ANALYSIS

Impact of the Economic Crisis in Russia on Central Asia

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Abstract
The 2014 Russian economic crisis caused by Western sanctions and the drop in the global oil price has transformed into a regional economic crisis. Central Asian economies are highly vulnerable to: shocks from low oil and gas prices; the current troubles facing the Russian ruble to which their currencies are closely linked; drops in remittance income from labor migrants working in Russia; and reduced Russian investment. Already in 2014 the impact of the Russian crisis had severely damaged growth in Central Asia and could further destabilize the region in 2015 if the decline becomes more severe. Longer term, the crisis will affect the prospects of the different models of Eurasian regional economic integration that Russia, China, and the United States are advocating.

What started in November 2013 with a small protest in Ukraine, transformed in 2014 into a complex regional economic crisis fed by Western sanctions against Russia and the unexpected plunge in the global oil price. Every country in the former Soviet Union that has not integrated with the European Union is now facing some level of economic crisis as Russia's stumbling economy drags Eurasia down.[1] This brief focuses on the five Central Asian countries and their four main vulnerabilities:

1. Low oil and gas prices, for the hydrocarbon export-dependent states of Turkmenistan and Kazakhstan;
2. Currencies, which are linked to the ruble and are experiencing both devaluations against the dollar, which hurt domestic buying power and threaten defaults on dollar-denominated debt, and increases in value against the ruble, which hurt exports to Russia;
3. Remittance income from labor migrants in Russia, which are already shrinking due to the ruble's lower buying power and will diminish further as the Russian economy contracts;
4. Russian investment and contracts, especially for critical infrastructure projects, which may be frozen or withheld.

Russia's Crisis

The first factor in Russia's economic crisis is the United States and European sanctions in response to the annexation of Crimea and invasion of eastern Ukraine that stoked almost $75 billion in capital flight in the first-half of 2014. Russian counter-sanctions on European and American food in August added to inflationary pressures, as well as the sense of economic panic.

As large, or larger, a factor in the crisis has been OPEC's decision, led by Saudi Arabia, to allow global oil prices to collapse in order to drive new oil producers out of the market. The plunge of benchmark oil prices from over $100 per barrel in July 2014 to just above $50 at the time of writing has eroded the basis of Russian growth. Oil and gas revenues made up more than 68 percent of total export revenues in 2013, with most of that coming from oil and petroleum products.[2] The original 2015 budget was based on oil at $100 per barrel. Growth projections have been revised repeatedly downwards. The World Bank in January projected negative 2.9 percent growth for 2015,[3] down from negative 0.7 percent just one month before.[4] As the crisis has intensified, the ruble has plunged, falling nearly 100 percent against the dollar since the start of the Ukraine crisis in November 2013, even as the Central Bank has spent more than $100 billion in its defense since June.

Kazakhstan

Due to its close economic relationship with Russia and its heavy dependency on oil exports (an estimated 69 percent of exports in 2014[5]), Kazakhstan has been the hardest hit in the region. The World Bank revised Kazakhstan's 2015 forecast down from 5.9% in June 2014 to

1 Belarus implemented a *de facto* devaluation in December 2014 and is locked in a bitter trade dispute with Moscow over re-export of sanctioned goods and a flood of cheap Russian imports; Moldova is desperately fighting runaway devaluation of the leu; Georgia and Armenia, like Tajikistan and Kyrgyzstan, rely on remittances and Russian investment and now have currencies under severe pressure; Azerbaijan is abandoning its currency's peg to the dollar in a *de facto* devaluation. Ukraine, of course, is the hardest hit in the region due to the collapse of the government, war in the east, and the loss of Crimea.

2 "Oil and natural gas sales accounted for 68% of Russia's total export revenues in 2013", *U.S. Energy information Administration*, July 23, 2014

3 "World Bank cuts Russia growth outlook, warns on global economy", *The BRICS Post*, January 14, 2015

4 "World Bank Revises Its Growth Projections for Russia for 2015 and 2016", *The World Bank*, December 9, 2014

5 "FSU oil producers face tough 2015", *The Economist Intelligence Unit*, January 21, 2015

1.8% in January 2015; the government itself now projects only 1.5% for this year. Astana has been activist in response, but thus far inconsistent and ineffective in stopping the spread of the crisis.

