Foreign Capital in Central Asia and the Caucasus: Curse or Blessing?

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Despite the wave of democratization that swept across the former communist states in Eastern Europe and parts of the former Soviet Union in the last decade, authoritarianism has endured in Central Asia and the Caucasus. Most of these states are ruled by former communist elites who have gained wide powers to rule by decree and who have systematically harassed the opposition, and stifled political rights and civil liberties. The Freedom House (2003) rankings indicate that these states have been stuck in a "twilight zone" between façade democracies and outright sultanistic regimes.[1] Not surprisingly, students of the region are now turning their attention away from issues of democratic transitions to understanding why authoritarian regimes have persisted for so long.[2]

Many factors can account for this phenomenon, such as the leading role and preferences of the old nomenklatura (Cummings 2001, McFaul 2002); persistence of informal, clan-based politics (Collins 2002); weak civil societies; simmering ethnic tensions; and low levels of economic development (Olcott 2003, Aslund 2003). Very little heed, however, has been paid to the role of foreign capital in the endurance of authoritarian regimes as well as the variation in the degree of authoritarianism in this region. This is surprising, considering that they have been exposed to the forces of financial globalization at the same time that they were struggling to establish their sovereignty and build new state institutions. The economic dislocations in the aftermath

[1] Between 1993 and 2003, the three Caucasus states Azerbaijan, Armenia, and Georgia were ranked as "partly free". The Central Asian states Kazakhstan, Turkmenistan, Tajikistan, Uzbekistan, and Kyrgyzstan (with the exception of the latter until 2001) were ranked as "not free".

[2] Thomas Carothers (2002) has argued that scholars need to stop looking at these states as if they are still in transition to democracy and acknowledge that they may not be moving at all, or if they are, it may be away from democracy toward a stronger authoritarianism.

of the Soviet collapse compelled them to court foreign capital to generate much-needed economic growth and development, both of which are in the long run linked to prospects for democracy.

To be sure, foreign capital does not directly cause regime transformation or persistence. However, as is widely accepted in the literature, especially in developing countries, the magnitude as well as the composition of foreign capital greatly *influences* the level of economic growth, the political fortunes of domestic actors, the pressures for market reforms, the risks for economic crisis, and thus intrinsically the regime trajectory. The types of foreign capital, distinguished by source, recipient, and volatility, have different effects on existing political regimes. I demonstrate in this paper that many of the states in Central Asia and the Caucasus depend heavily on external capital flows for the financing of their fiscal deficits and that the bulk of the flows go directly to authoritarian governments, while very little is received by the private sectors. Even though some of these resources that flow to government budgets have helped improve productivity and access to foreign markets-- thus helping to foster the integration of these economies into the global economy--, they have also further empowered authoritarian rulers, provided very little financial strength to local businesses, offered half-hearted incentives for market reforms, and finally sheltered these economies from a balance of payment crisis that could have undermined the legitimacy of the ruling elites and pushed for a regime change. Hence, the predominant type of foreign capital flowing to this region has indirectly enhanced the capacity of the authoritarian regimes to dole out rents, buy off opponents and cripple the transition to a genuine democracy. Moreover, the small - and yet important - differences among these states in terms of the composition of capital flows also may help us understand why some have moved towards a milder version of authoritarian rule while others have been stuck in hard authoritarianism. Even though these eight countries are all considered authoritarian, differences in pluralism stand out. Turkmenistan and Uzbekistan are full-fledged dictatorships, while Kazakhstan, Kyrgyzstan, Tajikistan, Georgia, Armenia, and Azerbaijan can be characterized as mildly authoritarian.

I begin with an overview of the literature that studies the effects of foreign capital inflows on democratization. Next, using Global Finance Indicators 2001 data, I document the magnitude and composition of capital flows to the economies of Central Asia and the Caucasus throughout the 1990s. I describe the main trends in time, as well as cross-sectional variation among these states. Then, I discuss the implications of different types of foreign capital on the political trajectories of these countries. I conclude on a not-so-positive assessment of the role foreign capital plays in the perpetuation of authoritarian regimes in the region.

Foreign Capital Flows and Democracy in the Developing World

Over the past five decades, there have been substantial shifts in aggregate flows of all types of capital into developing countries. In studying these dramatic shifts in the form and quantity of capital transfers, scholars have been increasingly looking at their implications for the transition to and the consolidation of democratic regimes (Nelson 1990; Mahon 1995; Stallings 1995; Pauly 1995; Claessens et.al., Block 1996; Winters 1996; Maxfield 1997, Chaudry 1997, Armijo 2001, Haley 2001). The theoretical hypotheses that this literature generates are alternatively applicable for studying the lack of democracy, or 'stickiness' of authoritarianism in some developing countries.

There are multiple ways in which capital flows are distinguished. In this paper, however, I use Armijo's (2001) schema and distinguish them in terms of identity of the foreign investor (source), the degree of public vs. private control over the allocation (recipient), and the ease with which the foreign investors can turn around and repatriate their funds (volatility). Based on these criteria, I discuss the impact of six types of foreign capital (See Table 1).

Foreign aid includes official grants, and low-interest loans from international organizations (such as the World Bank, regional development banks, International Monetary Fund [IMF]) and from foreign governments. The sources are public entities and their donations/credits flow almost always directly to the developing country governments. This type of capital flow has very low volatility. Due to the donors' long-term strategic, and political priorities, sudden reversal of these funds is very unlikely.

Foreign direct investment (FDI) flows from the foreign private sector to the private sector in the host country. However, often in the developing countries multinational corporations enter into joint ventures with state-owned enterprises, which means that FDI may also flow into the public sector.[3] FDI has low volatility because it is difficult for investors liquidate their assets immediately without encountering large losses.[4]

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[3] As will be discussed, most FDI in the Central Asia- Caucasus region goes to publicly owned enterprises and so essentially flows to government. Unfortunately, given the limitations of the data, I cannot distinguish between FDI into the public sector and into the private sector.

[4] FDI is defined as investment that is made to acquire a lasting management interest (usually of 10 percent of voting stock) in an enterprise operating in a country other than that of the investor. The investor's

Commercial bank loans to the government come from foreign private sector banks to the developing country's public sector. This category includes direct loans to the central bank and state-owned enterprises, and loans that flow to the private sector that are publicly guaranteed.[5] *Commercial bank loans to the private sector* similarly originate with the foreign private banks and are used by the local private sector. Both medium-term and long term loans by foreign commercial banks have medium volatility.

Portfolio investments to government flow from foreign private investors to the recipient country government in the form of treasury bonds or minority shareholdings in public sector firms. Finally *portfolio investments to the private sector* flow from foreign private sector to local private sector. These include nonguaranteed bonds that are privately placed as well as corporate equities and depository receipts (American or global). Both types of portfolio investments are considered extremely volatile because both bonds and equities can be traded and withdrawn relatively more easily.

[Table 1 about here]

Whether or not these characteristics of foreign capital will promote or retard democratization, ceteris paribus, depends significantly on the nature of the existing political regime. Relatively more democratic states are different than authoritarian regimes in terms of the way they utilize external resources. Given a non-democratic starting point, I follow Armijo's (2001) reasoning and argue that the composition of

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purpose is to acquire an effective voice in the management of the enterprise (Global Financial Indicators 2001).

[5] This measure obviously is not as accurate as one would like it to be. It to a certain extent exaggerates the size of this category. However given the data limitations, this is the type that comes closest to loans that are publicly placed. Loans that are publicly guaranteed provide extensive government oversight over foreign loans to private firms.

capital flows enables regime durability through its impact on economic growth and equality, the distribution of power among political actors, pressures for neoliberal reforms, and the risk of balance of payments crisis. Below I discuss how each type of foreign capital affects these intermediate variables, which in turn have significant implications for regime persistence.

Economic growth and equality

The relationship between capital flows and economic growth hinges to a large extent on whether the recipient of foreign capital is the public or private sector in the developing country. Capital flows that are privately placed (FDI, commercial loans and portfolio investments to the private sector) tend to generate more economic growth than those that are publicly placed (foreign aid, loans to the government, and portfolio investments in government securities) (see Table 2). The public choice school demonstrates how governments have fewer incentives to maximize profits and more incentives to allocate resources politically through patronage (Bates 1988; Bates and Krueger 1993).

