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## Services liberalization in transition economies: The case of North and Central Asia

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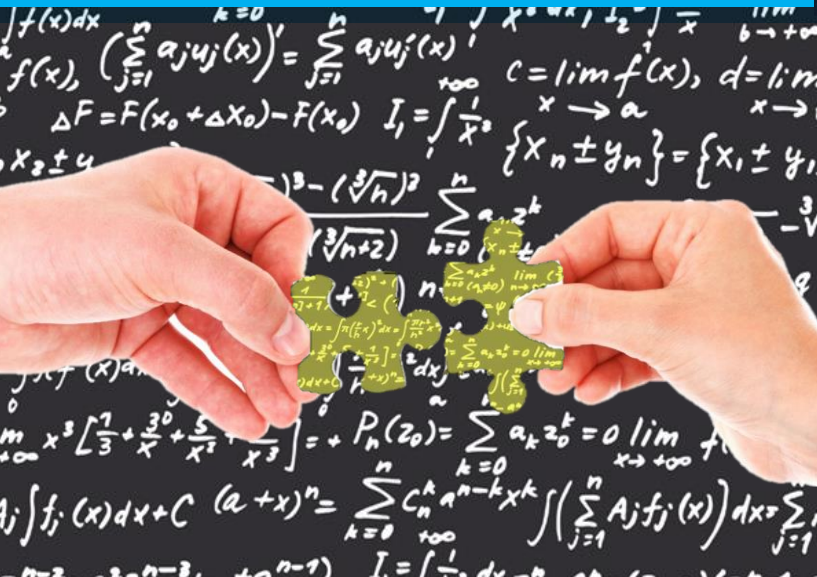
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## Services liberalization in transition economies:

### The case of North and Central Asia



Marta Soprana

ASIA-PACIFIC RESEARCH AND TRAINING NETWORK ON TRADE

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**Services liberalization in transition economies:  
The case of North and Central Asia**

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## **Abstract**

This paper offers a review, analysis and assessment of the status of services liberalization in North and Central Asia.

Following a brief introduction about the region and its economic context, this study provides an overview of the binding commitments undertaken by transition economies under the General Agreement on Trade in Services (GATS) and an evaluation of how they compare to domestic policy reform, with a focus on the three transition economies that most recently acceded to the WTO: Kazakhstan, the Russian Federation and Tajikistan. It proceeds to explore the scope of interest in services liberalization in North and Central Asia, highlighting the reasons behind the relative little attention so far received by the services sector in the region. This is followed by an assessment of the role that foreign direct investments can play in improving the treatment of foreign services suppliers and modernize services, and an illustration of how to prioritize services sectors for higher value-added participation in global value chains.

The paper concludes by offering a number of policy recommendations to support services liberalization with a view to diversity the economy, speed up the transition process and improve the overall standing of North and Central Asian countries in the world economy.

**Keywords:** Services trade, North and Central Asia, GATS, transition economies

**JEL classifications:** F13, F14, F15

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## 1. Introduction

Transition economies in the North and Central Asian region share several common traits. Mostly landlocked, with no direct access to the sea, they are located at the crossroads of Asia, Europe, the Persian Gulf, the Middle East and the Far East. They act, therefore, as a strategic gateway for trade and investments, which have increasingly poured in during the period 2000-2013, also from their neighbouring fast-growing developing countries, China and India (Akbar, 2012). Furthermore, transition economies are abundant in human capital, which represents one of the most significant legacies of Soviet rule. As a matter of fact, North and Central Asia boasts almost universal adult literacy as well as relatively high rates of female participation in university and enrolments in both primary and secondary education (Blua, 2011).

Since their independence from the former Soviet Union in the early 1990s, all transition economies in North and Central Asia embarked, albeit with different degrees of extent and intensity, on a series of important market-oriented reforms, including development of the private sector, trade liberalization, macroeconomic stabilization and infrastructure development. These reforms were an undisputed contributing factor for the region experiencing one of the fastest growing rates of the past two decades (Dowling and Wignaraja, 2006).

But growth in the area was also driven by high commodity prices, since countries in North and Central Asia strongly depend on the abundance of natural resources, from oil and gas to gold and other minerals. For example, Kazakhstan and Turkmenistan are major exporters of oil and gas, though the former is also significantly rich in minerals. Kyrgyzstan exports large quantities of gold, and like Tajikistan, which has great potential for aluminium production and exports, has major water reserves for hydroelectricity to rely on for development (Blua, 2011).

Unsurprisingly, being too dependent on exports of natural resources makes the countries in North and Central Asia particularly vulnerable to the volatility of international commodity prices and the uncertainty of international markets. Indeed, the sharp fall in oil prices that occurred in 2013-2015, combined with the weakening

of Russia's economy, the fall of the rouble, the devaluation of Kazakhstan national currency and the sudden downturn in China's economy, significantly affected the economy of most countries in the region, with reductions in remittances, revenues and, consequently, national budgets (Pannier, 2015). For instance, Turkmenistan, which relies almost exclusively on exports of natural gas and was unprepared for the crisis, saw the value of its exports reduced to a mere 30 per cent since 2013, forcing the country to cut subsidies for gas and electricity for the first time in almost 25 years (Pannier, 2015). Kazakhstan, Tajikistan, and Kyrgyzstan shared a similar fate (Sorbelli, 2015).<sup>1</sup>

Still, transition economies in North and Central Asia have the potential to diversify their economies, and thus mitigate the risks associated with volatile prices of natural resources and the uncertainties of international markets, should greater attention and effort for reform be dedicated to the variety of business activities that developed as a consequence of their natural resources-led growth, such as construction and banking services as well as a number of manufacturing activities (Dowling and Wignaraja, 2006).

**Table 1. Sector share of GDP (value added)**

	Agriculture		Industry (excl. mining, utilities)		Mining, utilities		Services	
	1995	2012	1995	2012	1995	2012	1995	2012
Armenia	41.9	20.9	26.7	24.5	2.6	7.7	28.8	46.8
Azerbaijan	26.9	5.5	16.2	15.2	16.7	48.0	40.3	31.3
Georgia	44.4	8.5	12.5	20.4	1.8	3.8	41.3	67.3
Kazakhstan	12.9	4.7	18.6	18.8	11.6	20.7	56.9	55.8
Kyrgyzstan	43.1	18.5	19.0	20.6	2.8	4.1	35.1	56.7
Russian Federation	7.2	3.9	28.9	22.6	10.4	14.4	53.5	59.1
Tajikistan	31.6	26.2	48.4	24.8	0.0	0.0	20.0	49.0
Turkmenistan	16.9	14.5	64.2	46.1	1.1	2.3	17.9	37.0
Uzbekistan	31.4	19.2	27.2	28.7	3.7	4.3	37.7	47.8
<b>North and Central Asia</b>	28.5	13.6	29.1	24.6	5.6	11.7	36.8	50.1
<b>World</b>	4.0	4.3	26.5	25.6	3.7	4.3	65.8	65.7

