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Issues Paper

Foreign Investment in Central Asia: Actors and Drivers

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Asia-Pacific • Africa • Eurasia • Latin America • MENA

Contents

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Forward

This is ITIC's fourth report in as many years on Central Asia that we have published as part of our Energy, Growth, and Security Program. Central Asia is increasingly attracting attention as a rich, rapidly developing region connecting Eastern Europe with Asia. ITIC has worked in Central Asia alongside local partners since 1993, focusing on tax and investment reform.

Central Asian countries have significantly improved regional prosperity and quality of life over the past 30 years, with varying degrees of growth across the former Soviet republics. Governments who made notable steps to liberalize their economies, encourage domestic capital formation and entrepreneurship, and welcome foreign investment have fared strikingly better. In many ways, these reforms have gone hand-in-hand with increasing life expectancy, alleviating poverty, and revitalizing human capital, as indicated by World Bank statistics.

The last 30 years of transformational growth have delivered for the people of Central Asia progress and prosperity. This report examines the policies that have helped to fuel that growth. At the same time, Central Asia has numerous country-specific and region-wide challenges that each nation must address in order to achieve its developmental potential.

In 2020, Central Asia implemented a total of 13 reforms in the World Bank's Doing Business 2020 study. Kazakhstan held steady as the region's top performer, ranking 25th globally. Uzbekistan and Tajikistan are among the top global improvers, ranking 69th and 106th globally — seven and 20 positions higher than their respective 2019 rank. The Kyrgyz Republic, meanwhile, dropped from its rank of 70 to 80 in 2020.

Growth-friendly reforms including easing access to credit; increasing minority shareholders' rights; contract enforcement; and simplifying cross-border trade, tax regimes, and payment systems; and the degree to which they have been implemented have produced primarily positive results across the Central Asian republics. Increased economic diversification away from fossil fuels, eliminating corruption, and addressing deficiencies in human capital must continue.

Furthermore, government leaders need to be more willing to open their economies to the world as the COVID-19 crisis comes under control. The rapid economic expansion of China and other nearby countries creates an unprecedented opportunity for Central Asia to emerge as a hub for trade and commerce, but over-reliance on China, as seen in the case of Turkmenistan, can prove dangerous. By investing in the education and civic infrastructure of their people, the nations of Central Asia will increase their economic productivity and overall participation in the labor market. If addressed properly, the additional challenges posed by the coronavirus pandemic could result in a more prosperous Central Asia.

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I. Introduction

The nations of Central Asia, independent from Soviet rule for the past 30 years, have a challenge: they must shed their reputations as resource-rich yet politically risky economies in order to attract foreign investment. Despite largely progressive transformations from central planning to market-oriented economic systems since 1991, the Central Asian Republics (CARs) of Kazakhstan, Turkmenistan, Tajikistan, the Kyrgyz Republic, and Uzbekistan share a lingering Soviet legacy of command-style economies, bureaucracy, and rampant corruption. Only Kazakhstan and arguably Uzbekistan have achieved "market economy" status, with Turkmenistan, Tajikistan, and the Kyrgyz Republic lagging behind. Though the region is not monolithic, the commodity and remittance-dependent growth strategies so prevalent across the CARs are now under the greatest pressure since the collapse of oil prices in 2014 – this time due to the coronavirus pandemic.

Central Asia's economy is projected to shrink by an average 1.7% in 2020, a massive reversal from pre-pandemic growth projections of 4-6% made in October 2019 by the World Bank and the OECD.[1] Global lockdown measures deployed in May 2020 led to a sharp decline in the region's exports, with subsequent contractions in services and manufacturing.

Economies with the closest trade, commodity, and remittances relationships with the Eurozone, Russia, and China saw a disproportionate impact from the COVID downturn. OPEC+ production cuts to buoy crude oil prices in tandem with collapsing demand for transportation fuels compounded national revenue issues in hydrocarbon exporters like Kazakhstan and, to a lesser extent, Turkmenistan and Uzbekistan. Price and demand drops for feed stocks (natural gas and petroleum) and industrial power sources (natural gas and coal) further hurt national economies. In Kazakhstan and Uzbekistan, robust fiscal stimulus packages of 9% and 1.5% of GDP respectively helped curb economic slowdowns and better positioned those countries for recovery.