Foreign capital flows that improve economic growth, however, may not necessarily aid in the promotion of democracy. In fact, high economic growth under an authoritarian regime may have the effect of legitimating the incumbent and thereby delaying democratic transition, at least in the short run.[6] Moreover, high economic growth facilitated by certain capital flows often accompanies economic inequality, which similarly may hurt the prospects for democracy. In fact, FDI is found to raise income

[6] The Latin American and East Asian newly industrializing countries (NICs) demonstrated that throughout the 1960s and 1970s, economic growth can lead away from democracy.

inequality significantly in host economies (Bornschier & Chase-Dunn 1985; Chan 1989; Dixon and Boswell 1996; Quinn 1997; Reuveny and Li, forthcoming). To court FDI, many developing countries offer favors such as tax holidays, generous terms for profit accumulation and repatriation, and public subsidies--steps that all tend to sustain and even exacerbate income inequality. Unequal income distribution is enforced by such government measures as the banning of free unions, the right to strike and to engage in collective bargaining, as well as the suppression or control of labor demands for improved wages, benefits, and working conditions. Numerous studies confirm that very little of the new wealth generated through FDI has in fact trickled down (Grant 1973).

[Table 2 about here]

Distribution of political power

The destination of foreign capital—public vs. private-- also has implications for the distribution of political power in a regime. It is commonly argued that barring a balance of payment crisis, all foreign capital flowing to the public sector bolsters the incumbent political regime because it signifies an external vote of confidence in the economic management skills of the ruling elites. It also augments the resources (patronage spending) that ruling elites can deploy vis-à-vis the resources of their political opponents. Dependency theorists provide ample examples of how foreign capital that flows into public enterprises (or to local firms that are dependent upon the political authorities) creates a particular transnational class coalition, a "triple alliance" between state elites, foreign firms and local firms, all of whom have a common interest in rapid accumulation of capital (Evans 1978, Cardoso 1973, Bennett and Sharpe 1983). Because its position of dominance is guaranteed by the support of its multinational ally, the ruling elite has little incentive to institute reforms to improve the conditions of the masses.

On the other hand, foreign capital that is privately placed, such as equity investments in and commercial loans to the private sector, can bring about conditions conducive to pluralism by augmenting the resources available to local businesses and thus changing the composition, vitality, and political character of entrepreneur groups and capital accumulation in the private sector (see Table 2). Because a shift away from the arbitrariness of unrepresentative governance to the rule of law reduces the costs of doing business, the domestic firms may favor political liberalization and provide an alternative source of power in society that can challenge and curb the authority of the state. Hence, private capital flows can over the long run help build a strong and politically assertive business class that is essential for the successful transition to mass democracy.[7]

The different types of foreign capital, distinguished by source, also have implications for the degree of influence donor governments, international institutions, and investors may have in the political system. A high volume of foreign aid, for instance, increases the impact of the preferences of external actors that may or may not regard democratization as a priority for the countries to which they provide funds. The priorities of foreign governments (bilateral donors) can often be strategic (such as access to military bases, cementing alliances, commercial reciprocity) or humanitarian, as opposed to democracy promotion (Armijo, 2001). Similarly, multinational banks often care about

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[7] It is also possible to argue that for local businesses dependent upon the government, even the ability to attract foreign capital may not bring much of an independent voice. Foreign capital in that case may in fact strengthen business families close to the regime, and consequently the regime itself.

creditworthiness and strong macroeconomic fundamentals (e.g., GDP growth, fiscal deficit, debt-to-GDP ratio, or monetary base to foreign reserves) but not necessarily the political environment in the country to which they are lending.

Foreign direct investors, on the other hand, may be more likely than aid donors or bank lenders to care about domestic politics and even a certain degree of liberalization in the political system. By investing in fixed assets in the host country, they themselves become local actors and may use the political system to lobby for their interests.[8] However, their pressure on the government policies is usually limited to those concerned with the provision of a stable regulatory environment that ensures strong property rights and profitable return on their investments. Beyond those policy areas, there are few indications that foreign investors support policy initiatives that would lead more directly to political reforms and democratization. In fact, there are strong reasons to suggest that it is in the interest of foreign direct investors not to push for political reforms. Foreign direct investors often desire a climate of political and economic stability, even if it takes authoritarian governments to deliver it (Winters 2001).

Pressure for Neoliberal Reform

Different composition of foreign capital can also produce different degrees of pressure for neoliberal reform, which in turn may have implications for regime change.

[8] Certainly their degree of influence varies depending on the sector they invest in. For instance, holders of foreign capital in manufacturing industries are more affected by the circumstances found in the host country because they rely on the local market for sales, they maintain extensive contacts with local firms that operate as suppliers and distributors, and they require access to large number of local workers In contrast, investors in extractive sectors are more insulated and have fewer contacts with the host government. Foreign capital gets concentrated in small enclaves, with their primary interest centering on extracting resources for international markets.

As discussed above, official lenders and commercial banks often lend money based on their strategic and political priorities or on the creditworthiness of the borrowers. They tend to care less about the efforts of the government to undertake neoliberal reforms (see Table 2). Despite questions about its effectiveness, IMF is notably the only international financial institution that actively promotes such reforms as a condition for its loans.[9] Foreign direct investors have more interest in the host country policy environment but, as discussed above, tend to focus on a narrow area of economic reform that can guarantee them stability and timely return on their investments.

Portfolio investors, on the other hand, arguably apply the highest degree of pressure for neoliberal reforms. The possibility of rapid movement of funds in and out of securities, and in and out of countries, gives these investors the economic clout to pressure governments for neoliberal reforms such as privatization, elimination of trade barriers, budget cutting, financial sector deepening, transparency, and the rule of law. Because such reforms tend to improve economic performance over the long term, one can argue that economic liberalization eventually leads to political liberalization and thus portfolio investments can help sow the seeds of democracy. Some also argue that this type of foreign capital can curb discretionary powers of authoritarian governments by disciplining the business environment, cutting patronage, promoting institution building and strengthening civil society (Lindblom 1982; Mahon 1995; Stallings 1995; Rogowski and Frieden 1995; Block 1996; Henry 1996/98; Winters 1996; Chaudry 1997; Maxfield

[9] There is considerable evidence that IMF loans and conditions are based more on patronage relationships than economic variables. Thacker (1999) and Dreher and Jensen (2003) find that U.S. allies are more likely to receive IMF support.

1997).[10] Governments that need a steady flow of foreign capital may have no option but to liberalize economic policies as well as allow changes in the policy environment that may be conducive to democracy.

There is no linear link between market-oriented economic liberalization and transition to democracy however. As the experience in many developing countries demonstrates, neoliberal reforms lead to significant cuts in social spending and income inequality associated with drastic social dislocations and widespread poverty. Increased insecurity and inequality easily can provoke societal pressures from groups that perceive themselves as losers. These social changes may produce extreme antidemocratic sentiments as well social unrest and violence.

Balance of Payment Risk

Finally, depending on degree of volatility, different types of foreign capital also have influence on the likelihood of a balance of payment crisis and thus a possible regime change. As discussed before, foreign aid and FDI have low volatility because they are unlikely to be removed overnight and thus cause economic crisis (see Table 2). Medium and long-term commercial bank loans are of intermediate volatility and therefore pose some risk of external payments crisis. Portfolio investments, on the other hand, pose the greatest risk because stocks and bonds are traded daily or hourly, and their prices fluctuate all the time. Sudden withdrawal of this type of foreign capital can do the most damage to the economy by affecting currency and exchange rate movements. Moreover,

[10] A seminal contribution to this idea comes from Albert Hirschman (1978), who outlines the role of "movable property" as a restraint on the government's freedom of maneuver by checking despotic and predatory rule.

if foreign investors hold large portions of the government's domestic public debt, a fiscal crisis ensues as well (Armijo 2001).