Source: UNCTAD Statistics (<http://unctadstat.unctad.org>)

Indeed, in the course of the past twenty years countries in North and Central Asia have undergone significant changes in the structure of their economy. As Table 1 shows, in the period 1995-2012 the majority of the countries in the region moved

<sup>1</sup> Kazakhstan's mining industry, Tajikistan's leading aluminium exporter and Kyrgyzstan's main gold mine are all experiencing difficulties that represent a real danger for each country's whole economy.



from an agricultural- or industry-based economy towards a services-based economy, albeit with a few significant distinctions. In Georgia, for example, the value added share of gross domestic product (GDP) of agriculture dramatically fell from 44.4 per cent to 8.5 per cent, a drop that was mostly absorbed by the services sector, which rose in value added share of GDP from 41.3 per cent in 1995 to 67.3 per cent in 2012. For Azerbaijan and Kazakhstan, on the other hand, the decline in value added share of GDP of agriculture reflected a shift towards the mining sector, rather than the services sector.

However, even though services' share of GDP increased remarkably in most countries in the region, with the exception of Azerbaijan and Kazakhstan, the average share of GDP for services in North and Central Asia (50 per cent) is well below the world average (70 per cent) and natural resources continue to make up the bulk of exports from the region.

## **2. GATS commitments: the binding regime in North and Central Asia**

Although economies in North and Central Asia can be viewed as a rather homogeneous grouping, a few notable differences exist within the region. For example, oil-exporting and non-oil exporting countries fall within different income level categories. Case in point is Tajikistan, a poor economy almost entirely dependent on agriculture, whose per capita income is markedly lower than rich energy-exporting powerhouses such as Kazakhstan and Turkmenistan (Dowling and Wignaraja, 2006).

But transition economies in the North and Central Asian region lack some common ground also with respect to their participation in multilateral trade negotiations and, in particular, their level of trade liberalization in the services sector. Out of nine countries, only one (i.e. Turkmenistan) has neither acceded to the World Trade Organization (WTO) nor started procedures to do so. In contrast, Armenia, Georgia and Kyrgyz Republic became WTO Members before 2010, whilst Kazakhstan, Russian Federation and Tajikistan are among the most recently acceded members.<sup>2</sup>

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<sup>2</sup> Kazakhstan, Russian Federation and Tajikistan became WTO Members in 2015, 2012 and 2013, respectively. Uzbekistan's accession has not progressed since 2005 ([https://www.wto.org/english/thewto\\_e/acc\\_e/a1\\_ouzbeistan\\_e.htm](https://www.wto.org/english/thewto_e/acc_e/a1_ouzbeistan_e.htm)).

As no transition economy in North and Central Asia participates in the Trade in Services Agreement (TISA) - i.e. the most recent attempt to improve upon the General Agreement on Trade in Services (GATS) with a view to address new issues and bring bound commitments closer to the applied regime - the GATS schedules of commitments still represent the most viable and reliable instrument to understand the nature and depth of the binding regime for services trade liberalization in the region.

How many sectors do transition economies in North and Central Asia inscribed in their GATS schedules? How do they compare with the rest of the WTO membership? A study conducted by Adlung and Roy found that on average, acceded countries tend to subscribe commitments in their GATS schedules on a high number of services (103), and the same can be said about transition economies, which include also countries that acceded the WTO between 1995 and 2005 and boast an average number of 105 sub-sectors per Member in their respective GATS schedules (Adlung and Roy, 2005). At a quick glance it emerges that Kazakhstan, Russian Federation and Tajikistan subscribed GATS commitments on 106, 114 and 105 sub-sectors listed in the services sectoral classification, respectively. Therefore, it is possible to conclude that, as recently acceded countries, the latter's average number of committed sub-sectors is in line with that of the countries that became WTO Members in the period 1995-2005.

**Table 2. Distribution of commitments in North and Central Asia**

	<b>WTO Accession</b>	<b>Sub-sectors <i>with</i> commitments (n)</b>	<b>Sub-sectors <i>without</i> commitments (%)</b>
<b>Armenia</b>	2003	96	38.1 %
<b>Georgia</b>	2000	124	20.0 %
<b>Kyrgyz Republic</b>	1998	131	15.5 %
<b>Kazakhstan</b>	2015	106	31.6 %
<b>Russian Federation</b>	2012	114	26.5 %
<b>Tajikistan</b>	2013	105	32.3 %
<b>Cambodia</b>	2004	88	43.2 %
<b>Nepal</b>	2004	73	52.9 %

*Source:* author's elaboration

It is worth mentioning that, as shows in Table 2, in comparison with other acceded countries outside the North and Central Asian Region, such as Cambodia and Nepal, recently acceded transition economies subscribed a higher number of sub-sectors (108 on average against 81 on average for Cambodia and Nepal).

Adlung and Roy's study allows also to draw some conclusions on how the most recently acceded North and Central Asian countries compare to those transition economies that became WTO Members before March 2005, and other income groups.

**Table 3. Distribution of commitments across groups of members (March 2005)**

Members	Average number of sub-sectors committed per Member <sup>3</sup>	Range (Lowest/highest number of sub-sectors per schedule)
Least-developed economies	24	1 – 111
Developing & transition economies	53	1 – 149
Transition economies only	105	58 – 149
Developing economies only	42	1 – 123
Developed economies	106	87 – 117
Accessions since 1995	103	37 – 149
ALL MEMBERS	52	1 – 149

*Source:* Adlung and Roy (2005)

As shown in Table 3 above, transition economies committed to a high number of sub-sectors (105 on average) whereas developing economies and least-developed countries subscribed commitments on an average number of 42 and 24 sub-sectors, respectively (Adlung and Roy, 2005). Interestingly, Adlung and Roy also found that transition economies tend to undertake a higher percentage of full commitments under mode 1 (cross-border trade), mode 2 (consumption abroad) and mode 3 (commercial presence) than all WTO Members, whilst also subscribing a high percentage of unbound commitments under mode 1 (second highest after developed countries) (Adlung and Roy, 2005).

A closer look at the GATS schedules of the most recently acceded transition economies (Kazakhstan, Russian Federation and Tajikistan) shows that health-related and social services, transport services and recreational, cultural and sporting services stand out as the sectors with the highest proportion of uncommitted sub-

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<sup>3</sup> Total number of sub-sectors: approximately 160. Acceding countries are not only counted as a separate group, but are also included as members of other relevant groups (developing countries, least-developed countries and, mostly, transition economies).

sectors across all three countries. More specifically, Kazakhstan did not undertake any commitment in health-related and social services, a sector where the Russian Federation and Tajikistan made commitments only in hospital services. Concerning transport services, all three countries subscribed a very limited number of sub-sectors, primarily related to the maintenance and repair of transport equipment, although Kazakhstan and the Russian Federation undertook commitments on a relatively higher number of transport services sub-sectors than Tajikistan. It should also be noted that, for audiovisual services, all three countries subscribed commitments in only half of the sub-sectors.

