

The Transition from Centralized
to a Free Economy
Within The Framework of Regional Cooperation.

By:

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70 years of domination of Communism in the Soviet Union has left behind a dismal economic structure in the new independent states, structure which was compatible to the centralized complex of the communist system under the great and powerful Gosplan Organization (Plan & Budget Organization) in Moscow. For these new independent states it will take many years to overcome the shortcomings of the old system and to fall in line with the free market mechanism. It is a risky transition process which may jeopardize their national integrity and economic independence. Therefore, the main purpose of this paper is to analyse the vulnerability of the prevailing system in the Central Asian Countries and Caucasians during the transition period. Also it will try to offer a remedy for accelerating the transition from a centralized to a free economy for economic integration of the said countries with the open market economics of the region.

The situation in each country of central Asia is a social system, consisting of a great number of conditions that are casually interrelated. Thus, any changes should include all relevant factors in social, economic, political and religious realities. In the beginning by reviewing the theoretical principles and basic characteristics of each country, we will indicate the necessity for regional cooperation, and the crucial role that I.R. of Iran may play in this respect.

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Lack of proper institutions for free enterprise, deficiencies in national consolidation, imperfections in the authority of government agencies, instability and low effectiveness in national policies are the outcome of a closed economy. In their foreign trade, these countries used to have more than 85 percent of their business transactions with the closed system of the former Soviet Union and had very limited transactions with the other nations (table 1).

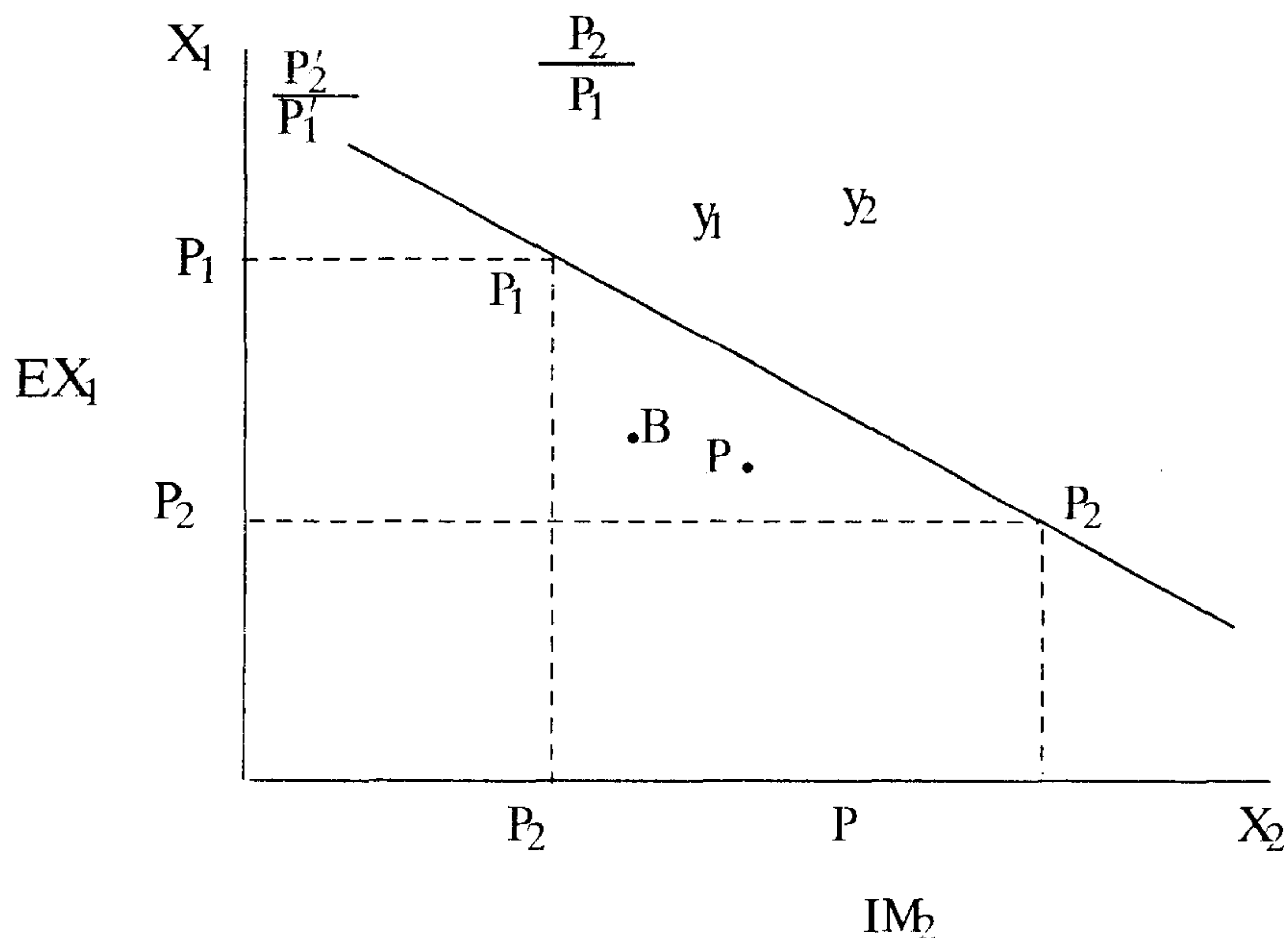
Table 1. The Import and Export of the Central Asian and Caucasian Countries or region with CIS and outside the CIS (by percent), 1989

