Foreign capital in Central Asia and the Caucasus: Curse or blessing?

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Abstract

In developing countries, the magnitude as well as the composition of foreign capital greatly influences the political fortunes of domestic actors, and thus regime trajectory. This paper demonstrates that the states of 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. This situation has empowered authoritarian rulers, provided very little financial strength to local businesses, and offered half-hearted incentives for market reforms. Moreover, the small differences among these states in terms of the composition of capital flows also explain why some of these states have moved towards a milder version of authoritarian rule while others have been stuck in hard authoritarianism.

Keywords: Foreign capital flows; Authoritarianism; Central Asia; Caucasus; Democratization; Globalization

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

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and who have systematically harassed the opposition, and stifled political rights and
civil liberties. The Freedom House (2004) 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 these states have been exposed to the
forces of financial globalization at the same time as they were struggling to establish
their sovereignty and build new state institutions. The economic dislocations in the
aftermath 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 political fortunes of domestic actors, and thus intrinsically the regime
trajectory. The types of foreign capital, distinguished by source and recipient 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, and offered half-hearted incentives for market reforms. 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 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

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 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.
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 data for 2001, 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., 1995, 1998; 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. Here they are distinguished in terms of identity of the foreign investor (source), and the degree of public vs. private control over the allocation of capital (recipient). 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. 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. Commercial bank loans to the government come from foreign private sector banks to the developing country’s

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3 FDI is defined as investment that is made to acquire a lasting management interest (usually of 10% of voting stock) in an enterprise operating in a country other than that of the investor. The investor’s purpose is to acquire an effective voice in the management of the enterprise (Global Financial Indicators, 2001).

4 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 quantitatively distinguish between FDI into the public sector and into the private 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. Commercial bank loans to the private sector on the other hand are loans directly flowing to local private sector from foreign private banks. 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 investors and include nonguaranteed bonds that are privately placed as well as corporate equities and depository receipts (American or global).

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 in most developing countries, I argue that the composition of capital flows enables regime persistence through its impact on the distribution of power among political actors and pressures for reforms. Below I discuss how each type of foreign capital affects these intermediate variables, which in turn have significant implications for regime persistence.

**Distribution of political power**

The destination of foreign capital—public vs. private—has implications for the distribution of political power in a regime (see Table 2). 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 (Armijo, 2001).

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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.

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Table 1
Characteristics of foreign capital flows

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<tr>
<th>Type of capital flow</th>
<th>Source</th>
<th>Recipient</th>
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<tbody>
<tr>
<td>Foreign aid</td>
<td>Public</td>
<td>Public</td>
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<tr>
<td>Foreign direct investment</td>
<td>Private</td>
<td>Private/public</td>
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<td>Commercial loan to government</td>
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<td>Commercial loan to private</td>
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<td>Portfolio investments to government</td>
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<td>Portfolio investments to private</td>
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</table>
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.6

Table 2
Implications of capital flows

<table>
<thead>
<tr>
<th>Type of capital flow</th>
<th>Increase the power of</th>
<th>Pressures for reform</th>
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<tbody>
<tr>
<td>Foreign aid</td>
<td>Government</td>
<td>Low</td>
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<td>Foreign direct investment to government</td>
<td>Private/government</td>
<td>Moderate</td>
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<tr>
<td>Commercial loan to government</td>
<td>Government</td>
<td>Low</td>
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<tr>
<td>Commercial loan to private</td>
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<td>Low</td>
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<td>Portfolio investments to government</td>
<td>Government</td>
<td>High</td>
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<td>Portfolio investments to private</td>
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Pressures for reform

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

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6 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.
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 creditworthiness and strong macroeconomic fundamentals (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. They also tend to care less about the efforts of the government to undertake neo-liberal reforms. Despite questions about its effectiveness, IMF is notably the only international financial institution that actively promotes such reforms as a condition for its loans.7

Foreign direct investors, on the other hand, may be more likely than aid donors or bank lenders to care about domestic politics and even about 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).

Finally, portfolio investors arguably apply the highest degree of pressure for neo-liberal 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 neo-liberal 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; Frieden and Rogowski, 1996; Block, 1996; Henry, 1996; Winters, 1996; Chaudry, 1997; Maxfield, 1997). 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.10

Capital flows to Central Asia and the Caucasus

Volume of foreign capital

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%). As a fraction of GDP, however, capital flows to Central Asia and Caucasus states were much higher than flows to all other developing countries11 during the same period (see Fig. 1). In terms of the volume of foreign capital, Azerbaijan and Kyrgyzstan received on average more foreign capital than the other Central Asian and Caucasus states (19.89 and 18.2% of GDP, respectively; see Fig. 2). However, despite some variation, except for Uzbekistan where foreign capital accounted for about 5.8% of GDP—all Central Asian and Caucasus states received substantial amounts of foreign capital relative to the size of their economy during the period.