The main consequence of a balance of payments crisis is the discrediting of the governing elites which may stimulate a regime change. The neoliberal structural adjustment policies such as cuts in government spending and liberalization of prices lead to the deterioration of the purchasing power of the low income groups. These prescriptions that are needed to overcome the balance-of-payments (BOP) crisis imply deep recessions and social pain that erodes the credibility of the political incumbents' economic policies and jeopardizes the length of their tenure. Even though not every BOP crisis in an authoritarian regime guarantees democratic transition, by exposing the incompetency of the ruling elites, it may produce significant incentives for regime change. A lack of portfolio investments denies a potent source of countervailing power against authoritarianism.

Capital flows to Central Asia and the Caucasus

The data that I compiled from Global Finance Indicators 2001 demonstrate that capital flows to the eight countries of Central Asia and the Caucasus were a relatively small share of the total flows to developing countries over the 1993-1999 period (about 1.2 percent). As a fraction of GDP, however, capital flows to Central Asia and Caucasus states were much higher than flows to all other developing countries[11] during the same period (see figure 1). In terms of the volume of foreign capital, Azerbaijan and Kyrgyzstan received on average more foreign capital than the other Central Asian and

[11] All other developing countries, hitherto refers to countries for which data was available in Global Finance Indicators 2001. Central Asian and Caucasus states are omitted from this category.

Caucasus states (19.89 and 18.2 percent of GDP, respectively; see figure 2). However, despite some variation, except for Uzbekistan--where foreign capital accounted for about 5.8 percent of GDP--all Central Asian and Caucasus states received substantial amounts of foreign capital relative to the size of their economy during the period.

[Figures 1 and 2 about here]

Composition: By Source

The transition process in Central Asia and Caucasus also influenced the composition of the capital flows. In terms of source, particularly early in the transition, the flows were largely fiscally driven and often came from official sources. In 1994, for instance, 77 percent of flows into the region came from bilateral and multilateral official donors in the form of grants and low-interest loans (see figure 3). This type of capital was made necessary by the substantial drop in fiscal revenues. Receipts from the state enterprise sector fell sharply, partly as a result of partial privatization, the elimination of price subsidies, and the breakdown of the tax system. Toward the end of 1990s, official flows declined, paralleling the decline trend in all other developing countries (see figure 4).

[Figure 3 and 4 about here]

The relatively low levels of private flows early on were due to the nature of the transition economies: partial and incomplete reforms or an uncertain commitment to reform in most countries; high political and social costs of the transition process itself; and high levels of corruption and political instability. However, as reform efforts were consolidated and economic prospects improved, a more rapid inflow of private capital began after 1995. By 1997, capital from private investors and commercial banks accounted for 76 percent of total flows. The region's economic prospects began to resemble those in the rest of the developing world as is evident by the increase in private capital flows going to developing countries throughout the 1990s. The growth parallels a trend among developing countries whose private capital flows also increased dramatically during the 1990s (see figure 4).[12] The major difference between this region and all other developing countries, however, has been in the composition of private flows. While all other developing countries received increasing volumes of portfolio investments during this period, the private capital into Central Asia and Caucasus was composed mostly of FDI and some commercial loans to governments but very few--almost nonexistent--portfolio investments.

Composition: By Recipient

In terms of destination, foreign capital overwhelmingly flowed into the public sectors of the eight countries of the region throughout the 1990s. On average, 61 percent consisted of (in descending order) grants, bilateral and multilateral official loans, commercial bank loans, and very little investment in government bonds and securities (see table 3). If we include in this amount the FDI flows (typically considered to be flowing to the private sector, but in the case of this region they flow predominantly to joint ventures with public sector enterprises), the percentage of foreign capital received

[12] For the developing world, the 1950s and 1960s were considered the era of foreign aid and the 1970s the heyday of commercial bank lending. After the 1982 Latin American debt crisis, developing countries saw a return of foreign aid, especially from multilateral lenders. The 1990s, on the other hand, has seen the rise of the new portfolio flows, which also corresponded to the third wave of democratizations in developing and transitional economies from Latin America, to East Asia, to Eastern Europe and Africa.

by these governments is roughly 90 percent of total capital flows, equivalent to 9 percent of the total GDP. Over time, foreign aid (and to a certain extent commercial loans to governments) decreased, while FDI increased from 9.2 percent of total flows to 44.3 percent in 1997, averaging 31.8 percent throughout the 1990s. If FDI is excluded from this category (capital flowing to private sector) the picture is even more striking. The average percentage of total flows received by the region's private sector was a paltry 8 percent, compared to more than 30 percent overall for developing countries in the 1990s (see table 3).

[Table 3 about here]

Variation in the Region

Analyzing the regional distribution of capital inflows, one can easily discern differences among the states in Central Asia and Caucasus. For instance, Armenia, Georgia, Kyrgyzstan, and Tajikistan have received significant amounts of foreign aid, almost to the exclusion of other forms of foreign capital throughout 1993-2000 (72.6, 69.8, 79.6, and 83.2 percent of total flows, respectively; see figure 5).[13] The numbers are not too surprising. Armenia is the world's second largest recipient of U.S. official aid and receives the highest per capita foreign aid amount in the newly independent states, thanks to the lobbying efforts of the Armenian diaspora in the United States.[14] Humanitarian aid originally accounted for up to 85 percent of total U.S. assistance, reflecting the economic effects caused by closed borders with Turkey and Azerbaijan related to the Nagorno

[13] The data has year 2000 figures for Central Asia and Caucasus but not for all other developing countries. That is why the developing country figures are only up to 1999.

[14] BISNIS Country Commercial Guide for Armenia (January 2004). Armenia has a worldwide diaspora of approximately 5 million, which brings in many of Armenia's investors, works to raise the country's international profile, and ensures continual inflows of Western aid.

Karabakh conflict as well as to the devastation in northern Armenia caused by the 1988 earthquake.[15] Over time, Armenia's ambitious reform program allowed a gradual transition from humanitarian aid to more developmental assistance. Starting in 1994, Armenia engaged in loan programs with the IMF, World Bank, International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), and other financial institutions. Loans have been targeted at eliminating the budget deficit, stabilizing the local currency, developing energy generation and agricultural production, food processing, and so on. Armenia still remains heavily dependent on foreign assistance, mostly because annual government revenues are low, 17 percent of GDP.[16]

[Figure 5 about here]

Similarly Georgia has received significant humanitarian and economic aid during the early 1990s. Recently to encourage and support the reform process, the U.S. and other donors have shifted the focus of assistance from humanitarian to technical and institution-building programs. Provision of legal and technical advisors to various government ministries is paired with training opportunities for law enforcement officials, and economic advisers, complemented by extensive educational exchange programs. Especially since 9/11, Georgia has been receiving U.S. bilateral security assistance, including the International Military Education and Training (IMET) program. In 2003, almost 40 percent of all U.S. aid was in the security and law enforcement areas (see table 9).

Kyrgyzstan has been the "donors' darling" of Central Asia. It has received foreign aid equivalent to 14.6 percent of its GDP during the 1990s. Most came from the World

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[15] U.S. Department of State, Background Note: Armenia (March 2004).

[16] BISNIS Country Commercial Guide, Armenia (2004).

Bank, the EBRD, the Asian Development Bank and was concentrated in social services such as education, community development, health care, and in market reform programs such as accounting, commercial law, customs modernization, banking, and land reform. Especially since 9/11, U.S. aid and other forms of foreign assistance have grown significantly. Some of this has taken the form of debt relief but most of the additional funding, from the United States at least, has been in the area of security assistance to rebuild military and security forces (Olcott 2003).

Tajikistan, one of the poorest countries in the world, has been highly dependent on foreign aid, which became essential for rehabilitation programs that reintegrated former civil war combatants into the civilian economy, thus helping keep the peace. Foreign assistance was also necessary to address the severe drought that eventuated in ongoing shortages of food. As the recent distribution of U.S. assistance also demonstrates, humanitarian aid constituted the bulk of foreign aid into the Tajik economy (53 percent in 2002, 44 percent in 2003; see table 4).