	Import from CIS	Export to CIS	Import other countries	Export to other countries
Kazakhstan	82.90	90.20	21.10	9.79
Kyrgyzstan	78.30	98.08	21.70	1.92
Tajikistan	82.70	86.17	21.70	13.83
Turkmenistan	82.30	90.98	17.70	9.02
Uzbekistan	85.10	83.97	14.90	16.03
Azerbaijan	73.00	93.68	27.00	6.32
Armenia	78.40	97.56	21.60	2.44
Georgia	75.60	93.92	24.40	6.08

Source: United Nations conference on trade and development Interregional workshop. Kiev, Ukraine, 19-22 May 1992.

The division of industries and the chain of agricultural products in each state were planned under the dominance of Russia and institutionalized structure of the centralized system. This prevented them from having direct access to the outside world. This inhibited the system to utilize the advantages of international division of labor and best allocation of resources, leaving the equilibrium point for both producers and consumers lower than the desirable free trade point. In other words, consumers enjoy a lower level of satisfaction and producers do not have the opportunity to gain the benefit of competition and profit maximization. Consequently, the national economy loses its efficiency in comparison with that of the international one. In Figure 1,

Figure 1: Inefficiency in a closed economy.



assuming that no distortions exist due to domestic economic systems and the centralized planning allocates resources efficiently, then point P_0 represents the optimum level of consumption and production. The consumer's utility curve is shown by Y_1 , and the price ratio of the two groups of commodities X_1 and X_2 is given by P_2/P_1 . In case these countries had full trade relations with other countries of the world, the price ratio would become P'_2 / P'_1 with the slope less than that of P_2 / P_1 . Therefore, each country could produce at point P_1 and consume at point P_2 , and the production surplus of EX_1 becomes available for export in return for IM_2 which is imported, and consumer could enjoy a higher level of satisfaction. While in the absence of free trade, the first type of inefficiency appears in the system at the expense of general standard of living of the society.

The aforementioned analysis indicates the autarky (self-sufficient) point P in a closed economic system. The new independent states are also confronted with two other inefficiencies. The first of which occurs because of misallocation of resources, namely "allocative inefficiency", and the second type arises due to omitting incentives and blocking human motivation which are basic cause for lack of incentive and innovative activities in a centralized economy. In other words, due to these inefficiencies, the country is not even able to focus on its autarky point, which is located in the production possibility curve, rather it has to set its production and consumption level on a much lower position on production feasibility curve, point B .

Price distortion in the factors market, commodity market and money market are the main determinants which cause allocative inefficiency. In the factors market, prices and the market mechanism are not regarded as instrumental in allocation of resources. But matters is decisions made by the planning committee and the policy makers. Employment of labor force is not dependent on the marginal productivity of labor and the changes in the wage rate, but the political factors and the state desires are the basis for such decisions. Therefore, the pareto optimality is not considered in the allocation of resources, labor or machinery in production processes.