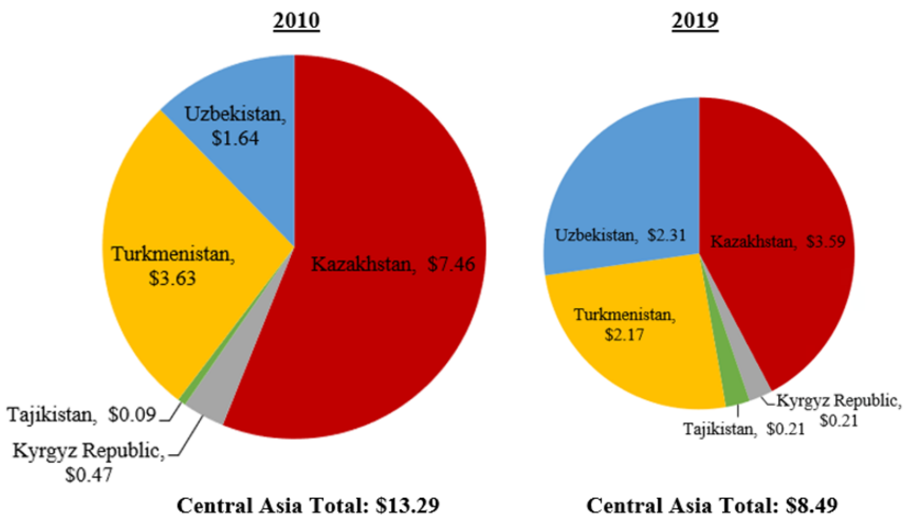
COVID-19 also highlights the vulnerability of the extractive/remittance-dependent economic model, a system that brings with it the slew of social, political, and economic risks that remain barriers to outside investment. Concerns over governance, protectionist trade policies, and private sector competition are also front-and-center in the eyes of potential investors. If there is a silver lining to the global pandemic, it is the clarity in barriers to economic development and the reinvigorated interest in accelerating Central Asia's economic transition away from fossil fuels, raw materials, and remittances towards knowledge-based industries.

While the strength of regional recovery is uncertain amidst the pandemic, the World Bank is anticipating 3.1% growth throughout 2021, providing for a moderate rise in commodity prices. A "downside scenario" of sustained low commodity prices and weaker than anticipated demand could mean growth closer to 1.5%. The ability of the CARs to attract foreign direct investment (FDI), be it from China's anticipated two trillion dollar, thirty year-long Belt and Road Initiative (BRI), Russia, the Eurozone, U.S. International Development Finance Corporation (DFC), international financial institutions (IFIs), or the private sector will also play a significant role in the region's recovery efforts.

Central Asia offers a number of valuable assets to the global business community. The region is increasingly attractive, not least because of its strategic location between Europe and South/East Asia. With the recent establishment of the Regional Comprehensive Economic Partnership (RCEP), the Central Asian nations will play an increasingly significant role as trade partners of member states.[2]

Diverse natural resources, plentiful human capital, a burgeoning small and medium-size enterprise (SME) sector, and emerging tech and financial centers are beginning to draw investors' attention. In the wake of COVID-19, Central Asia's more advanced economies are pursuing policies of economic diversification and advancement accompanied by structural reforms intended to invite further investment — with some making annual progress in the World Bank's "Ease of Doing Business" index.

i. Foreign Direct Investment Net Inflows in Central Aisa (USD Billions)



* *Data sourced from World Bank Open Data, 2020*

The CARs have shown varying degrees of success in their efforts to pursue business-friendly reforms and improve their respective investment climates. FDI inflows from all sources have struggled to regain their strong growth trajectory in Central Asia prior to the implosion of energy prices in 2014. However, as documented in previous reports by the International Tax and Investment Center (ITIC) including *"Soft Infrastructure Development in Central Asia 2020"* and *"Post COVID-19: Building Resilience in Central Asia,"* the CARs are enacting a host of monetary, fiscal, tax, and regulatory policy adjustments that have put them well on their way to shaking off their Soviet-era legacies. There exists a tremendous potential for international investment inflows into the region.