FDI has also been heavily concentrated in the region. Azerbaijan and Kazakhstan are well endowed with natural resources and as a result were able to attract significant amounts of FDI in these sectors, even when overall market reforms were still at an early stage. On average, roughly about 68 and 45 percent, respectively, of total capital flowing into the economies were in the form of FDI. As viable alternatives to Middle Eastern oil and gas resources, these countries are an extremely attractive destination for multinational corporations. Kazakhstan holds about 2.5 percent and Azerbaijan 0.6 percent of proven recoverable world oil reserves. According to the UN World Investment Report 2002, of the 140 countries on the foreign direct investment (FDI) performance index, Azerbaijan and Kazakhstan ranked third and seventeenth from 1994 to 1996 and eighth and twenty-first respectively from 1998 to 2000.[17]

In Azerbaijan, most FDI flows into the public sector because the oil and gas industry is wholly owned and dominated by the state. Foreign investors have developed projects under production-sharing agreements (PSAs) directly with the state oil company, SOCAR. Every contract with foreigners is written and signed by SOCAR officials and the president of Azerbaijan. Bonuses for signing contracts go directly to the government budget, the State Oil Fund, or the pockets of government officials. Similarly, a portion of the investment is used to repatriate government expenses in oil development.

Similarly in Kazakhstan, even though the majority of onshore oil production had been privatized to foreign investors by the end of 2000, a large proportion of important assets remain fully or partially in state hands, including the national oil and gas company, the railroads, and a significant share of the telecommunications sectors. The government also is dominant in the oversight of contracts with foreign companies. Government officials, sometimes at the highest levels, screen major FDI proposals and determine the government share. .

Finally, Uzbekistan and Turkmenistan are interesting in that both have received some official funds in the form of foreign aid and commercial loans for government, but they lack any type of private investment, in the form of FDI, commercial loans, or portfolio investments (see figure 5). Each has been extremely cautious in moving to a market-based economy. Continuing restrictions on currency convertibility and other

[17] The FDI Performance Index is a new measure that the UN Conference on Trade and Development (UNCTAD) introduced in 2002 to benchmark success in attracting FDI. The index is the ratio of a country's share in global FDI flows to its share in global GDP.

government measures to control economic activity, including the implementation of severe import restrictions, have constrained economic growth and made it extremely difficult for foreign companies to invest. Uzbekistan and Turkmenistan have the lowest levels of FDI per capita in the CIS despite their abundant natural resources. Turkmenistan has the world's fifth-largest reserves of natural gas; Uzbekistan is the world's seventh-largest producer of gold, and fourth-largest uranium producer.

Their exercise of utmost state control over the economy has also alienated Western donor organizations and led international lending operations to suspend or scale back credits. Turkmenistan has not yet had an IMF agreement. The World Bank, EBRD, and Asian Development Bank have provided credits to Uzbekistan mostly for major infrastructure and development projects, including railway rehabilitation and agricultural development, but most recently have reduced their credits. Thanks to its support for the U.S. war in Afghanistan, Uzbekistan lately has been receiving more U.S. assistance, which mainly focuses on security and on law enforcement to improve border security and to enhance Uzbek counterterrorism capability. Interestingly Uzbekistan's domestic commercial banks have received some foreign loans, but the majority of their credit goes to state-owned enterprises as opposed to the private sector.[18]

Common to the region is the lack of credit and of project financing for private firms. Foreign capital accounts for a very small percentage of total private bank capital in these countries, a circumstance that considerably hampers the development of private sectors. Lending from domestic commercial banks-- if they even exist-- is very limited. The private banks are undercapitalized and their lending is limited to short-term loans at

[18] BISNIS Commercial Overview, Uzbekistan (08/2001).

interest rates of 15-20 percent. The few small independent banks reflect the small size of the financial market. On average, only 2-3 percent of the region's population has bank accounts.[19]

In some ways Kazakhstan stands out among its peers. As the composition of foreign capital in Kazakhstan demonstrates (see figure 5), its capital flows are relatively more diversified than elsewhere in the region. Despite FDI's priority, other types of capital flows are almost evenly distributed. Kazakhstan, in fact, has the highest level of foreign capital flowing into the private sector of all in the region (almost 2.4 percent, versus 0 to 1 percent). The banking system is a good indicator of this trend. Kazakhstan's banking system is the most developed in Central Asia. Of the 38 banks operating, nine are fully foreign owned, and six have more than 50 percent foreign ownership. Most domestic borrowers receive credit from Kazakh banks. Private deposits in the banking system grew from less than $300 million in 1999 to $1.84 billion in April 2003.[20]

Composition in terms of Volatility

Because of the minimum amount in portfolio investments, the region is fairly immune to international financial shocks and balance of payments crises. Low volatility foreign capital is, on average, 74 percent of total flows into the region, whereas high-volatility foreign capital is only 2 percent (see figure 6). This is a pattern very different from the one that we see in all other developing countries. As the numbers show, the percentage of portfolio investments has increased significantly in the developing countries in the 1990s (from 1 percent in 1980s to 23 percent, on average, during 1993-

[19] *Ibid*.
[20] BISNIS Country Commercial Guide, Kazakhstan (09/2003).

1999, see figure 7). Kazakhstan was the region's only country with an effective stock market during this period and hence is the only one that attracted some portfolio investment (5.2 percent and almost 1.0 percent of foreign capital went to government bonds and private company equities, respectively). The Kazakhstan Securities Exchange (KAIE) was founded in 1997. As of June 2000, capitalization of all stocks traded on the KAIE equaled $1.7 billion; the capitalization of bonds stood at $1.3 billion.[21] Kazakh banks since 1998 have placed Eurobonds on international markets and obtained syndicated loans, the proceeds of which have been used to support domestic lending. Since 2000, stock markets have also been established in Armenia, Azerbaijan, Georgia, and Kyrgyzstan but they are still in the initial stages of development with only a handful of more or less attractive domestic companies trading locally. In these countries, there is, in essence, a lack of effective mechanisms for private capital accumulation.

[Figure 6 and 7 about here]

Why Authoritarianism Persists?: Implications of Different Capital Flows

Foreign Aid

My expectation is that foreign aid to an authoritarian government would make a rather small contribution to economic growth; that the political influence of the donor governments and international organizations would be strengthened, as would that of the recipient governments; and that this type of foreign capital would pose a comparatively low balance-of-payments risk, ensuring the survival of the authoritarian regime.

[21] BISNIS Country Commercial Guide, Kazakhstan (09/2003).

Findings from this region generally support these hypotheses. As discussed earlier, aid from both multilateral sources such as the World Bank or through bilateral programs with Western governments provided important budgetary support to these governments, especially in the initial phases of the transition. Large quantities of aid strengthened the authoritarian leaders' overall control of resources and influence to perpetuate dense networks of patronage.

Foreign aid, the predominant form of capital flow to many of these countries, has also increased the influence of donor institutions and countries. Although democracy promotion was important for many of the donors, it never became a priority that was aggressively pushed. In fact, major donations have been made in the areas of infrastructure development, social services, humanitarian efforts and security. If for instance, we look at the composition of U.S. assistance to the region in 2003, we see that the amount going to economic and social reforms, security and law enforcement, humanitarian assistance, and cross-sectoral initiatives is more than 80 percent of the total assistance, while the rest goes to democracy-promotion programs such as support for the work of nongovernmental organizations (NGOs) to foster civil society, enhance local government accountability, and support independent media (see table 4). Certainly, it can be argued that a portion of economic development assistance can also aid the promotion of democracy in the long run by increasing access to credit for entrepreneurs of small and medium enterprises and invigorating the private sectors. Still, the actual amounts donated for these purposes were minuscule in comparison to other objectives. Especially since 9/11, the bulk of the U.S. assistance has been concentrated on security and military reforms in accordance with the rising strategic importance of this region in the war against terrorism. Hence, foreign aid even from democratic donors has made little contribution to hastening the transition to democracy.

Moreover, except for IMF loans that promoted macroeconomic stabilization reforms throughout the region, foreign aid did not play a part in increasing economic efficiency in any of these countries. In the region, the recipients of the highest foreign aid are not necessarily its high-growth economies. Even so, despite rare withdrawals of World Bank and IMF credits to Georgia, Uzbekistan, and Turkmenistan, foreign aid has been a stable source of capital and has not led to a balance-of-payment crisis. Foreign aid has given incumbent authoritarian governments additional room to maneuver both economically and politically, without leading to a sudden foreign exchange crisis that could have destabilized these regimes.

