table A5.2. Intraregional Trade Costs
(Tariff-equivalent trade costs in 2007)

CCA	SAARC	ASEAN	East Asia	NAFTA	EU5
162%	150%	61%	128%	62%	72%

Source: UNESCAP, *Intra-regional Trade Costs in Asia*, 2010.

Note: CCA (for this table: Armenia, Azerbaijan, Georgia, Kazakhstan, and the Kyrgyz Republic); SAARC (Bangladesh, India, Pakistan, and Sri Lanka); ASEAN (Indonesia, Malaysia, Philippines, and Thailand); East Asia (China, Japan, Korea, and Mongolia); EU5 (France, Germany, Italy, Spain, and the United Kingdom).

Other institutional factors also hamper economic cooperation. Tensions among CCA countries, including disputes over territory (Nagorno-Karabakh) or water and energy resources (Tajikistan and Uzbekistan) have hampered

economic cooperation in the past and may be difficult to overcome in the future. Also, challenges in the areas of accountability and corruption have made it difficult to create enabling business environments.

Prospects

The success of economic integration in the CCA will depend on how cooperatively all key trading partners can be involved: China, the European Union, and Russia. Prospects for broader integration and the CCA's emergence as a "land bridge" on the Eurasian continent will depend on collaboration not only among the CCA countries, but also among the region's important neighbors. So far these have tended to pursue "exclusive" cooperation initiatives with the region. Russia has recently set up a development fund of US\$1 billion for the Kyrgyz Republic as part of plans for the latter to join the EEU. Large-scale Russian financial support for energy and other infrastructure projects was also discussed when Armenia decided to join the ECU in 2013. China has also expanded economic agreements with many CCA countries for investment, especially in the energy sector. Concerns about cross-border issues and potential ethnic and religious discord are also key for China.

Advancing economic cooperation and integration will not be easy, given the multilayered complexity of the process. The EEU is a good example: although the treaty has been signed, various details, particularly those related to free capital and labor mobility and equal educational opportunity, still need to be agreed on. Bilateral agreements on "exclusions," that is, traded goods excluded from the ECU CETs and phasing-out, remain unclear and unpredictable. Another concern is the lack of clarity on the extent of harmonization, or on a timetable for steps in other policy areas (tax policy, financial regulation). Free labor mobility will be hard to achieve in the short term because of significant income gaps among CCA countries and restrictive migration policies. On CAREC, further tangible progress hinges on developing stronger country ownership

and mainstreaming CAREC into the national development agenda.

Policy Implications

CCA countries should move toward liberalizing their restrictive trade regimes on a multilateral basis within the WTO framework. Accession to the WTO by more CCA countries would provide a common framework for formal trade policies, as well as access to a powerful multilateral dispute resolution mechanism. WTO accession could bring further benefits by encouraging liberal policies and punishing backsliding on commitments.

Regional integration initiatives should be complemented with structural reforms to promote openness, with due consideration given to potential vulnerabilities associated with increased external openness. Experience in other regions suggests that successful economic integration hinges on ambitious and decisive complementary structural reforms, including establishing proper governance mechanisms and institutions. More forceful market-enabling and market-deepening reforms are necessary to underpin further promotion of openness by mitigating such key constraints as corruption, inadequate labor skills, and poor infrastructure. Structural reforms should be complemented by encouraging strong political commitments and grassroots efforts at integration, involving individuals, private sector firms, nongovernmental organizations, and other stakeholders. Strengthening and modernizing macroeconomic frameworks and prudential regimes in tandem with increased openness and integration is also important, especially because the CCA countries have common vulnerability to external shocks owing to their limited diversification and links with the same regional trading partners. Greater integration among similar countries can exacerbate shocks, and sudden changes in the direction of capital flows may induce boom-bust cycles, especially in countries with less developed financial sectors. Gradual and flexible implementation of integration initiatives can help mitigate these risks.