**Table 4. Percentage of free sectors in GATS schedules by WTO members**

	<i>Percentage of free sectors</i>	<i>Percentage of partial sectors</i>	<i>Percentage of unbound sectors</i>
<b>Armenia</b>	38.5	3.5	58.0
<b>Georgia</b>	52.3	2.2	45.5
<b>Kyrgyz Republic</b>	56.9	3.8	39.4
<b>Kazakhstan</b>	25.6	20.7	53.7
<b>Russian Federation</b>	27.7	26.3	46.0
<b>Tajikistan</b>	37.2	12.8	50.0
<b>Cambodia</b>	34.2	4.0	61.8
<b>Nepal</b>	24.6	8.2	67.2

*Source:* author's elaboration based on Eschenbach's methodology (2006)

According to Table 4, which illustrates the average share of free, partial and unbound sectors subscribed by each WTO Member in its GATS schedule of commitments, Kazakhstan, Russian Federation and Tajikistan undertook full commitments in a lower percentage of sub-sectors, in comparison to Armenia, Georgia and Kyrgyz Republic (Eschenbach, 2006).

It follows that, with an average of about 49 per cent free sectors, Armenia, Georgia and Kyrgyz Republic seem more highly committed to liberalization than the three most recently acceded transition economies (on average 30 per cent of sectors with full commitments) (Eschenbach, 2006). Still, it is worth pointing out that, within the latter grouping, Tajikistan shows the highest percentage of free sectors, followed by the Russian Federation and Kazakhstan. Russia, on the other hand, presents the highest percentage of sectors with partial commitments (26 per cent), as well as the

greatest balance between full and partial commitments, whereas Kazakhstan registers the highest percentage of sectors with non-binding commitments.

A closer look at the depth of their commitments discloses differences in commitments across all four modes of supply: cross-border trade (mode 1), consumption abroad (mode 2), commercial presence (mode 3) and movement of natural persons (mode 4).<sup>4</sup> For instance, it emerges that Kazakhstan and Tajikistan differ quite substantially in their approach to commitments under mode 1, with the former undertaking mainly unbound commitments and the latter inscribing primarily full commitments. On the other hand, under mode 2 all three recently acceded transition economies inscribed predominantly full commitments.<sup>5</sup> As far as mode 3 is concerned, Kazakhstan and the Russian Federation undertook especially partial commitments on the establishment of a commercial presence, followed by unbound and full commitments, under both market access (MA) and national treatment (NT), whereas Tajikistan, which also inscribed primarily partial commitments under this mode, inscribed only partial and unbound under MA but mainly full commitments under NT. Unsurprisingly, like the vast majority of WTO Members, Kazakhstan, Russian Federation and Tajikistan undertook non-binding commitments in almost all inscribed sectors under mode 4 (presence of natural persons), although the Russian Federation inscribed partial commitments in about 14 per cent of sub-sectors under market access for this mode.

Differences in commitments emerge also at sectoral level. For example, construction, environmental and distribution services are the top three sectors where Kazakhstan inscribed full commitments, whereas, for the other two transition economies the top three sectors with full commitments are, respectively, construction, business and tourism services (Russian Federation) and educational, construction and environmental services (Tajikistan). As far as partial commitments are concerned, the Russian Federation has made larger use of them in comparison to Kazakhstan and Tajikistan, particularly in financial and environmental services. In health-related

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<sup>4</sup> See Annex 1 for reference.

<sup>5</sup> Although, a marked difference exists between Kazakhstan, which inscribed about 51 per cent of all sub-sectors without limitations under mode 2, and the Russian Federation and Tajikistan, which undertook full commitments in over 60 per cent of services sub-sectors under market access for mode 2.

and transport services all three transition economies inscribed mainly non-binding commitments.

### **3. Domestic policy reform and GATS commitments**

In light of the fact that Kazakhstan's accession to the WTO took place only at the end of 2015 and that the Russian Federation and Tajikistan also acceded quite recently, little can be said at the moment about how domestic policy reform compares to their GATS commitments. Still, a few considerations are worth mentioning.

The Services Reform Index (SRI)<sup>6</sup>, designed by the European Bank for Reconstruction and Development (EBRD) to measure progress in policy reform in the services sector, can provide some guidance in understanding whether the three countries at issue have used the GATS to commit to liberal policies or rather as a simple tool to signal their willingness to become a member of the multilateral trade governance 'club', as exemplified by the work done by Eschenbach in the early 2000s (Eschenbach, 2006). When he used the SRI to analyse the political economy of GATS commitments undertaken by a number of countries in Europe and Central Asia, including Moldova, Georgia, Armenia and Kyrgyz Republic, he found that, despite ranking higher in terms of average free sectors in comparison to other groupings (e.g. South Eastern European economies and potential EU candidates), these four countries performed poorly in the period 1995-2005 in terms of actual applied policy, which allowed him to conclude that they used their GATS commitments more as a signalling device rather than as a tool to lock in reforms (Eschenbach, 2006).

By applying Eschenbach's methodology to the three North and Central Asian countries that most recently acceded to the WTO, i.e. Kazakhstan, Russian Federation and Tajikistan, a similar conclusion can be reached. For example, the EBRD Services Reform Index shows that, in the period 2004-2015, Tajikistan continued to lag behind in terms of policy performance, in spite of a number of reforms that were implemented at the beginning of the 2010s, particularly in non-

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<sup>6</sup> The EBRD Services Reform Index corresponds to the average of three sub-indexes on banking, non-banking and infrastructural reform. Although time series for these indexes are available only until 2010, information on additional single years can still be collected through the EBRD annual Transition Report.

banking financial institutions (See Annex 2). Considering that Tajikistan has the highest proportion of sub-sectors with full commitments (37.2 per cent), in comparison to Kazakhstan (25.6 per cent) and the Russian Federation (27.7), but also the lowest SRI in 2015 (i.e. 1.9 Tajikistan, 2.9 Russian Federation and 2.8 Kazakhstan), it can be concluded that the country has done little on the reform front to reflect its GATS commitments and that, therefore, Tajikistan used the GATS as a signalling device rather than as a commitment to opening up. It could be argued that a slight improvement in policy reform registered ahead of Tajikistan's accession to the WTO should be considered as an attempt to lock-in reforms through the GATS, but the lack of real progress made ever since indicates that this is not the case.