Composition of capital 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% of flows into the region came from bilateral and multilateral official donors in the form of grants and low-interest loans (see Fig. 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.

9 A seminal contribution to this idea comes from 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.

10 There is no linear link between market-oriented economic liberalization and transition to democracy, however. As the experience in many developing countries demonstrates, neo-liberal 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 as social unrest and violence.

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.
Lankes and Stern, 1998. Toward the end of 1990s, official flows declined, paralleling the decline trend in all other developing countries (Fig. 4).

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 (Gabibaldi et al., 2001). 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% 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 Fig. 4). 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 of capital 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% 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 flowing predominantly to joint ventures with public sector enterprises), the percentage of foreign capital received by these governments is roughly 90% of total capital flows, equivalent to 9% of the total GDP. Over time, foreign aid (and to a certain extent commercial loans to governments) decreased, while FDI increased from 9.2% of

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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.
total flows to 44.3% in 1997, averaging 31.8% 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%, compared to more than 30% overall for developing countries in the 1990s (Table 3).

Why authoritarianism persists and how it varies in the region

Foreign aid

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% of total flows, respectively; see Fig. 5).13 The numbers are not too surprising. Armenia is the world’s second largest recipient of US 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 (BISNIS, 2004: Country Commercial Guide: Armenia 2004).14 Humanitarian aid originally accounted for up to 85% of total US assistance, reflecting the economic effects caused by closed borders with Turkey and Azerbaijan related to the Nagorno-Karabakh conflict as well as to the devastation in northern Armenia caused by the

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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 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.
Table 3
Comparison of capital flows, by recipient (% of total flows)

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* Central Asian and Caucasus states are omitted from this category.


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% of GDP (BISNIS, 2004: Country Commercial Guide: Armenia 2004).

Similarly Georgia has received significant humanitarian and economic aid during the early 1990s. Recently to encourage and support the reform process, the US 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 US bilateral security assistance, including the International Military Education and Training (IMET) program. In 2003, almost 40% of all US aid was in the security and law enforcement areas (Table 4).

Kyrgyzstan has been the “donors’ darling” of Central Asia. It has received foreign aid equivalent to 14.6% of its GDP during the 1990s. Most came from the World Bank, the EBRD, and 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, US 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 resulted in ongoing shortages of food. As the recent distribution of US assistance also demonstrates, humanitarian aid constituted the bulk of foreign aid into the Tajik economy (53% in 2002, 44% in 2003; Table 4).

My hypothesis is that large volume of foreign aid to an authoritarian government tends to strengthen the political influence of the donor governments and international organizations as well as that of the recipient governments. Findings from this region generally support this hypothesis. As expected, 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.
Table 4
Composition of US assistance in 2003 (in US$ millions)

<table>
<thead>
<tr>
<th></th>
<th>Armenia</th>
<th>Georgia</th>
<th>Uzbekistan</th>
<th>Turkmenistan</th>
<th>Kazakhstan</th>
<th>Kyrgyzstan</th>
<th>Tajikistan</th>
<th>Total</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic and social</td>
<td>46.80</td>
<td>26.10</td>
<td>18.20</td>
<td>2.40</td>
<td>23.40</td>
<td>19.90</td>
<td>14.30</td>
<td>151.10</td>
<td>30</td>
</tr>
<tr>
<td>Security and law enforcement</td>
<td>18.40</td>
<td>41.40</td>
<td>30.20</td>
<td>1.40</td>
<td>49.20</td>
<td>10.30</td>
<td>1.10</td>
<td>152.00</td>
<td>30</td>
</tr>
<tr>
<td>Democracy programs</td>
<td>22.40</td>
<td>20.40</td>
<td>14.70</td>
<td>4.70</td>
<td>13.90</td>
<td>13.50</td>
<td>7.30</td>
<td>96.90</td>
<td>19</td>
</tr>
<tr>
<td>Humanitarian assistance</td>
<td>7.10</td>
<td>15.10</td>
<td>18.50</td>
<td>0.50</td>
<td>0.50</td>
<td>9.10</td>
<td>21.80</td>
<td>72.60</td>
<td>14</td>
</tr>
<tr>
<td>Cross sectoral initiatives</td>
<td>11.80</td>
<td>7.40</td>
<td>4.50</td>
<td>2.10</td>
<td>5.00</td>
<td>3.80</td>
<td>4.50</td>
<td>39.10</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>106.50</td>
<td>110.40</td>
<td>86.10</td>
<td>11.10</td>
<td>92.00</td>
<td>56.60</td>
<td>49.00</td>
<td>511.70</td>
<td>100</td>
</tr>
</tbody>
</table>

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 US 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% 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 (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 sector. In fact IMF lending pushed for privatization in the region. Today, in Kyrgyzstan and Armenia the private sector amounts to 65 and 75% of the GDP, respectively. Still, the actual amounts donated for these purposes were minuscule in comparison to other objectives. Since 9/11, the bulk of the US 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.