For this reason after the collapse of Soviet Union, many government failures emerged and unemployment which was not cared for during the centralized system started to appear in different republics (Table 2),

Table 2: Unemployment rate in some selected republics (by 1000 persons), 1992 (2) and started to rise in the subsequent years.

<u>Name of countries</u>	<u>Nos. of people unemployed</u>
KHAZAKESTAN	40
KIRKIZESTAN	24
TAJIKESTAN	10
TORKEMANESTAN	--
UZBAKESTAN	16

The financial and money markets are not equipped with the appropriate mechanism for the proper functioning of the economic system. The banks, investment and credit units, stock exchange, future markets and insurance institutions are at their most elementary stages of evolution and they are unable to meet the current domestic needs and are unable to establish trade relations with the outside world. Therefore, the value of money is by no means a proper signal and indicator of allocation and movement of capital in different economic sectors. Any distortions of this nature will of course cause inefficiencies. These distortions have created a lack of confidence as well as crisis in all republics after the collapse of communism which followed great fluctuations of domestic currency against the foreign

currencies⁽¹⁾.

It is obvious that by such distortions the commodity market could not perform well. The trade within and among the republics were principally on the basis of clearing or barter system while competition which is the most important tool for promoting the efficiency, had no place in the abovementioned system.

Another aspect of inefficiency stems from the lack of proper investment, technological achievements and initiatives and innovations. The centralized economy enjoys none of the self-induced motivations for the compensation of depreciation of capital, new investments, innovations and initiation to compete with free world of capitalism. The East Germany which used to be one of the most advanced countries of the eastern bloc, regarded most of its industrial complexes as old, obsolete and uncompetitive with industrial complexes of the West Germany and the asset value of some factories were even less than that of metal substances used. Lack of incentive among labors and managers took away the entrepreneurial behavior from the human organization of the system and suppressed the initiative efforts. Neglecting the basic human factors results in "creative inefficiency", hence a further drop in total capacities of the economic system.

Entrepreneurship, as described by Austrian school of thought of being a motive power and the architect of development, could not be found in these countries. Factory managers and manufacturing and trading units have been working in a risk free atmosphere. They have never been involved in serious trade competition and consequently they have never learned the basic lessons of new manufacturing and trading management in a free economy. Although, preparing the grounds for competition, formulation of rules and regulations for companies, monetary and financial institutions and execution of property rights are the foundation stones of a dynamic movement towards economic development, transition from these stages take a long time?

All these inefficiencies have caused the output productivity to be at a low level in comparison with advanced countries. For instance, return on capital in East Germany is estimated $\frac{1}{3}$ of that of West Germany⁽²⁾. In other words, on average, the required capital for each unit of

1- Economist, Feb 1994.

2- Akerlof et.al (1991) East Germany in from the Cold: The Economic Aftermath of Currency Union, University of California: Working paper, March, 1991. P.95.

production in East Germany is 3 times as much as West Germany's.

Industries in different republics were not located on the basis of efficiency or potential and actual advantages, but it was on the basis of the so called strategy of "center " and "periphery ". The centrality belonged to Russia, while Ukraine, Belarus, Baltic (Lithuania, Latvia and Estonia) and Kazakhstan Republics were at a lower status and other republics such as Tajikistan, Turkmenistan, Uzbekistan, Kyrgyzstan, Azerbaijan, Armenia and Georgia were at the periphery. This structure during the seventy years of dominance of the centralized economy brought about a dependent and often single product economy in the countries at the periphery. This is a kind of relation which used to exist between industrial and agricultural countries or between developed and developing countries on the basis of international division of labour especially before World War II. The real dependence of these republics to the center and their interdependence among themselves is not understandable unless we analyze the industrial, services and trade links of the former Soviet Union. For instance the indivisibility existing in the economic services, infrastructure related to the main products, monetary and banking system, fuel, transport network, similar technology and dependence on the specialized personnel are crucial elements in our analysis.