The Russian Federation has likewise used the GATS to simply signal its willingness to become a member of the WTO 'club'. Although it is at a more advanced transition stage than Tajikistan in terms of SRI in 2015, the share of full commitments in its GATS schedule is well below that of Tajikistan, Armenia, Georgia and Kyrgyz Republic. Thus, factors other than the WTO accession may have contributed to encouraging liberal reforms in the country. Moreover, at a closer look it appears that even though the Russian Federation carried out a number of infrastructural reforms following its accession, its EBRD Services Reform Index has actually remained quite constant for the past decade, despite a relatively significant upward change in the period 2004-2006. Therefore, it can be concluded that, for this emerging economy, GATS was not necessarily an instrument to lock-in reforms.

As far as Kazakhstan is concerned, its SRI shows that the country's policy reform process is at rather advanced stage, in comparison to other countries in the North and Central region, and that a significant change has in fact occurred ahead of its accession to the WTO, a development that, in divergence with the Russian experience, can be attributed essentially to reforms in banking and non-banking services rather than in infrastructure. Still, it should be noted that this positive variation has actually partially compensated the decline that the country's SRI, and its financial services components, has actually registered in the period 2009-2014, resulting in a 2015 index value that is almost identical to its 2004 value (see Annex 2). Therefore, considering that Kazakhstan inscribed full commitments in its GATS schedule in only approximately one fourth of all services sub-sectors, and that its EBRD Services Reform Index, albeit higher than Tajikistan at 2.8, did not undergo

significant changes in the past decade, it can be argued that the country may have used the GATS agreement more as a signalling device rather than as a means to lock in reforms.

**Table 5. Services trade restrictions Index**

	<i>Armenia</i>	<i>Georgia</i>	<i>Kazakhstan</i>	<i>Kyrgyzstan</i>	<i>Russian Federation</i>	<i>Uzbekistan</i>
<b>Overall</b>	11.4	11.5	17	15.2	25.7	23.4
<b>Mode 1</b>	44.65	17.59	18.96	21.29	22.44	27.07
<b>Mode 3</b>	4.84	5.35	11.38	8.95	18.78	22.48
<b>Mode 4</b>	50	65	60	50	70	35
<b>Financial services</b>	2.6	9	22.1	8.4	46.7	24.6
<b>Professional services</b>	32	37	28	28	32	31.5
<b>Retail services</b>	0	0	0	0	0	0
<b>Telecom services</b>	0	0	25	0	50	50
<b>Transport services</b>	25	8.8	16.4	45.7	14.2	32

Source: World Bank STRI database, <http://iresearch.worldbank.org/servicetrade/home.htm>.

A closer look at the regime currently applied in several North and Central Asian transition economies shows that, in spite of the many liberal reforms implemented since the 1990s (with the sole exception of Turkmenistan), a number of services sectors tend to be still relatively closed and several services trade restrictions continue to persist. For example, according to the World Bank Services Restrictions Index (World Bank STRI database, 2016)<sup>7</sup>, which provides information on applied services trade policy, Kazakhstan is overall relatively less trade restricted than the Russian Federation, although they both fare worse than Armenia, Georgia and the Kyrgyz Republic.<sup>8</sup>

Differences emerge also across modes of supply. For instance, Kazakhstan and the Russian Federation are virtually open but with minor restrictions to cross-border trade, whereas Armenia maintains major restrictions on mode 1. All six North and Central Asian countries have a rather open regime also for the establishment of a commercial presence abroad, although the Russian Federation and Uzbekistan are less virtuous than their neighbours. On the opposite front is the approach to mode 4. Indeed, with the sole exception of Uzbekistan, with keeps a low number of major

<sup>7</sup> The World Bank's STRI provides comparable information on services trade policy measures for 103 countries five sectors (telecommunications, finance, transportation, retail and professional services) and key modes of delivery.

<sup>8</sup> Tajikistan is not included among the countries surveyed.



restrictions on mode 4, all other economies in the region maintain a highly restrictive regime on the movement of natural persons. Case in point is the Russian Federation, which toughened legislation on foreign workers (including temporary services suppliers), with language and health insurance requirements (Sorbello, 2015).<sup>9</sup>

Sector-wise, professional services are subject to relatively significant trade restrictions across all six countries, whereas financial services are virtually open in Armenia, Georgia and Kyrgyz Republic, but subject to a rather restrictive regime in the Russian Federation, which retains major limitations also on telecommunication services, but has minimal restrictions in transport services. Unsurprisingly, poor trade liberalization in consulting, telecom and banking services in Kazakhstan and Uzbekistan can be primarily blamed on the burden of the domestic regulatory environment, in combination with a high level of administrative red tape (Vakulchuk et al., 2006).

Attempts to enhance services trade liberalization have recently been made by Georgia, which has been implementing a Deep and Comprehensive Free Trade Agreement (DCFTA) negotiated with the European Union since 2014. Given that its scope extends to services liberalization, standards harmonization and trade facilitation, this DCFTA could provide greater benefits to Georgia than a shallower agreement that focuses exclusively on tariff reductions (Jensen and Tarr, 2011).<sup>10</sup> Still, only a throughout analysis of the implementation process and future EBRD Services Reform Index would allow to verify whether this agreement was actually concluded with a view to lock in reforms or, as in the case of Georgia's GATS commitments, it was merely used to signal an interest in closing ties with the European Union.

#### **4. Interest in services in North and Central Asia**

In the last twenty years, when technological progress has significantly contributed to the expansion of world interconnectivity and the shortening of geographical barriers, services have increasingly become a fundamental component of an economy, now accounting for about 70 per cent of world GDP. Countries in North and Central Asia

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<sup>9</sup> Foreign workers are now required to pass a Russian language proficiency exam and meet the requirements to enrol in health insurance schemes.

<sup>10</sup> The DCFTA with Armenia, on the other hand, was withheld because of the incompatibility of negotiations for the creation of a custom union between Armenia, Russia, Belarus and Kazakhstan.

could strongly benefit from greater openness in the services sector, because of the essential role services play in three aspects of economic development: (i) economic growth; (ii) employment; and (iii) production process. First of all, services can be instrumental in connecting suppliers with markets and individuals as well as providing access to basic needs, such as transport and education, thus contributing also to economic growth. Secondly, countries in North and Central Asia, which are abundant in human capital, could greatly benefit from increasing trade liberalization in services, because of the positive effects they can have on employment. Recent data show that services account for almost 50 per cent of total employment, experiencing a 6 per cent growth of share of services employment to total employment in the 2000-2010 decade alone (World Bank Open Data, 2016). Thirdly, services can affect the productivity of fundamental factors of production that generate goods, other services and knowledge because, like capital goods, they act as direct inputs in economic activities and determinants of overall economic efficiency (François and Hoekman, 2010).