*Foreign direct investment*

FDI has been the second largest form of foreign capital flowing into the region. Even though almost all of these states received it, it has been mostly concentrated in Azerbaijan and Kazakhstan, which are well endowed with natural resources. Kazakhstan holds about 0.8% and Azerbaijan 0.6% of proven recoverable world oil reserves (*British Petroleum, 2004*). On average, roughly about 68 and 45%, respectively, of total capital flowing into these economies were in the form of FDI. These countries have been able to attract significant amounts of FDI, even when overall market reforms were still at an early stage. 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 2000.15

In Azerbaijan, most FDI flows into the public sector because the oil and gas industry is wholly owned 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.

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15 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.
and the late president of Azerbaijan (Bayulgen, 2003). 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.

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 remains 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.

As expected, 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, these 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 (BISNIS, 2004: Country Commercial Guide: Azerbaijan 2004). Similarly Kazakhstan’s economy grew substantially throughout the later 1990s, buoyed by impressive FDI levels and high world oil prices. Oil output has grown annually at about 15% and now accounts for roughly 25% 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 multinational companies 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.”

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

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16 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 indicates a misbalance (CEE Bankwatch Network, 2002). 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,” 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% Azeris have not improved. The average per capita income is $40/month for a population of eight million and the official poverty line is at $89/month (CEE Bankwatch Network, 2002). 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 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%, respectively). I have theorized that bank loans to government are likely to contribute to regime persistence by expanding the resources available to the political authorities, with little oversight or external pressure to follow sound economic policies. Evidence from the region supports this hypothesis. In both Uzbekistan and Turkmenistan, foreign loans to authoritarian leaders have shored up unrepresentative political regimes by allowing their leaders to bolster state-owned

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17 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.

18 Author’s translation of “Neftin adi bizimdir, tadi baskalarinindir.” Interview with Ismayil Musayev, a political science professor of Baku State University. Baku, July 14, 1999.
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.\(^{19}\) 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, reduced inflation rates and budget deficits, and even privatized to a certain extent, thanks to IMF conditionality.

**Commercial loans to the private sector**

I have hypothesized that the effects of commercial bank loans to the private sector are likely to push for regime change in the long run by increasing the political weight of the private sector vis-à-vis the government. Hence, 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.

Common to the region, however, 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 interest rates of 15–20%. The few small independent banks reflect the small size of the financial market. On average, only 2–3% of the region’s population has bank accounts (BISNIS, 2004: Country Commercial Guide: Uzbekistan 2004).

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. Uzbekistan’s domestic commercial banks have received some foreign loans, but the majority of their credit has gone to state-owned enterprises as opposed to the private sector (BISNIS, 2004: Country Commercial Guide: Uzbekistan 2004). 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% of all flows and 2.3% of its GDP. In some ways Kazakhstan stands out among its peers. As the composition of foreign capital in Kazakhstan demonstrates (see Fig. 5), its capital flows are relatively more diversified than elsewhere in the region. Despite FDI’s priority, other types of capital flows are

\(^{19}\) Their exercise of utmost state control over the economy has alienated Western donor organizations and led international lending operations to suspend or scale back credits. 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.
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%, versus 0–1%).

The banking system is a good indicator of the vitality of the private sector. 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% 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 (BISNIS, 2004: Country Commercial Guide: Kazakhstan, September 2003). The average amount of domestic credit given to the private sector relative to GDP during 1993 and 2001 was the highest in Kazakhstan (15.12%), followed by Armenia (8.35%), Georgia (6.28%), and Kyrgyzstan (6.16%) (World Development Indicators, 2003). As a comparison the state sector in Turkmenistan accounts for 80% 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% 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.

**Portfolio investments to government and the private sector**

I hypothesized that portfolio investments in the private sector are likely to strengthen the domestic firms and give them incentives to push for further economic liberalization. Portfolio investments to government can similarly produce incentives for the deepening of economic reforms (even though they strengthen the governments as opposed to private sectors). This is because portfolio investments by nature are prone to sudden reversals and thus 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. These reforms, in turn, may prove to be conducive for democracy in the long run.

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 5.2% of total flows) but investment in equities of domestic firms is still disappointingly low (1%). 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 (BISNIS, 2004: Country Commercial Guide: Kazakhstan 2003). 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.
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

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20 For instance, Uzbekistan and Turkmenistan have the lowest levels of FDI per capita in this region 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). This is because they both have been extremely cautious in moving to a market-based economy. Continuing restrictions on currency convertibility and other 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.
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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