The centralized system of the former Soviet Union on the basis of its development goal and within the framework of unwritten domination of center over periphery led the economy of the periphery to be specialized on agricultural and to be merged in the Russian economy. In line with the above- mentioned strategy, cotton became the specialized product in central Asia. In 1986, the total production of cotton in the Soviet Union was 8.2 million tones of which 60.6 percent in Uzbekistan, 11.2 percent in Tajikistan and 13.8 percent were produced in Turkmenistan where as their domestic consumption of the said cotton were insignificant⁽¹⁾. For instance, Uzbekistan produces and consumes only 4.5 percent of its cotton production for domestic consumption. Also, production of 90 percent of tea consumed by CIS and production of almost 100 percent of citrus fruits required in the CIS by Georgia shows the state of specialization in different republics.

By the collapse of the Soviet Union, when the heritage of communism was unjustly divided, the Russian federation possessed 60 percent of national product, 62 percent of industrial production, 90

1- UNCTAD, Interregional Workshop, Table 2, P. 9.

percent of crude oil enjoyed the most powerful military force, and took possession of foreign assets and facilities which belonged to the former Soviet Union.⁽¹⁾

The estimate made by a research center regarding economic power and technological capabilities of some of the republics is pessimistic. The four republics Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan having the technological capabilities index of 34, 27, 23, and 18 respectively have the lowest ranking amongst the CIS countries⁽²⁾.

A short review of some of the economic indices in some selected republics shows the specialization basis of production and strong inter-system economic relations and stresses the necessity of regional cooperation with the participation of independent countries of the region including the I.R. of Iran.

Of course, the precise knowledge of economic relations and choosing the best strategy for development in these regions calls for technical analysis enjoying tools for econometrics or analysis based on input-output models in the said countries.

Turkmenistan, with a population of less than 4 millions, 13 percent of which are Russian, was at the periphery in the former Soviet Union's centralized economy and was responsible for production of a few agricultural products and raw materials in a large scale. This country by producing 1.4m tones of cotton, 450,000 tones of cereals and 5m head of sheep used to supply part of the agricultural needs of the former Soviet Union. It should be mentioned that only 3 percent of cotton production is consumed domestically and the government of Turkmenistan tries to increase domestic consumption to 50,000 tones by increasing the number of textile factories in order to decrease the domestic shortages for clothes.

This country has embarked upon an extensive campaign of privatization and has made efforts to broaden its foreign trade. But, due to low quality of its manufactured goods, lack of technological capabilities and other structural problems, it has to still rely upon exporting raw materials as the only source of hard currency. In this context, she has little choice but to cooperate with independent countries for the purpose of expanding investment and enjoying new technology.

1- Ibid, P. 5

2- Sohrab Shahabi "A General View of the Economic Conditions of Central Asian Republics the Journal of Central Asia & Caucasian Review, Vol. 1, No. 2, Aut. 1992. P. 123.

Kazakhstan, with a population of 18m in 1993, 38 percent of which are Russian, because of its strategic and its economic military power, ranks the second amongst the CIS countries. In this republic, important and strategic industries such as metallurgy and other minerals existed so that it possessed 50 percent of the copper, lead, nickel, molybdenum production of the former Soviet Union. This country used to have a special status in the former Soviet Union by producing and exploiting 25m tones of oil, refinery capacity of 18.5m tones of petro-chemicals, exploitation of 144m tones of coal, 20m tones of Iron and 30m tones of cereals. Existence of huge mineral reserves, 1800 nuclear missiles (the fourth nuclear power of the world), being the main uranium producer and having very high potential capacity of atomic and space research has attracted the attention of many industrial countries particularly the United States of America. Therefore, the conflict of interest of this country with Russia is probable in the near future. In 1993, this country with \$US 5 bn of export, has expanded its trade relations with China, United States of America, Cyprus, England, Germany, Former Yugoslavia and Middle East Countries.

This country has given priority for foreign investment in agricultural projects, chemical industries, energy and fuel, light industry and services.

Also, in the agriculture sector, it annually produces 32m tones of Cereals, 8m tones of wheat and rears 40m livestock. This republic is able to take significant part in the regional trade.