But, North and Central Asian countries should also pay greater attention to services because they contribute to a significant degree to each of the three pillars of sustainable development, which the world community has pledged to pursue in the coming years, as exemplified by the adoption of the recent ground-breaking agreement on climate change at the 2015 Paris Climate Change Conference, and the inclusion of 17 Sustainable Development Goals in the United Nations Post-2015 Agenda.<sup>11</sup>

In consideration of the primary role that services play in an economy, it is quite striking, but not necessarily surprising, to notice how reforms in this sector have so far gained relatively little attention in transition economies in North and Central Asia. This limited interest in services can be partly attributed to the legacy of Soviet rule and central planning, which was biased against services – i.e. ‘unproductive employment’ according to Marxist thinking - and in favour of tangible inputs, such as industry and manufacturing production (Eschenbach, 2006).

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<sup>11</sup> According to the Johannesburg Declaration, adopted at the 2002 World Summit for Sustainable Development, sustainable development refers to three interdependent and mutually reinforcing pillars: economic development, social development and environmental protection.

Despite the collapse of the Soviet Union and its central planning system and the implementation of a number of market-oriented reforms, policymakers in transition economies in North and Central Asia have yet to properly consider services as an engine of growth and employment, and tend to focus their efforts in attracting natural resources seeking investments rather than other types of investments, such as efficiency-seeking FDI. As a consequence, services in the region have developed in the form of activities accessory to energy- or other natural resources-related ventures rather than as core foundations of the economy. Case in point is the development of construction services in several energy-exporting transition economies in the Caucasus region that was driven mainly by the need for adequate pipelines and other energy-related infrastructures.

The meager interest demonstrated by North and Central Asian countries in actively pursuing greater services liberalization can also be ascribed to their strong dependence on exports of natural resources, which continue to remain the primary focus of most policy action. Indeed, government intervention in the region tends to be chiefly directed at fostering energy- and mining-related exports, rather than towards a greater diversification of the economy that may comprise an increase in the share of services in GDP.

But policymakers in North and Central Asia may prefer to refrain from engaging in further services trade liberalization and remain unconstrained in an effort to preserve their policy space too. Deeper trade integration would require governments to lose part of the decision-making autonomy they have in pursuing policies that can effectively support their economic development (Mayer, 2009). Though the dilemma between further liberalization and preservation of policy space affects all governments at all times, pressure towards the latter and a surge in protectionism tend to arise more often when countries are faced with economic crisis, as it is currently the case for natural resources-based transition economies in North and Central Asia that are struggling with a sharp fall in oil prices and economic uncertainty.

## 5. The role of foreign direct investments

Using binding commitments in a multilateral or preferential setting to actually lock in reforms rather than simply as a signalling tool can be particularly important for transition economies in North and Central Asia because services liberalization contributes to increasing total factor productivity, exports and economic growth (Tarr, 2012).<sup>12</sup> Most significantly, providing market access to foreign services suppliers, primarily through the establishment of a commercial presence in the host country, allows for technology to be transferred, new services to be developed, and expertise to be introduced in the local production process. Services tend to generate more foreign direct investments (FDIs) and new jobs in developing countries, since services liberalization brings enhanced competition, innovation and economies of scale (Office of the U.S. Representative, 2006).

A closer look at the Transition Indicators developed by EBRD shows that the average level of services sector performance in transition economies in the North and Central Asian region remains considerably below the level of industrialized market economies. More specifically, in comparison to countries that became WTO Members early on, such as Armenia and Georgia, the most recently acceded (e.g. Tajikistan) or those that have yet to do so (i.e. Azerbaijan, Turkmenistan, Uzbekistan) show more limited services sector liberalization (Tarr, 2012). In other words, the latter have been slower in removing all those requirements that discriminate against foreign service suppliers and providing more transparent regulation, two important steps that would contribute to making trade liberalization a powerful tool for the creation of an attractive business and investment climate (Office of the U.S. Representative, 2006).

In their bid to improve their treatment of foreign services suppliers and modernize services, countries in North and Central Asia can make use of foreign direct investments to overcome a number of institutional hurdles: under-developed financial systems (banking and non-banking); high transport and transit costs, mainly associated with their landlocked condition and fragmented transport systems; lack of an appropriate legal and regulatory system for a market economy; and variable levels of administrative capacity (Dowling and Wignaraia, 2006).

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<sup>12</sup> Services liberalization increases the productivity of users of services in manufacturing, agriculture and services themselves.

Given the abundance in cheap and productive labour, as well as the role of FDIs in energy infrastructure as a catalyst for other related FDIs, if North and Central Asian economies were to put into place adequate reforms in the services sector, especially financial, education and transport-related services, with a view to boost trade liberalization and make domestic regulation more effective, they could greatly improve their competitiveness and, in turn, attract more FDIs, which have recently experienced a significant decline (Blua, 2011).

Since the collapse of the Soviet Union in the early 1990s, foreign investors have increasingly looked at transition economies in North and Central Asia as a potential destination of direct investments, particularly in energy-related and mining sectors. Whilst the 1990s were characterized by investments in South East Europe, in the following decade FDIs moved towards Central Asia, with a nine folds growth just in the 2000-2009 period, when the region experienced an 8.2 per cent average GDP growth (Akbar, 2012).

Transition economies in the Caucasus region, however, have not been impervious either to the world financial crisis or the economic and security difficulties that have marred their neighbours. Indeed, UNCTAD data show that, in line with the general decline in global FDI inflows, in 2014 FDI in the region dropped by 52 per cent, mainly due to security concerns, falling oil prices and international sanctions (UNCTAD, 2015).<sup>13</sup> This dip in FDI inflows hit especially hard the Russian Federation, which registered a 70 per cent decline between 2013 and 2014.

But UNCTAD data also reveal that transition economies are themselves investing abroad and, as exemplified by a number of Russian natural-resources-based multinationals, whose outward investments decreased primarily in response to low commodity prices, constraints in international financial markets and the depreciation of the rouble, their share of outward FDI did also register a decline in 2014. Among transition economies, the Russian Federation, Kazakhstan and Azerbaijan emerged as top three home (FDI outflows) and host (FDI inflows) economies in 2014, although Turkmenistan also fared high as host economy, with 3.2 billion US\$ of FDI inflows in 2014, a 3 per cent increase since 2013.

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<sup>13</sup> The sharp decline in FDI inflows in Russia in 2014 could simply be a physiological adjustment to the level reached in 2013 that resulted from the Rosneft-BP mega-transaction.

In spite of the decline in inward foreign direct investments, the shift towards services FDI has continued over the past decade, in response to a greater level of liberalization in the sector, increased services tradability and the emergence of global value chains (UNCTAD, 2015). As a matter of fact, in 2013 most greenfield FDI projects in transition economies were announced in services sectors, primarily in construction, transport, storage and communications as well as finance (UNCTAD, 2015).