[Table 4 about here]

Foreign Direct Investment

FDI has been the second-largest foreign capital flowing into the region and, as discussed earlier, has gone predominantly to state-owned energy and energy-related sectors (such as pipeline construction). Just like foreign aid, FDI has significantly empowered the political fortunes of authoritarian leaders by giving them a symbolic vote of confidence from outside and stimulating economic growth. Fueled by FDI, the eight countries began a period of steady growth in the latter half of the decade. Azerbaijan's real GDP rose by the following percentages: almost 6 in 1997, 10 in 1998, 7 in 1999, 11 in 2000, and 10 in 2001.[22] Similarly Kazakhstan's economy grew substantially throughout the later 1990s, buoyed by impressive FDI levels and high world oil prices.

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[22] BISNIS Country Commercial Guide, Azerbaijan (2004).

Oil output has grown annually at about 15 percent and now accounts for roughly 25 percent of GDP. These high growth rates have not only increased the legitimacy of the ruling elites, but have also produced high levels of income inequality in society.

FDI into the region has also heightened the political and policy influence of multinational energy companies. Although the companies insisted on various economic reforms, their goals have been limited to making the regulatory investment environment more stable and predictable. Thus FDI did little or nothing to promote democracy in the region. In fact, one can argue that it gave legitimacy and international recognition to the authoritarian regimes.

FDI in Azerbaijan's oil sector provides an illustrative example of the cozy relationship between multinational corporations and authoritarian leaders. The absence of strong and relatively autonomous democratic institutions in Azerbaijan is seen as a blessing for foreign investors. SOCAR's strong position and direct relations with the president makes it a favorable negotiating partner for the investors. During the negotiation and implementation of the contracts, foreign investors feel no pressure to defend their intentions to opposition parties or interest groups. They have been satisfied with the simple power structure and absence of institutional opposition to their contracts. This "one-stop shopping", as one company representative put it, provides them with 'a suit of armor in terms of being able to walk through terrain that what would otherwise be dangerous and difficult.'[23]

FDI in Azerbaijan is seen as fortifying a preexisting network of nepotism and corruption within the state. Secretiveness of energy contracts has created suspicion in

[23] Author's interview with Peter Henshaw (BPAmoco Vice-President, Government and Public Affairs) in Baku, July 20, 1999.

society that foreign oil companies sustain a freewheeling and unaccountable system. The bonuses that foreign companies pay when contracts are signed are a perfect illustration of corruption for Azeris. Many believe that even though the Special Oil Fund was set up to keep oil revenues from being inappropriately used, a comparison of figures from oil contracts and the National Bank of Azerbaijan clearly indicate a misbalance.[24] It is asserted that some bonus payments are pocketed by corrupt officials and that foreign companies are turning a blind eye to this process even though they are well aware of it. According to the common elite perception of the Western oil companies in Azerbaijan, the companies are aggravating rather than ameliorating the culture of corruption; collaboration with a corrupt regime is itself corrupting (Heradstveit 2000).

Finally, many in Azerbaijan see foreign capital's alliance with the regime as resulting in high levels of income inequality and poverty. There is a common saying among the Azeris: 'The name of oil belongs to us but the taste of it belongs to others,'[25] meaning that the Azeri people own significant amounts of oil resources but the benefits of oil accrue to ruling elites and foreign companies. The development of oil resources has rarely meant immediate or long-term prosperity for the Azeri people. The government estimates that the economy has grown significantly over the past decade as a result of oil revenues, but the UN Development Report declares that the lives of 60 percent Azeris have not improved. The average per capita income is $40/month for a population of eight

[24] CEE Bankwatch Network (2002). According to the IMF, which oversees the organization of the Special Oil Fund, this arrangement has been deficient due to a lack of formal and clear operating rules, and to the sole authority of the president on the use of the funds.

[25] Author's translation of *"Neftin adi bizimdir, tadi baskalarinindir."* Interview with Ismayil Musayev (political science professor, Baku State University) in Baku, July 14, 1999.

million and the official poverty line is at $89/month.[26] Despite considerable foreign investment in the energy sector, most of the populace suffers from unemployment (18-19 % since 1997) and a low standard of living--foreign capital notwithstanding. On the contrary, it has enriched those in charge of oil contracts and their patronage networks. Foreign direct investment has contributed to the zero-sum nature of Azerbaijani politics and widened the gap between the state and society.

Commercial Bank Loans to Government

Loans to government is the third-largest category of capital flows to the region. While all of these governments received some commercial loans, as a percentage of their total flows, Uzbekistan and Turkmenistan received by far the highest amount (36.4 and 67.9 percent, respectively). In both states, foreign loans to authoritarian leaders have shored up unrepresentative political regimes by allowing their leaders to bolster state-owned enterprises and extend favors to politically crucial groups through central bank credit. Moreover, these flows have increased the de facto economic policy autonomy of governments from both foreign and domestic pressure to reform. Uzbekistan and Turkmenistan have had very few loans from international institutions; in fact Turkmenistan has had no IMF agreements. This circumstance has given additional room for fiscal autonomy (irresponsibility) to the incumbent regimes. This is perhaps one of the reasons that in terms of macroeconomic reforms, the two have lagged behind the other Central Asian and Caucasus states that have stabilized their currencies against the dollar,

[26] Ref.22.

reduced inflation rates and budget deficits, and even privatized to a certain extent, thanks to IMF conditionality.

Even though large-scale privatization has been sketchy throughout the region and the governments still dominate the economies, the countries that stayed with the IMF programs have created private sectors, which could potentially provide an alternative source of political power and help push for more political liberalization in the future. For instance, today the private sector is 50 percent of GDP in Kazakhstan, 65 percent in Kyrgyzstan, and 75 percent in Armenia.[27] Similarly, the average amount of domestic credit given to the private sector relative to GDP during 1993 and 2001 was highest in Kazakhstan (15.12 percent), followed by Armenia (8.35 percent), Georgia (6.28 percent), and Kyrgyzstan (6.16 percent).[28] On the other hand, the state sector in Turkmenistan accounts for 80 percent of economic activity. There has been small scale privatization but large enterprises have not been privatized at all. Domestic credit given to the private sector is the lowest in the region, 3 percent of GDP. Given the composition of foreign capital, one can perhaps understand better why some countries in the region have retained hard authoritarianisms and others have slowly but surely relaxed their political system by empowering local businesses.

Commercial Loans to the Private Sector

I have suggested that the effects of commercial bank loans to the private sector are likely to produce a greater stimulus to economic and industrial growth and an increase in the political weight of domestic private firms vis-à-vis the government. Hence,

[27] World Bank, Privatization Fact Sheet 2003.

[28] World Development Indicators, 2003.

authoritarian regimes may experience pressure from their entrepreneurs to liberalize; at least in the areas of respect for property, legal and predictable regulatory frameworks, and even political rights.

The problem in the region in this respect is that it lacks significant amounts of commercial credits for the private sector. Between 1993 and 2000, the Turkmenistani private sector did not receive any loans, mostly due to the fact that Turkmenistan has no effective private sector. The other countries have received some loans, but they amount to only small percentages of their GDPs. Kazakhstan is the country with the highest amount of loans to its private sector, constituting 21 percent of all flows and 2.3 percent of its GDP. This could be taken as an indicator that its private sector is slowly becoming relatively vibrant and independent of the authoritarian state.

Portfolio Investments to Government and the Private Sector

Because portfolio investments are prone to sudden reversals and thus can be highly volatile, authoritarian governments may embark on structural reforms such as reducing government ownership, creation of capital markets, deepening of financial sector, strengthening the rule of law and so on to retain the confidence of fickle investors. Portfolio investments, especially in the private sector, could also strengthen the domestic firms and give them incentives to push for further economic liberalization. These reforms, in turn, may prove to be conducive for democracy in the long run, but unfortunately this kind of a pressure does not exist in this region. This type of capital has been absent in all of these countries during 1993-2000, except for Kazakhstan. Kazakh government bonds do attract some foreign capital (about 5 percent of total flows) but investment in equities of domestic firms is still disappointingly low. One advantage of the lack of portfolio investments for these authoritarian governments, however, is that they have been sheltered from potential BOP crises. Kazakhstan, for instance, has been running balance-of-payment surpluses for the past four years. Without a potential economic crisis that can delegitimize the incumbent governments, it appears that there will not be any liberalizing economic pressures brought to bear on the hold of political power by authoritarian leaders in the region.