Iran and Kazakhstan have entered into several agreements dealing with oil, coal and meat, while land transportation facilities are to be expanded. Likewise, efforts are underway regarding sea transportation, port facilities, cargo and passenger transportation across the Caspian Sea. However, banking operation constitutes the main obstacle to trade cooperation in which Kazakhstan must undertake further commitments.

Uzbekistan had a population of 21.2m, of which 10.7 percent were Russians. This country is an important cotton grower, (third in the world) while it also possesses favourable conditions for raising cereals. Aircraft manufacture is the most important industrial activity, while significant potentials also exist in other industries.

Despite its high potentials for cereals, as a result of former economic centralization, Uzbekistan has not been able to be self-sufficient in production of many basic needs such as wheat, rice and sugar.

The republic has applied extensive measures in order to solicit foreign investment. Among these are legal framework, tax discounts, guaranteed withdrawal of foreign capitals. These are very positive steps which may effectively contribute to an expanded regional economic

relation as well as transition to the market economy.

Uzbekistan has started joint efforts with Iran in the area of educational and cultural activities, trade exhibitions and banking services. Other measures are also underway to eliminate obstacles to transportation, (land and air), insurance and marketing.

Tajikistan, a mountainous country, with a population of 5.4m (about 10.5% Russians), is one of the poorest republics of the former USSR. Agriculture forms the pillar of economic activity and employs 2/3 of the population. Cotton and aluminium are the two major export products. However, because of the low world market prices combined with lack of necessary marketing institutions, the country has encountered numerous economic difficulties.

In the wake of independence, the leaders of the country have attempted to attract foreign investments and to create favourable conditions for establishing relations with the free countries in the region. However, owing to the political instability and structural obstacles inherited from the centralized economic system, the republic's efforts have not been very successful.

Kyrgyzstan, with a population of 4.5m of which 25 percent are Russians is another peripheral republic of the former USSR. Its economy is based on farming and animal husbandry. With sheep numbering 10.5m, its livestock products, wool in particular, have outstanding significance in the country's trade.

Kyrgyzstan has undertaken some joint investments with other countries including Canada, Turkey and the Republic of Korea for oil exploration and industrial manufacturing. Presently, India, Pakistan, China and Turkey are Kyrgyzstan's major trade partners. Because of geographical handicaps combined with insignificant industrial potentials, the country's future does not seem very promising. However, within the framework of regional cooperation this republic may take a complementary part in certain agricultural and animal husbandry areas.

Kyrgyzstan and Iran have entered into vast cooperation dealing with trade of goods, trade exhibitions, as well as transportation facilities.

Azerbaijan has a population of 7.14m, including 7.9% Russians. The area is endowed with fertile land producing diverse agricultural products. Major crops are grapes, cotton and cereals. Vast farming land combined with a favourable climate, have provided a great potential for an expanded livestock rearing.

The acute difficulty in this country is the border dispute with neighbouring Armenia over the Gharabagh area. The ongoing war has interrupted numerous investment and trade development schemes.

Following its independence, Azerbaijan has enhanced its ties with the free world. It has signed agreements with American and European companies on oil exploration, and industrial development through foreign investment has been given priority. Azerbaijan's membership in ECO and the Caspian Sea cooperation promises a very bright future in the regional cooperation.⁽¹⁾

Following the disintegration of the USSR, the recognition of interdependence amongst republics in various aspects, led them to sign the commonwealth treaty in the shortest time. Despite the obvious haste made in this respect, many important reforms necessary for transition to a free market economy were given due consideration. However, the details of the measures, appropriate time tables for implementation were not sufficiently taken into account.

Among the grass roots measures proposed for creating free market potentials are; transformation of ownership system, reforming the monetary and banking system, attempts to balance trade among republics, liberalization of prices, expansion of foreign trade activities, forming customs systems and transit of goods, financing defence expenditures, convergence in tax policies and development of joint venture enterprises.

Since the dissolution of the Soviet Union, several regional pacts have come in to being. There is no doubt that the cooperation of a group of countries within the context of economic unions or common markets will bring multilateral benefits to all participating states. Moreover, the world wide experience has proved that such unions have contributed to the global peace and stability. In spite of aforementioned advantages, treaties such as CIS, ECO, the Caspian Sea coastal bloc or Black Sea Economic Cooperation have not been accompanied by scientific research and studies and sometimes unhealthy political rivalries have weakened the central objectives of the regional treaties.