## **6. Participation in global value chains**

The combination of technological progress and trade and investment liberalization, which enable goods and service to move more quickly and efficiently around the world, has been instrumental for the emergence of global production networks (UNESCAP, 2011). The range of cross-border value added business activities that are organized in interlinked stages of production for the manufacture of goods and services that straddle international borders, most commonly known as global value chains (GVCs), depend primarily on the disaggregation of production and services being traded as tasks (Cheng et al., 2015).

According to the number of stages of production that remain before reaching the final consumer and the value added provided, it is possible to distinguish between upstream and downstream activities within a global value chain. The former, which refers to the provision of intermediate inputs to other countries, tend to be higher in value added and located at a long distance from the final stage of production (e.g. design). Downstream tasks, on the other hand, involve the processing of inputs that adds lower value added and takes place at a short distance from the final stages of production (e.g. assembly) (Cheng et al., 2015).

With the exception of the Russian Federation, the participation of transition economies in North and Central Asia to global value chains, especially producer-driven and technology-intensive GVCs, is very limited, if not even almost non-existent (UNECE, 2014). This is due primarily to the region's remoteness from coordinating centres, its strong dependence on natural resources (which tend to attract the bulk of FDI), the inadequacy of the business climate, the limited size of the local market, with its weak purchasing power, and the high costs associated with

cross-border trade (Pomfret and Sourdin, 2014). It follows that, in order to increase their participation to GVCs, transition economies in the region should implement a number of reforms aimed at creating a more favourable business climate, improving the regulatory environment, implementing trade facilitation, removing existing non-tariff barriers, strengthening legal institutions, and enhancing human capital formation and technology development.

As services can contribute to almost half of the value added embodied in exports and be instrumental in enabling the development of GVCs - as well as creating value chains in their own right – North and Central Asian economies should aim at pursuing more actively a process of reform of their services sector in order to boost and intensify their participation in global value chains, especially in high value-added activities (Lanz and Maurer, 2015).

In order to determine which services sectors transition economies in North and Central Asia should prioritize, two criteria should be considered more closely: (i) the level of trade barriers; and (ii) the role of services. Trade barriers most commonly affecting services include underdeveloped financial systems, poor regulatory and business environments as well as infrastructural deficiencies. It follows that, in order to boost participation to GVCs, transition economies in North and Central Asia should first identify the type and depth of protectionism plaguing their services sector, in order to design an appropriate reform program aimed at reducing trade restrictions and enhancing liberalization in the services sectors concerned. For example, most countries in North and Central Asia are landlocked and, therefore, strongly dependent on the efficiency and well functioning of transport services and physical infrastructure. However, the majority of the economies at issue are marred by underdeveloped and inadequate infrastructures and forced to rely on transport services that are either subject to significant trade restrictions, or simply relegated to the role of transport corridor, leading to higher production and trade costs. By promoting greater liberalization in transport and construction services transition economies in North and Central Asia would be able to reduce trade-related costs and improve connections between suppliers, intermediaries and consumers, thus enabling them to enhance their international competitiveness and participation in global value chains.

The second criterion refers to the very essential role that services play in economic development and growth. A country's competitiveness is determined, among others, by the extensiveness and efficiency of its physical infrastructure, the quality of its workforce (including their health and education), the well functioning of its financial system, its openness to innovation and the quality of its business climate. In other words, transition economies can increase their competitiveness in a bid to enhance their participation to GVCs by advancing liberalization in transport, construction, health, educational, telecommunication and financial services, i.e. services that, generally provided by state monopolies in response to a public purpose, are instrumental to the functioning of other services and manufacturing sectors of the economy, thus operating as the backbone of the economy. Among the latter, priority for reform should be given to banking and non-banking services, because trade liberalization in financial services would provide firms with greater access to credit and, consequently, support the development and growth of diversified economic endeavours - including upstream activities that are greater in value added – and offer North and Central Asian economies new opportunities to better integrate in global value chains.

## **7. Policy recommendations**

The decline in economic performance and investments in North and Central Asia, combined with the paltry participation to GVCs and the still insufficient performance registered by EBRD indexes, requires transition economies in the region to launch a new reform agenda, with the aim of speeding up their transition process and improving their overall standing in world economy.

In response to the need of reducing the risks associated with the volatility of international commodity prices as well as the excessive dependence on natural resources-driven exports, North and Central Asian countries should implement, first and foremost, a number of reforms with a view to diversify the economy.

Although a rather natural course of action would seem to further advancing some of the services sectors that were initially developed simply to support mining and energy-related activities, namely a number of sub-sectors in construction, transport and financial services, priority should be given to those services sectors that embody



the foundation of the economy and upon which other services and manufacturing can flourish and develop (i.e. education, telecommunication, financial and health services), as well as to those sectors that they act as building blocks for commercial activities and everyday life and play a crucial role in fostering economic growth and competitiveness (e.g. distribution, logistics and construction services) (Office of the U.S. Representative, 2006). For example, reforms should focus on educational services, in order to capitalize on the second most important resource that North and Central Asian economies have in abundance: human capital. Skilled labour can be crucial for attracting those foreign investors that may be interested in locating part of the value chain in the region. Thus, transition economies in the region should include a reform of the educational system that focuses on liberalizing the market, favouring transfer of knowledge and fostering vocational training.

Still, no real reform progress in transition economies can yield adequate outcomes without advances in financial services (banking and non-banking) liberalization, because of the positive effects it has on production, growth, FDIs and participation in GVCs. Opening up their markets to foreign banks and non-banking entities would lead to increased efficiency and diversity in the services sector, through the introduction of new financial services, a modernization of banking techniques, an improvement in management and expertise, increased accounting and auditing transparency, and lower prices (Samman and Shahnawaz, 2013). Also, market liberalization in the banking sector would lead to a surge in interest rates that, by making savings more attractive, would encourage more borrowers to take loans to finance productive activities - other than natural resource-based endeavours - triggering a cycle of increased investments, greater participation in productive networks and GVCs, overall growth and economic diversification (Ekmekçioğlu, 2012).

But countries in North and Central Asia could also greatly benefit from the increased presence of foreign banks that may derive from a deepening in financial services liberalization. Indeed, well capitalised foreign banks can stimulate domestic investment in host countries, attract FDI - enhancing a country's access to international capitals - and offer domestic SMEs the opportunity to resort to other potential sources of loans when adverse conditions may lead domestic banks, which

often rely on government revenues to operate, to reduce their credit supply (Stichele, 2014).

Clearly, financial services liberalization must also be accompanied by a process of reform on domestic regulation, with a view to increase the efficiency, transparency and reliability of the regulatory environment and ensuring that benefits arising from market access liberalization are not hampered by burdensome or trade restrictive rules and regulations.