Foreign direct investment** is a key driver of international economic integration. With the right policy framework, FDI can provide financial stability, promote economic development and enhance the wellbeing of societies. According to the OECD Handbook:

> *Foreign direct investment (FDI) provides a means for creating direct, stable and long-lasting links between economies. Under the right policy environment, it can serve as an important vehicle for local enterprise development, and it may also help improve*

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* World Bank Foreign direct investment calculations: sum of equity capital, reinvestment of earnings, and other capital. World Bank defines direct investment as category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy. Ownership of 10 percent or more of the ordinary shares of voting stock is the criterion for determining the existence of a direct investment relationship. Data are in current U.S. dollars.

** The authors of this report, in order to better compare varying FDI metrics across countries, consider financing from international financial institutions (IFIs) as foreign direct investment despite minor definitional discrepancies between these organizations and recipient governments.

the competitive position of both the recipient ("host") and the investing ("home") economy. In particular, FDI encourages the transfer of technology and know-how between economies. It also provides an opportunity for the host economy to promote its products more widely in international markets. FDI, in addition to its positive effect on the development of international trade, is an important source of capital for a range of host and home economies.[3]

How the nations of Central Asia manage the post-COVID recovery, and the extent to which they embrace economic diversification and pro-business policy reform, will determine the future of their foreign investment profiles.

II. Country Overview

1. Kazakhstan

A. Overview

Since its independence in 1991, Central Asia's largest and wealthiest country has made steady and concerted efforts toward a diversified market economy, becoming a top destination for foreign investors. Reforms introduced in 2019 under President Kasym-Jomart Tokayev included easing access to credit, providing public access to court rulings, registering new companies for value-added tax at the time of incorporation, and creating a new electronic customs declaration system (ASTANA-1 IS). These efforts earned Kazakhstan a ranking of 25th worldwide in the World Bank's 2020 Doing Business Report.

While this growth is impressive and encouraging, there is ample space for improvement. The business community remains concerned about corruption, red tape, and arbitrary administrative measures. Increased efforts to bolster transparency and accountability will be essential as Kazakhstan sheds perceptions of corruption.

In October 2020, the Kazakh government and USAID agreed to launch a five-year program with the goal of boosting judiciary independence and establishing a transparent legal environment for individuals, businesses and civil society organizations.[4] Such efforts stem from the government's active dialogue with foreign investors through the President's Foreign Investors Council and the Prime Minister's Council for Improvement of the Investment Climate. In 2019, Kazakh courts demonstrated an above-average performance in case resolution, keeping the average number of days to resolve a dispute well under the regional and world averages, 370 compared to 590 (global).[5]

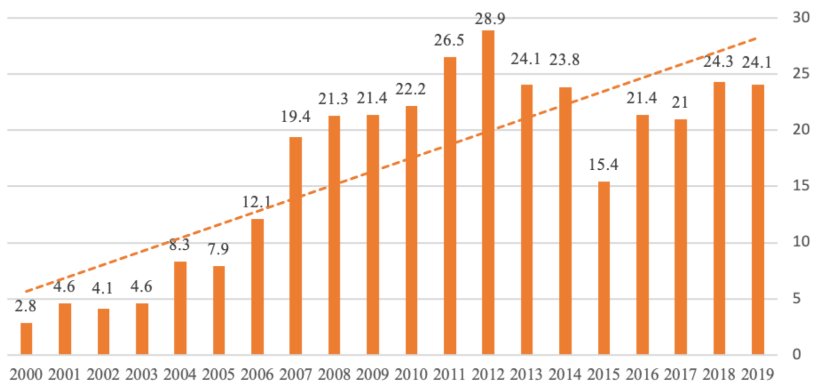
Despite the pandemic and declining oil prices, the Kazakh economy has proven comparatively resilient. Kazakhstan registered a 1.8% contraction in GDP in the second quarter of 2020, after a 2.7% expansion in the year's first quarter, faring better than the World Bank's prediction of -3% for the year.[6] Inflation is expected to remain above the Central Bank's 6% target following the 12% depreciation of the Kazakh tenge since the beginning of the year. Kazakhstan has maintained its BBB credit rating with Fitch throughout the pandemic period.[7]