Conducting studies on factors such as industrial development, communications, and energy, are the first steps in understanding the necessities of the cooperative structure. It is through these surveys that

1- Commerce Department Magazine, No 9810, (1372) & The Economist Intelligence Unit, Country Report, 3rd quarter 1993, Georgia, Armenia, Azerbaijan, Kazakhstan, Central Asian Republics 7 UNCTAD, Country- By- Country Synopsis of the commonwealth of Independent States.

the benefits and probable disadvantages of treaties, including trade creation or trade diversion, capital and labour movement, convergence of monetary and fiscal policies and differentiated natural resource endowment should be thoroughly investigated and evaluated.

These studies will clarify the practical mechanisms of treaties and facilitate the implementation of appropriate policy measures which are vital to the objectives of the single economic market.

The need for regional economic cooperation should not be considered as an international gesture, nor a foreign-incited plan, rather, it should be recognized as a genuine emergency originating in the very inside of the newly independent republics. This should be seen as a "return towards their deep rooted cultural, religious and historical ideals and aspirations".

The break-up of the Soviet Union and the resultant independence, which was against the desire of certain leaders of the republics, has not ended the reliance on the Russian economy. Such an idea is neither possible nor essential. What is more desirable in economic independence is the mutual interdependence, a balanced economic relation and the elimination of unilateral domination of periphery by the center.

The global peace and stability calls for the enhancement of the convergence factors and elimination of those which might lead to divergence. The dependence of aforementioned countries extends well beyond the boundry of economic and technological reliance which today exist among the advanced economies and some of the developing countries.

The Soviet army is still the biggest armed force which provides protection and safeguards for the newly emerged republics. Its presence in military and security decision-making is clearly evident. Existing nuclear arms in Kazakhstan is a deciding factor in shaping its relations, including economic relation, with the rest of the world. These countries have very weak economic foundations to manufacture arms or form their own independent armies. In view of pressing transitional emergencies, military expenditures seem to be a mere waste of scarce resources.

Border disputes, ethnic and ideological conflicts among republics can always act as divergence factors, representing serious threats. Promotion of regional cooperation can mitigate these tensions and contribute to unity within the context of mutual needs.

The extent of dependence is in high proportion of Russian origin immigrants in the Baltic republics, & Russian ethnic majorities in

Kazakhstan and around 10m Russians living in Central Asia. According to another estimate the Russian population of the newly independent republics amounts to 28m. It should be particularly noted that Russian immigrants constitute the bulk of the skilled and professional workforce, occupying higher technical, bureaucratic and planning positions. According to Olcott it will be a matter of at least one generation before these republics can achieve comparative self-reliance regarding expertise⁽¹⁾.

The unilateral reliance of the Central Asian States on Russia is far greater than that of other republics. This suggests two probable cases in the future; in the first instance, it is presumed that the economic cooperation between the region and open economies would continue at a gradual and sluggish pace. This would clearly lead to a return to the former economic bindings, followed by a strengthened political and military dependence on the "center". This is a reality which is indisputable in nature of economic independence.

In the second case, the presumption is that these republics would want to join in a common cooperation based on a free economy, create new ties, diversify their production, strengthen their independence and economic self-reliance within the context of a free economy. However, the major barriers are; lack of entrepreneurial values, legal framework (including private ownership rights), institutions and market relations in these republics. In some of these states, the main economic activities are still handled by government. For example, in 1992, almost 90 percent of major economic activities were in the hands of the state sector.

Transferring these activities to private sector, without first putting in place the initial prerequisites, does not seem possible in the near future. In particular, the political consequences of the socio-economic transformation may lead to crisis, jeopardizing the political sovereignty.

These obstacles make sluggish any trade cooperation and joint investment efforts, while such programmes in the free countries of the region, particularly Iran, or in the joint free trade zones with cooperation of major industrial countries are feasible.