Conclusions

The implications of different types of foreign capital on regime durability or change are not easy to disentangle because no country exemplifies a single type of capital flow and the causal connections are indirect. In some cases, different types may have conflicting effects on the political system. In Kazakhstan, for instance, large volumes of FDI in state-controlled energy sectors help bolster the economic power and legitimacy of the authoritarian state. At the same time, foreign capital flowing into the private sectors of the economy-- in the form of commercial loans and even very little portfolio investment-- allows for a vibrant private sector to form that may push for economic and political liberalization eventually. The diverse forms of foreign capital flowing into Kazakhstan may explain the softer version of authoritarianism that we observe there.

Despite contradictory pressures from different types of foreign capital as well as the lack of adequate data from the region, this paper points to some of the general trends in the financial integration of the region to the world economy and their implications. I have demonstrated that these are countries that heavily depend on external capital flows and that the bulk of the flows go directly to authoritarian governments, with little received by the private sectors. Foreign aid, FDI, and commercial loans to governments have augmented the resources (patronage spending) that ruling elites deploy vis-à-vis their political opponents and thus have ensured the durability of authoritarian regimes. These investors and donors provided very little in the way of democracy promotion. Moreover, domestic private sectors could not act as counterweights to authoritarian governments, mostly because they have not received much outside funding in the form of commercial loans or portfolio investments. The outcome has been the perpetuation of the existing authoritarian regimes and little prospect of liberalization.

This paper also emphasizes the importance of foreign capital in understanding the qualitative differences in the degree of authoritarianism in the region. To the extent that some countries were able to attract foreign capital into their private sectors and to the extent that they adhered to macroeconomic reforms conditioned by IMF loans, they were able to allow for some private initiative--which in the long run could produce conditions conducive to democracy. One can argue that there is a reverse causation here as well, that is that the countries that have embarked on major structural reforms in the first place were able to attract different types of foreign capital. Despite this mutual reinforcing effect, there are reasons to believe that current trends in the financial flows to the region have not been entirely favorable for a short-term move towards democracy. This is not to say that countries would be better off by not receiving any foreign capital. Some forms of financial integration do promote economic growth in recipient countries. The question of which the students of the region should be cognizant is how different types of foreign capital assist in the maintenance of existing regimes or creation of incentives for a regime change.

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TABLE 1: Characteristics of International Capital Flows

Type of capital flow	Source	Recipient	Volatility
Foreign Aid	Public	Public	Low
Foreign Direct Investment	Private	Private/Public	Low
Commercial Loan to Gov't.	Private	Public	Medium
Commercial Loan to Private	Private	Private	Medium
Portfolio Investments to Gov't.	Private	Public	High
Portfolio Investments to Private	Private	Private	High

TABLE 2: Implications of Capital Flows

Type of capital flow	Economic growth	Increase the political power of	Pressure for neoliberal reforms	Risk of balance-of-payment crisis
Foreign Aid	Low	Foreign donors, government	Low	Low
Foreign Direct Investment	Low/High	MNCs, government or private	Moderate	Low
Commercial Loans to Gov't.	Low	Government	Low	Moderate
Commercial Loans to Private	High	Private sector	Low	Moderate
Portfolio Investments to Gov't.	Low	Foreign investors, government	High	High
Portfolio Investments to Private	High	Foreign investors, private sector	High	High

TABLE 3: Comparison of capital flows, by recipient (% of total flows)

Central Asia and Caucasus

By recipient	1993	1994	1995	1996	1997	1998	1999	2000	Average
Private Flows	**9**	**13**	**36**	**42**	**54**	**61**	**54**	**58**	**41**
FDI	9	12	35	39	44	40	40	35	32
Loans to Priv	0	1	2	3	7	19	12	23	8
Portfolio to Priv	0	0	0	0	1	1	0	0	0
Official Flows	**91**	**90**	**65**	**59**	**49**	**41**	**49**	**42**	**61**
Foreign aid	69	77	51	41	24	28	31	27	44
Loans to Gov	22	10	12	13	19	13	16	9	14
Portfolio to Gov	0	0	0	4	5	0	0	7	2
Total Flows	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

All Other Developing Countries*

By recipient	1970	1980	1990	1993	1994	1995	1996	1997	1998	1999	Ave(93-99)
Private Flows	**35**	**24**	**24**	**52**	**56**	**53**	**61**	**60**	**59**	**64**	**58**
FDI	11	7	12	21	27	26	28	31	33	35	29
Loans to Priv	24	17	10	10	11	12	15	17	20	18	15
Portfolio to Priv	0	0	2	21	18	14	18	12	7	11	14
Official Flows	**65**	**76**	**76**	**48**	**44**	**47**	**39**	**40**	**41**	**36**	**42**
Foreign Aid	42	37	46	25	25	29	18	20	23	20	23
Loans to Gov	23	38	27	15	12	12	10	9	9	8	11
Portfolio to Gov	0	1	3	8	7	7	11	10	9	8	9
Total Flows	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

source: World Bank, Global Finance Indicators 2001

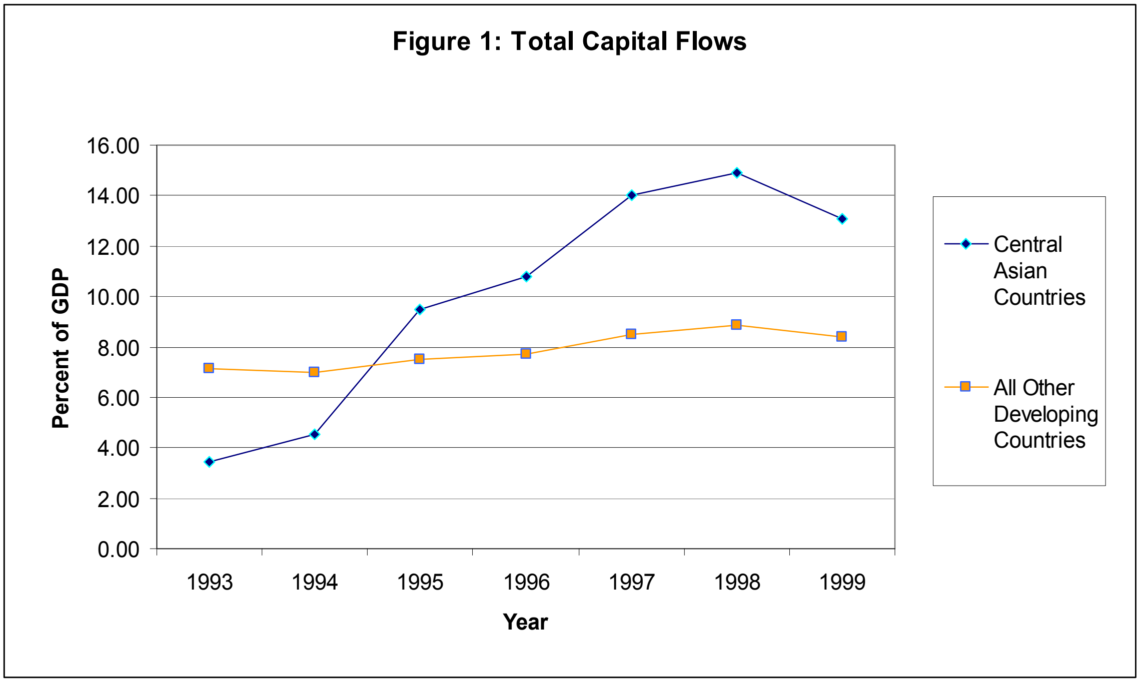
* Central Asian and Caucasus states are omitted from this category