Kazakhstan's first policy move came in February 2014. The crisis was only in its infancy when the National Bank devalued the Kazakh tenge 19 percent without warning, in order to stay ahead of the ruble's decline. The sudden devaluation proved a shock to Kazakhstanis, as those holding tenge awoke to find their savings slashed overnight by almost a fifth, and those holding dollar-denominated debt saw it go up by just as much. The government also announced it would spend one trillion tenge ($5.4 billion) from the National Fund to stimulate the economy, claiming that its target of 6–7 percent annual growth was still achievable.

Although ostensibly done to prevent panic from spreading, the result of the overnight devaluation has been mistrust in the government's economic plans for tackling the crisis, and even more so in the stability of the tenge. Foreign currency holdings have skyrocketed as more and more people bet on a further devaluation; at the end of 2014 over two-thirds of retail deposits were in foreign currency.[6] With deposits flowing into foreign currencies, the government is also deeply concerned about tenge liquidity and vulnerability to dollar dependency. On February 11, President Nazarbaev urged state companies to shift their holdings from dollars into the national currency.[7] This "advice" complements steps outlined in December by the National Bank to incentivize savers to move from dollar to tenge accounts.[8] There is a serious risk of financial crisis. The National Bank reported in January that non-performing loans made up a dangerous 23.55 percent of total loans nationwide.[9]

The February devaluation failed to keep Kazakhstan competitive. With the tenge now up 80 percent against the ruble from where it was after the February 2014 devaluation, domestic consumption and production are eroding, especially in border regions and manufacturing areas reliant on export to Russia. In February 2015, after months of Kazakhstanis crossing the open border with Russia to buy daily consumer products, foodstuffs, and even cars, the government requested negotiations with Russia to impose restrictions on cross-border trade.[10] President Nazarbaev has called for a "Made in Kazakhstan" label to encourage patriotic consumption.[11]

The strong tenge is starting to directly affect wages and employment in key sectors. In February 2015, the Temirtau subsidiary of commodities giant ArcelorMittal announced that it would hold a quarter of its 13,000 local employees' wages in escrow until it had more cash, because the falling ruble had made export of its Kazakhstan-produced steel uncompetitive.[12] The government scrambled to respond, immediately releasing over $20 million in overpaid VAT to the company.

The government appears unsure whether to pursue stimulus or austerity. In November, President Nazarbaev announced the economic project "Nurly Zhol" (Shining Path), billed as a countercyclical approach to the crisis, including an ambitious new approach to regional and national transportation infrastructure.[13] Yet the proposal actually only re-allocated funds already promised in February 2014, and the pledge of stimulus has already been undermined by more recent plans. On February 11, 2015 President Nazarbaev called a meeting of the government to lay out a further round of anti-crisis measures. The government announced it would cut annual expenditures by ten percent, or almost $4 billion, including reductions in spending on prestige projects like the Winter Universiade and EXPO 2017.

Kyrgyzstan–Tajikistan–Uzbekistan: the Fragile Southern Tier

Each country of the poorer southern tier of Central Asia has suffered from a currency that is weakening against the dollar, but not fast enough to avoid strengthening against the ruble. The Tajik somoni is down 13 percent against the dollar and up 45 percent against the ruble; the Kyrgyz som is down 25 percent and up 37 percent.[14] Uzbekistan is notorious for presenting unreliable or incomplete economic statistics, but its underlying issues are the same as in Tajikistan and Kyrgyzstan. The official rate of the Uzbek som is down 12 percent against the dollar and up 75 percent against the ruble.[15] Preventing all-out crashes has been expensive. The Kyrgyz National Bank has spent 17 percent of its foreign

6 "Bank deposits show Kazakhs fear another devaluation", *BNE IntelliNews*, February 12, 2015

7 N. Gizitdinov, "Kazakhstan Tells Companies to Prop Up Tenge in Ruble Rout", *Bloomberg*, February 11, 2015

8 "Kazakhstan considers de-dollarizing its economy", *Tengrinews.kz*, December 29, 2014