Finally, governments would also greatly benefit from a reform process that is aimed at increasing transparency and reducing the pressure exerted by the government, in order to improve the business climate. Currently, the competitiveness of domestic companies in North and Central Asia, especially small- and medium-sized enterprises, is strongly affected by the persistent asymmetry of information with respect to knowledge of foreign markets and the extensive use of informal channels and governmental connections to develop cross-border trade. Greater transparency and the institutionalization of formal channels would contribute to improving the general business environment and attracting foreign investors, whose investments can be crucial to help the economies in the region to participate more actively to GVCs.

## Appendix

### Annex 1. Depth of commitments

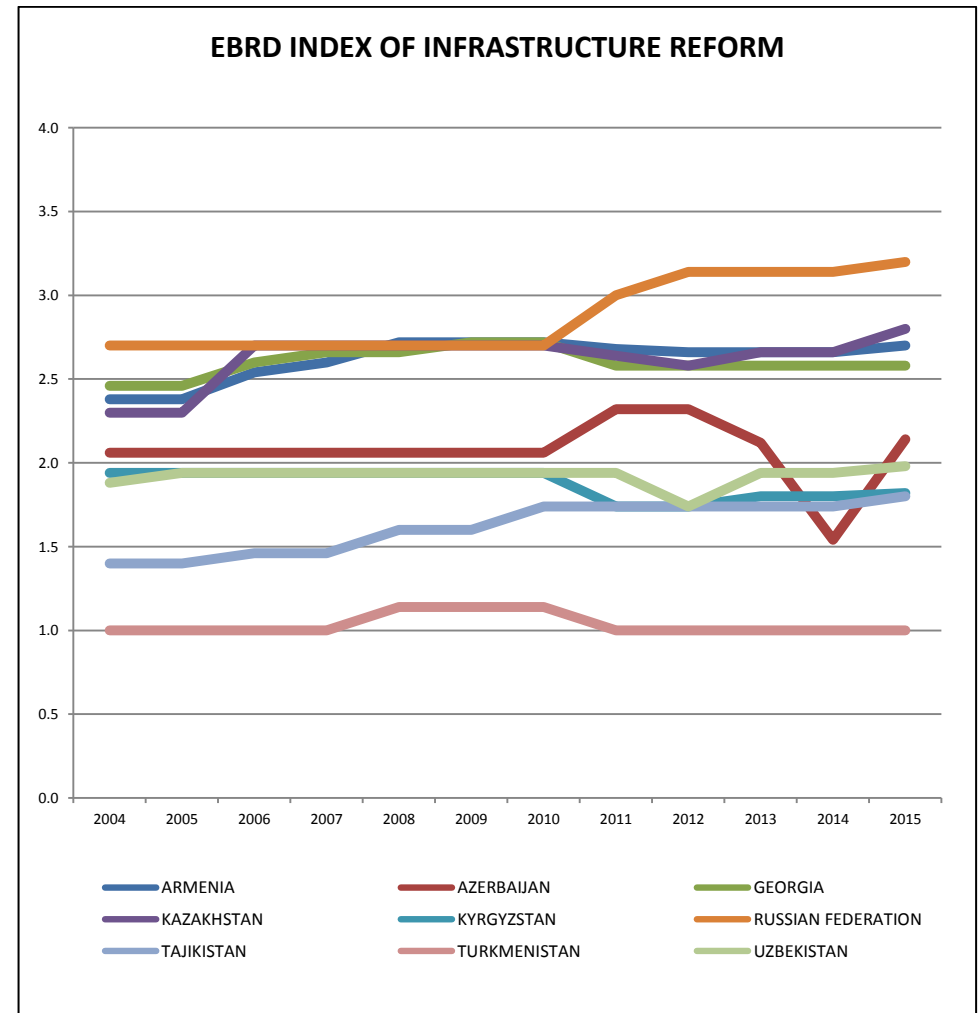
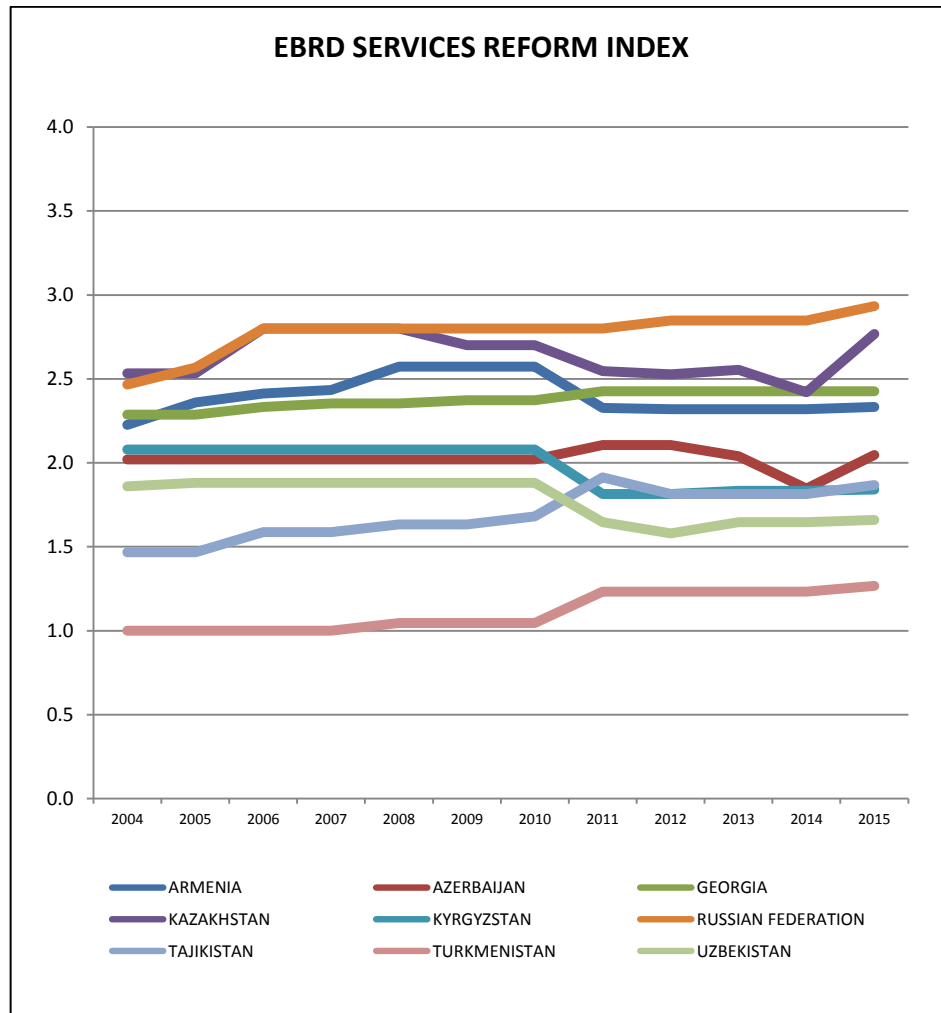
Kazakhstan								
	Market Access				National Treatment			
	Mode 1	Mode 2	Mode 3	Mode 4	Mode 1	Mode 2	Mode 3	Mode 4
<b>% FREE</b>	37.4%	51.0%	14.2%	0.0%	37.4%	51.0%	13.5%	0.0%
<b>% PARTIAL</b>	15.5%	15.5%	52.3%	0.0%	14.8%	15.5%	52.3%	0.0%
<b>% UNBOUND</b>	47.1%	33.5%	33.5%	100.0%	47.7%	33.5%	34.2%	100.0%