TABLE 4: Composition of U.S. assistance in 2003

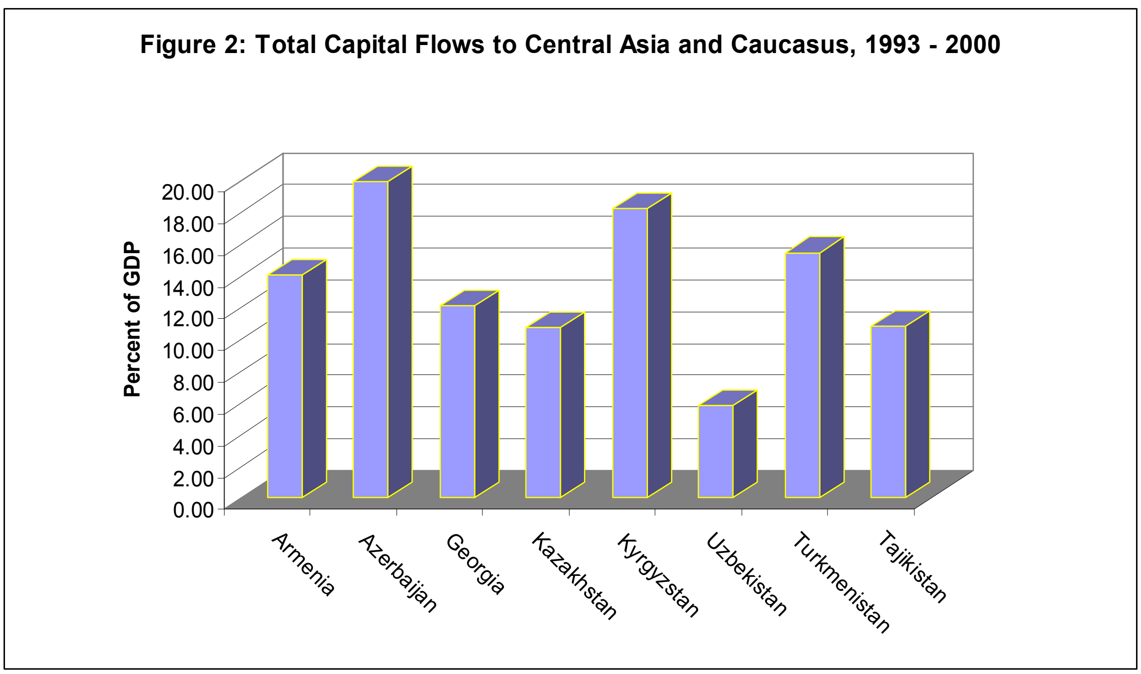
	Armenia	Georgia	Uzbekistan	Turkmenistan	Kazakhstan	Kyrgyzstan	Tajikistan	Total	% of total
Economic & Social	46.80	26.10	18.20	2.40	23.40	19.90	14.30	151.10	**30%**
Security & Law Enforcement	18.40	41.40	30.20	1.40	49.20	10.30	1.10	152.00	**30%**
Democracy Programs	22.40	20.40	14.70	4.70	13.90	13.50	7.30	96.90	**19%**
Humanitarian Assistance	7.10	15.10	18.50	0.50	0.50	9.10	21.80	72.60	**14%**
Cross Sectoral Initiatives	11.80	7.40	4.50	2.10	5.00	3.80	4.50	39.10	**8%**
Total	106.50	110.40	86.10	11.10	92.00	56.60	49.00	511.70	**100%**

source: U.S. Department of State, Fact Sheet (2004)

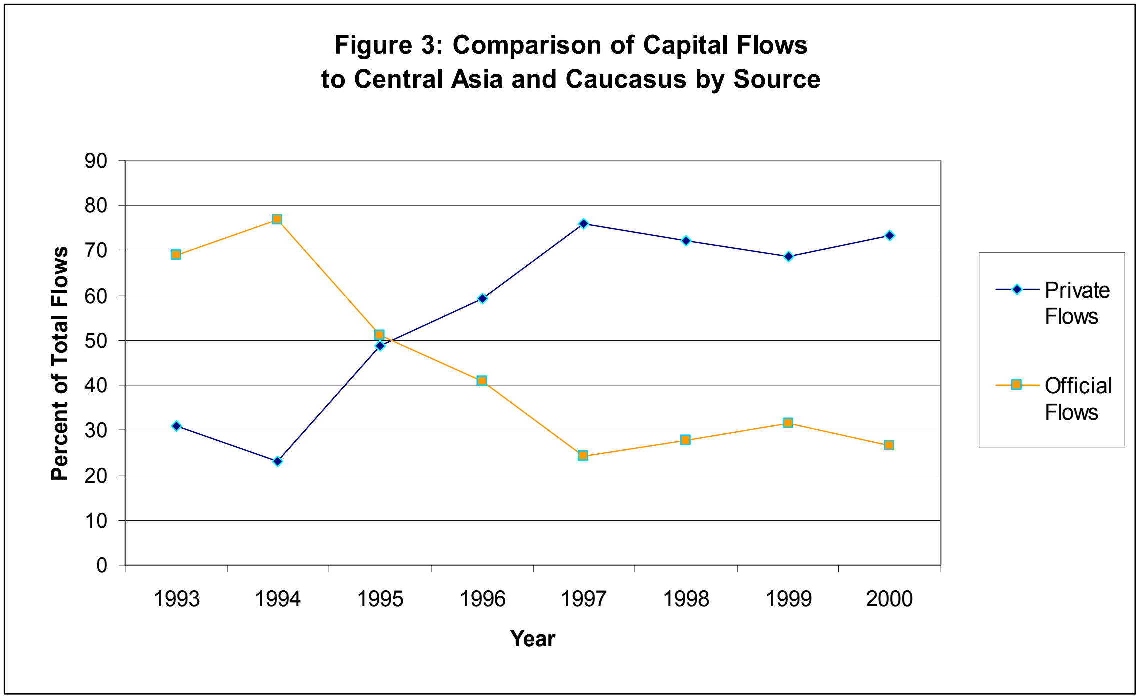
(Data for Azerbaijan N/A)



source: World Bank Global Finance Indicators, 2001



sources: World Bank Global Finance Indicators, 2001 and World Development Indicators, 2003.



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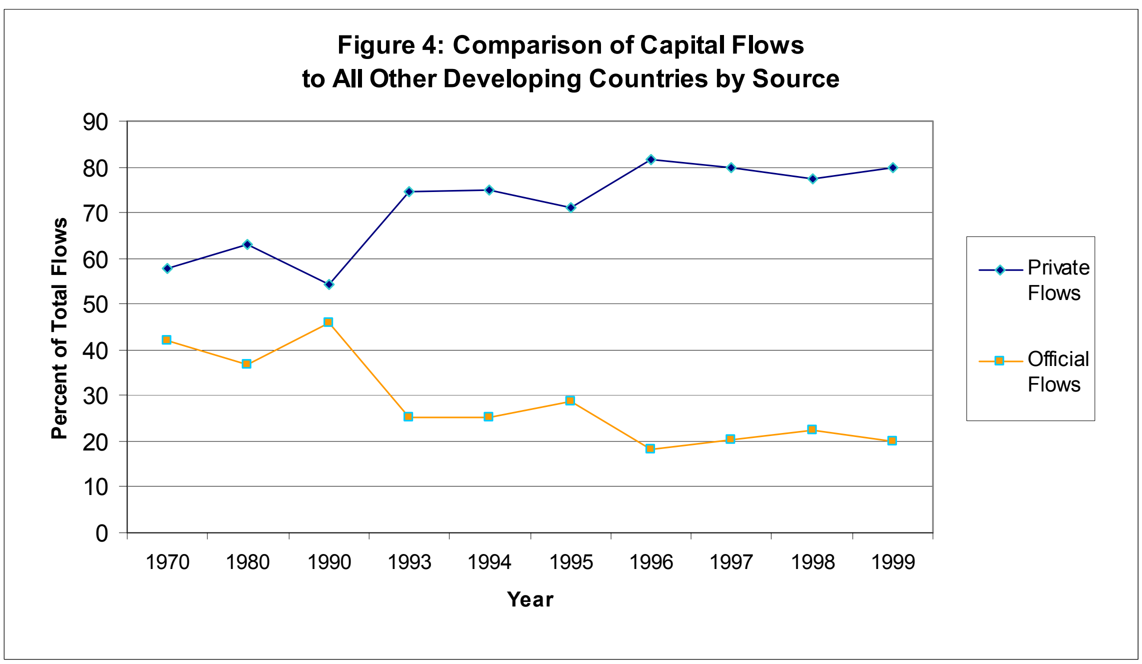