9 J. Dettoni, "Kazakhstan Anxious about Another Devaluation", *Eurasianet*, February 5, 2015

10 The same dynamic in Belarus has led to threats from President Lukashenko to leave the Eurasian Economic Union.

11 "N.Nazarbaev predlozhil zapustit' aktsiyu 'Sdelano v Kazakhstane'", *Zakon.kz*, February 11, 2015

12 "ArcelorMittal Temirtau cuts wages by 25% for locals and by 50% for foreigners", *Tengrinews.kz*, February 4, 2015

13 "Nurly Zhol—The Path to the Future", Kazakhstan Embassy in the USA

14 All figures are from November 21, 2013 to February 16, 2015.

15 Most people in Uzbekistan use black market currency traders. The dollar rate on the black market is roughly 50% lower than the official rate, but they tend to move in sync.

currency reserves trying to keep the som steady against the dollar, and late in the year threatened to ban foreign exchange points after accusing them of hoarding dollars and speculating on the som's further decline. The Tajik National Bank spent $137 million in 2014, more than a fifth of its foreign currency reserves.[16]

As in Kazakhstan, strength against the ruble is a curse. Agricultural producers in Central Asia had greeted Russia's food sanctions on Europe with joy, seeing an opportunity to return to a market they had lost to more efficient and closer European producers. But plans announced in August to increase agricultural exports by five (Tajikistan) or fifteen (Kyrgyzstan) times will be hard to pull off with a weak ruble. The argument for Kyrgyzstan's accession to the Eurasian Economic Union was that it would promote access to the Russian market, which looks less profitable now that the ruble has made Kyrgyz goods less competitive. A representative of Kyrgyzstan's textile industry stated in February 2015 that half of the country's apparel producers—one of the only successful finished-goods industries in the country—were idle because of the Russian crisis.[17]

The first big unknown for 2015 is how millions of Central Asian labor migrants will react to the crisis. Each country in the southern tier relies heavily on the remittances of labor migrants in Russia, which are equivalent to 31.5 percent of GDP in Kyrgyzstan and are equal to roughly half of Tajikistan's GDP (the country stopped reporting numbers in 2013). Uzbekistan also does not provide official information, but the GDP equivalent is thought to be between 15 and 25 percent. The value of remittances is guaranteed to drop in 2015, as migrants earning in rubles lose dollar purchasing power. What is unknown is how many migrants will leave Russia, or at what pace. New data through January 2015 from Russia's Federal Migration Service shows a decline from 2–4% in citizens of the three countries registered in Russia. However, the enormous degree of informal migration, as well as the large numbers of migrants who have taken dual citizenship, make it hard to rely on these early figures. The scale of return will only be discernible by mid-2015 at the earliest.[18] Tightened Russian visa and immigration rules, especially for non-EEU citizens of Tajikistan and Uzbekistan, could reduce migrants' numbers.

The second big unknown is how the crisis will affect Russian investments in Central Asia. In Uzbekistan, as in Turkmenistan, Gazprom is drastically cutting its gas imports from the country for this year, purchasing only one quarter of the supply it took in 2014.[19] Kyrgyzstan is in the most danger from a retreat in Russian investment. As the country has drawn closer to Russia by agreeing to join the Eurasian Economic Union, it has also become more reliant on Russian money. Russia's state-owned Inter RAO has not even started work on the Kambarata 1 hydropower plant that it pledged to build in exchange for extending Russia's lease on the Kant military base.[20] As part of the EEU negotiations, Russia pledged $1.2 billion in transition funds to ease Kyrgyzstan's accession, and in January Gazprom announced it would spend half a billion dollars to overhaul the country's gas infrastructure. At least the total figures, if not the investments themselves, are in doubt given the scale of Russia's crisis.