In the latter case, through the application of export substitution strategy, and establishing links between various industries in the region, the goals of transition to free economy can be achieved in the shortest

1- Martha Brill Olcott. Central Asia's Catapult to Independence, foreign affairs. Vol. 71. No. 3, (Summer 1992), PP. 108- 130.

time span. For example, through joint investment by industrialized countries, I.R. of Iran can set up and develop textile industries in its free zones and northern regions and produce finished products from cotton, wool or oil products. Iran can pioneer the first practical efforts in creating healthy economic ties which in turn would establish peace and security in the region and contribute to the global peace.

Due to the ethnic, racial, religious as well as historical reasons, ECO countries share numerous common values which may serve their joint interests within a far-reaching economic union. Focus on common religious values and spiritual ties can play a significant part in bringing about healthy economic and political relations among the countries in the region.

The Central Asian countries generally have an obvious inclination towards Islam. This has been an important element in the revival of "identity" and a sense of national brotherhood among these states and their neighboring Moslem countries.

The role of religious leaders in political decision-making in Tajikistan, Turkmenistan and Uzbekistan and the inter-relation of religious values with national values are an obvious illustration of the significance of religion in these republics. Kyrgyz and Kazakh leaders have in many instances pretended their support of religious rituals. Even during the communist oppression, the Soviet leaders failed in their attempts to dominate the heartfelt beliefs of people and failed to eradicate Islam in the region.

In this description of culture and the Soviet Union, Leonid Brezhnev a former leader of USSR, admits that the Islamic culture is steadfast against alien cultural aggression. He states:

"No, despite continuous efforts by the political system to expand relations among various nations and ethnic groups and to fuse all ethnical peculiarities within the context of a "unified political culture of the Soviet", now it has become clear that any endeavour to change the attitude and morale of people in the Moslem-inhabited parts of this country has encountered a political and social reality which is very difficult to penetrate. The peculiarities of these nations originate in Islam ... (1)"

Fortunately, the rich Moslem countries such as Saudi Arabia, Libya and Kuwait have furnished significant assistance in reviving Islamic values, printing the holy Qur'an and building Mosques in these

1- Keyhan, Thursday, Jan, 17, 1995, No. 14968. P. 7.

republics. The public have greatly welcomed and carried out the Islamic rites.

Iran has focused on common religious values existing in the central Asian countries and believes that these shared values can be an asset in the enhancement of regional convergence, expansion of relations with other Islamic nations as well as enriching friendship and cooperation with all nations of the world.

I.R. of Iran can take a complementary role in bilateral cooperation and regional participation within the context of ECO and the Caspian Sea economic unions action and creating linkage between these republics and enterprising world economy. With complete goodwill, Iran has so far furnished significant facilities in the areas of trade and services expansion, and investment within the framework of joint agreements. With the aim of strengthening economic cooperation, Iran has stated its willingness to facilitate the access of these countries to open sea waters in the south. Iran has also welcomed any joint effort in providing energy and the sale of oil of these countries on the free world market as well as expansion of the road systems.

Since the existing communication facilities including postal service, telephone, telegraph, international traveling have been developed within the closed network of the former Soviet Union, therefore these countries will need tremendous assistance from countries in the region in order to establish new links. Establishing new infrastructure including satellite communication with Iran, development of air routes between republic capitals and Tehran, construction of the Turkmenistan-Iran railway, cooperation in transferring Iranian oil to Ukraine, transferring oil and gas from some of these republics to Europe and open seas through Iran, are among essential projects which will strengthen the economic sovereignty of these republics within the concept mentioned earlier.

Iran believes that Russia has a significant part in the development of economic relations and multilateral cooperation. Therefore, keeping friendly relations with this country is given priority in Iran's foreign policy. Russian experts and scholars, too, admit that the progress of regional aims depends on friendly mutual relations among republics, Russia and free nations in the region.

However, no single country is ever willing to commit itself in investing in infrastructural development and establishing fundamental market institutions in these republics. Such investments tend to be seen by independent nations in the region, as "Public goods". In other words, all countries will benefit from infrastructures such as international routes, telecommunication links, as well as banking and insurance

services. Therefore, it is not in the interest of any single country to individually bear these expenditures. However, through the regional cooperation within the context of ECO and the Caspian Sea bloc, these investments can be made profitable and rewarding for all participating members.