Russian Federation								
	Market Access				National Treatment			
	Mode 1	Mode 2	Mode 3	Mode 4	Mode 1	Mode 2	Mode 3	Mode 4
<b>% FREE</b>	37.4%	62.6%	19.4%	0.0%	34.2%	58.7%	9.0%	0.0%
<b>% PARTIAL</b>	27.7%	9.7%	52.3%	14.2%	31.0%	12.9%	61.3%	1.3%
<b>% UNBOUND</b>	34.8%	27.7%	28.4%	85.8%	34.8%	28.4%	29.7%	98.7%

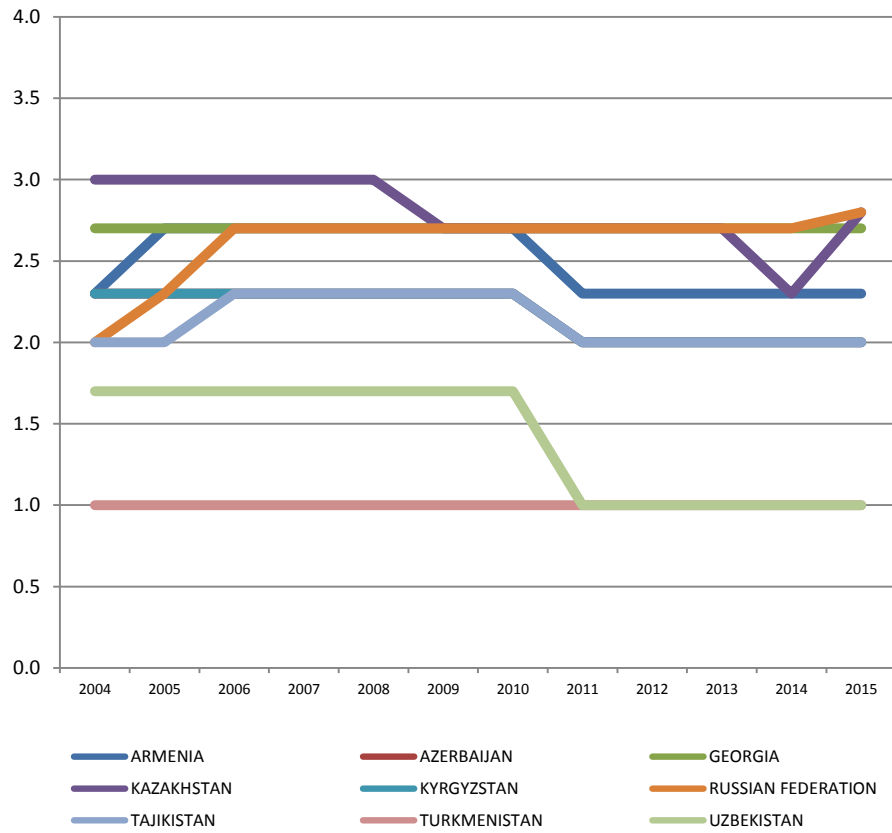
Tajikistan								
	Market Access				National Treatment			
	Mode 1	Mode 2	Mode 3	Mode 4	Mode 1	Mode 2	Mode 3	Mode 4
<b>% FREE</b>	56.8%	65.8%	0.0%	0.0%	64.5%	66.5%	43.9%	0.0%
<b>% PARTIAL</b>	8.4%	1.9%	67.1%	0.6%	0.6%	0.6%	23.2%	0.0%
<b>% UNBOUND</b>	34.8%	32.3%	32.9%	99.4%	34.8%	32.9%	32.9%	100.0%

*Source: Author's elaboration based on methodology illustrated by Eschenbach (2006)*

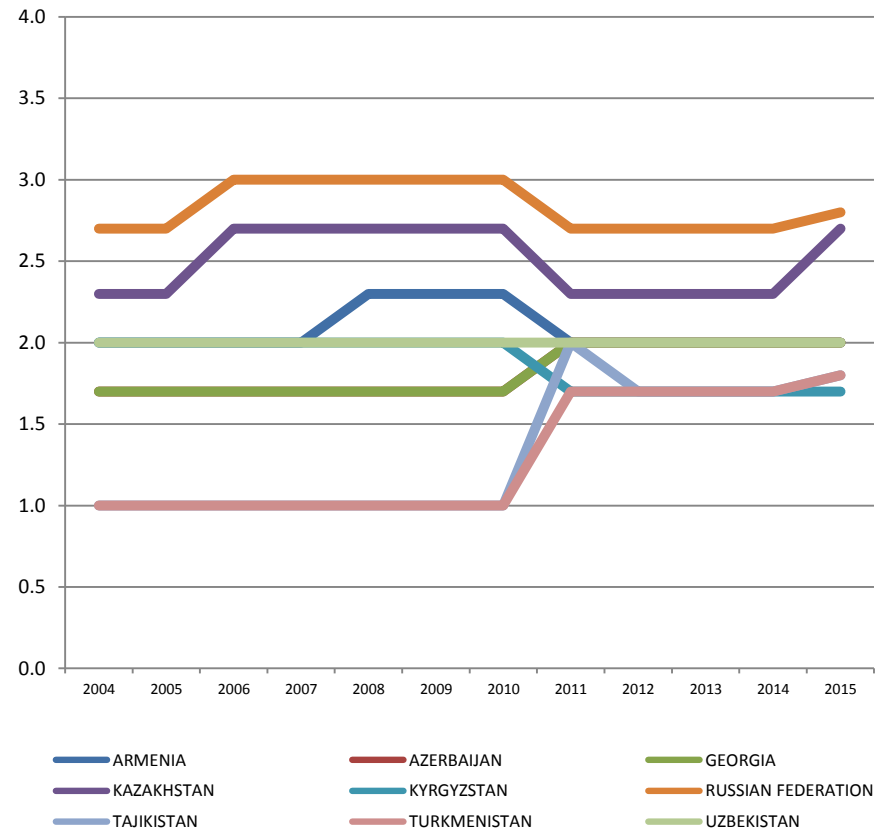
## Annex 2. EBRD Indexes – Transition economies (2004-2015)



**EBRD INDEX OF BANKING SECTOR REFORM**



**EBRD INDEX OF REFORM OF NON-BANK FINANCIAL INSTITUTIONS**



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