Turkmenistan

Even in the most opaque country in an opaque region, the crisis has already had visible consequences. On January 1, the Central Bank announced an overnight 18.6 percent cut in the manat. Ten days leader President Gurbanguly Berdymukhamadov fired the head of the Central Bank, as well as of the national gas company. As in Kazakhstan, the overnight devaluation led to spreading anxiety, with exile-operated independent news outlets reporting long lines at exchange points and limits on conversion.[21] With minimal exports to Russia, fewer labor migrants, and complete dependence on gas exports, Turkmenistan is likely feeling the pressure more from the drop in natural gas prices as they follow oil downward than from Russia's crisis. There may be knock-on effects however, as Gazprom announced in February that it will slash its purchases of gas from Turkmenistan by three-fifths, to only 4 billion cubic meters (bcm).[22] That will leave Turkmenistan even more dependent on its main Chinese purchaser. The government has denounced the cut in unusually strong language, calling Russia an unreliable partner and accusing it of violating contracts.[23]

16 "Tajikistan's gold and forex reserves total $481 million", *The Times of Central Asia*, January 22, 2015

17 "Half of Kyrgyzstan's sewing enterprises standing idle," *The Times of Central Asia*, February 20, 2015

18 D. Trilling, "Central Asians Leaving Russia: Flood or Trickle?", *Eurasianet*, February 8, 2015

19 C. Rickleton, "Gazprom Clarifies Drawdown in Turkmenistan", *Eurasianet*, February 3, 2015

20 C. Rickleton, "Kyrgyzstan: Russia Has Made "No Real Progress" on Hydropower Promises", *Eurasianet*, February 16, 2015

21 C. Rickleton, "Turkmenistan: Rumors Reign as Economic Crisis Grows", *Eurasianet*, February 1, 2015

22 C. Rickleton, "Gazprom Clarifies Drawdown in Turkmenistan", *Eurasianet*, February 3, 2015

23 OilGas.gov.tm

Short-Term and Long-Term Regional Consequences

Because both factors driving the crisis—OPEC's willingness to tolerate low oil prices and the war in eastern Ukraine—are themselves still unpredictable, and because of the opacity of the governments and economies of Central Asia, it is difficult to predict precisely how the crisis will develop in 2015. What is certain is that the crisis is only in its early stages, and that none of the governments in the region have the resources to avoid it. At a minimum, the crisis will cripple public spending and result in more lost years in a region that never recovered from the post-Soviet collapse in infrastructure, social services, and education. At worst, the crisis could lead to violent unrest.

The long-term significance for the region will depend on how long the crisis lasts and how severe it becomes. But long-term consequences for regional economic development are already taking shape. The first is that the Russia-centric regional integration model of the EEU is withering. Russia's counter-sanctions against Europe, which were imposed without consultation within the EEU, have shown the shallowness of its commitment to rules-based regional integration. Kazakhstan is the key defector from the project. Even as President Nazarbayev maintains a rhetorical commitment to the EEU, steps to impose limits on Russian imports, to encourage reliance on the tenge, and to curtail labor migration to Kazakhstan show that the government has gotten cold feet about integrating into an axis that pivots on Russia.

Second, as the EEU regional integration model fails, the China-led model of integration, in which Central Asia acts as a source of natural resources and a transit zone for Chinese goods to Iran, Europe, and South Asia, will continue to gain ground. The rapid completion of pipelines and transportation infrastructure crossing the entire region has shown that China is not just an alternative investor in Central Asia, but its dominant one. Russia will remain dominant politically so long as China sees no benefit in confronting it. But Russia's levers for economic influence are weakening, especially if large numbers of migrants return to the southern tier. The crisis will hasten the region's turn away from reliance on Russia and towards China.

Lastly, the crisis has reaffirmed how irrelevant the US's plans for the region are. The Afghanistan-centered New Silk Road Initiative, announced with great fanfare in 2011, has failed to produce liberalization in intraregional trade, or major new connections between Central and South Asia that would spur economic development. Its signature CASA-1000 electricity export scheme and the TAPI gas pipeline are both still years, or more likely decades, from completion. Moreover, pressure is building to "de-dollarize" local economies, especially in Kazakhstan, as the price of reliance on the dollar-centric international financial system sinks home. United States assistance to the region badly needs reevaluation to focus on Central Asia in its own right, rather than as a helpmeet to Afghanistan, so that the conceptual framework can engage with actual sources of economic and social dynamism in the region.

About the Author

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