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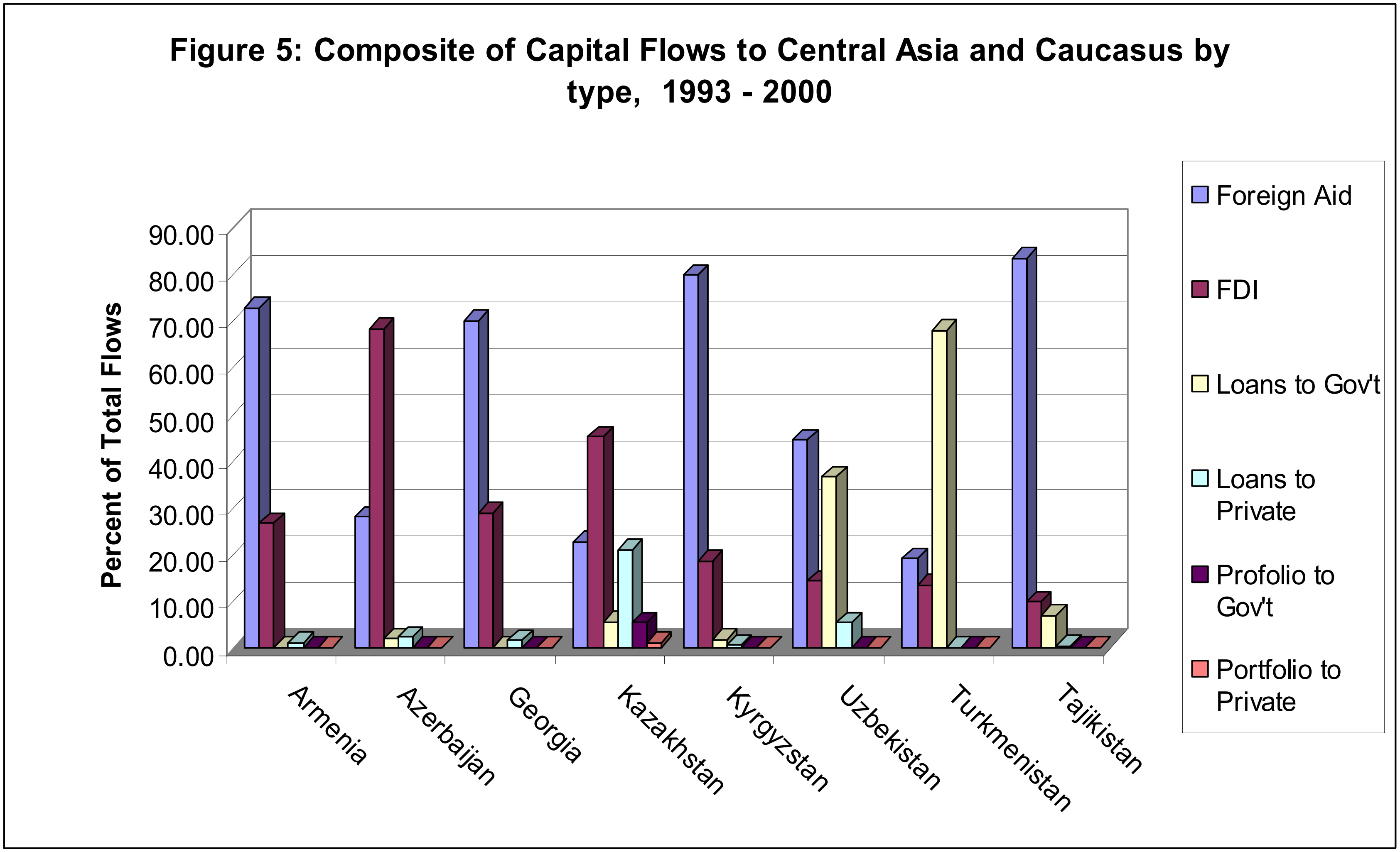

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Figure 6: Comparison of Capital Flows to Central Asia and Caucasus by Degree of Volatility, 1993 - 2000

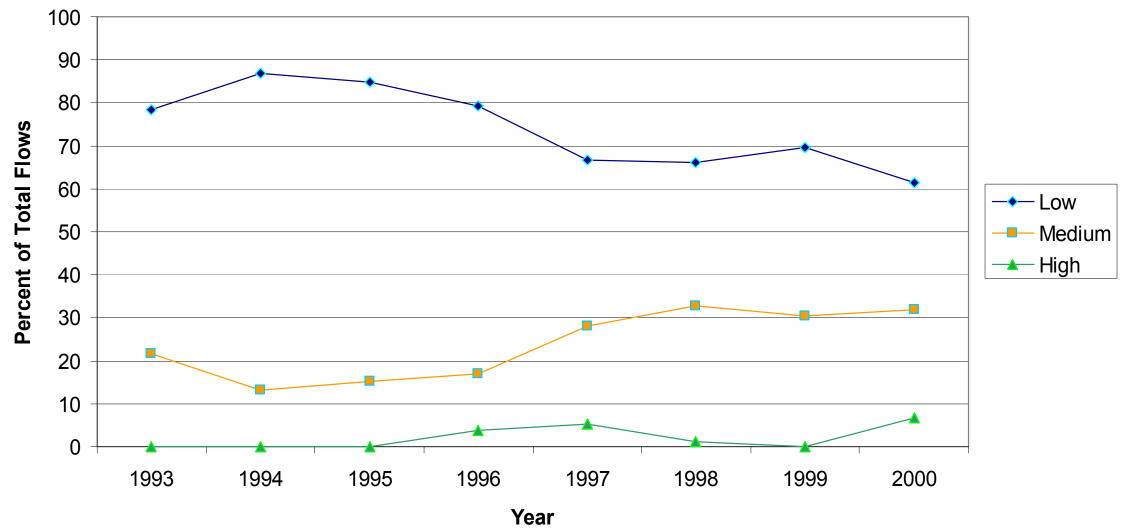

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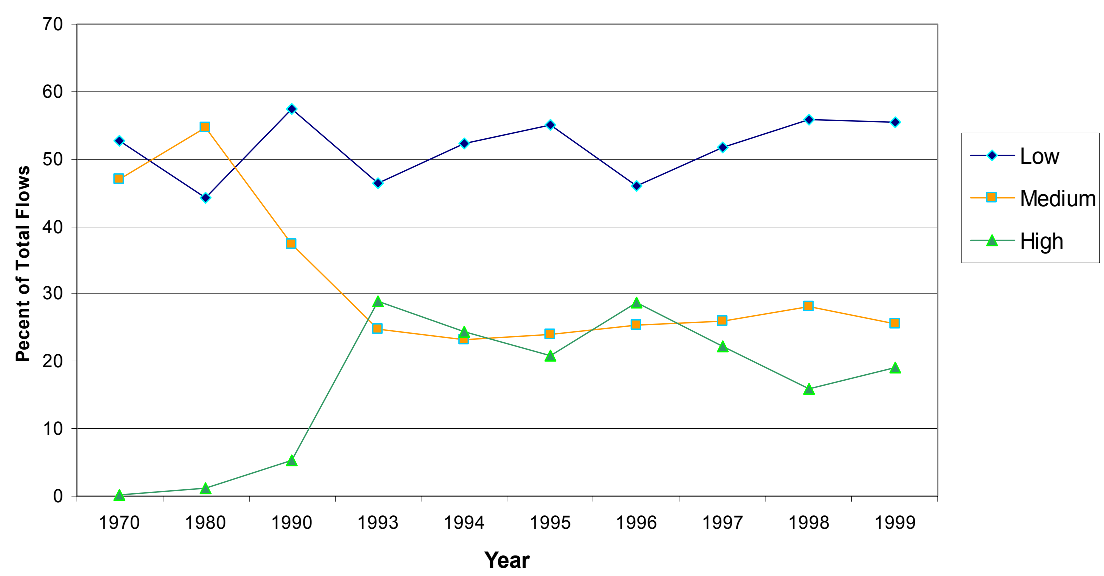
Figure 7: Comparison of Capital Flows to All Other Developing Countries by Degree of Volatlity, 1970 - 1999



source: World Bank Global Finance Indicators, 2001.