The Deputy Minister of Foreign Affairs Almas Aidarov announced in October that the Kazakh government had developed three-year investment programs for 66 strategic foreign institutions.[8] The programs seek to forecast the volume and sectoral make-up of investments flowing from source countries. The minister stated that agriculture, mining and metallurgy, and container transportation were areas of mutual interest for investors and the government. The program also allows potential investors to establish investment contracts online on the government website (egov.kz). From January to October 2020, 20 such contracts had been established via the online platform for a value of nearly $700 million. Such measures showcase the government's role in minimizing and mitigating the negative impacts of COVID-19.

B. Kazakhstan's FDI Profile

Kazakhstan's considerable natural resources form the backbone of its economy, with oil and gas revenue making up 17.1% of GDP in 2018.[9] FDI is concentrated in the extractive industries, and attracting foreign investment outside these areas continues to present a challenge. Over 56% of FDI was dedicated to natural resource extraction in 2019, followed distantly by manufacturing (14%).[10] Despite being highly concentrated, FDI inflows have proven resilient through the post-commodity-boom period, and Kazakhstan weathered the 2018 slowdown better than its neighbor Russia.[11]

1.A. Gross FDI Inflows, 2000-2019 (USD Billions)



Data sourced from Kazakh Invest National Company

Oil investment's focal point is the Kashagan offshore oil field, Kazakhstan's most productive site and the fifth largest oil field in the world. It is expected to play a major role in Kazakhstan's future oil production, with a projected output of 955,000 barrels per day by 2025.[12] The country's current oil-refining capacity is small in comparison to oil extraction. However, a Chinese-Kazakh project to build an oil refinery in Shymkent worth $2.1 billion is estimated to be ready as soon as 2021.[13]

Copper and uranium are the centerpieces of Kazakhstan's mining sector. While Kazakhstan is the world's largest producer of uranium, copper provided $2.6 billion from exports in 2019 compared to $1.5 billion from uranium the same year. Overall, ore mining investment increased by 60% in 2019 from 2018.[14]

Mining companies KAZ Minerals and Vostoktsvetmet are the main domestic participants in copper mining with more than $1 billion in combined revenue in 2019.[15] Foreign companies with assets in Kazakhstan include Glencore (Switzerland), Rio Tinto (UK), Iluka Resources (Australia), ArcelorMittal (Luxembourg), Yildirim Group (Turkey), and Russia's Russian Copper Company and Rusal.

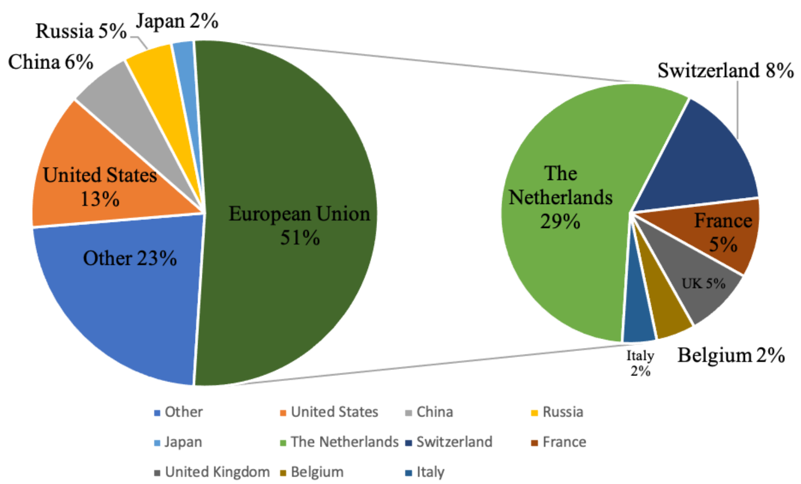
In 2019, Kazakhstan accounted for 43% of the world's total uranium production and 51% of global exports. State-run Kazatomprom, which went public in 2019, is the world's top uranium producer, accounting for 21% of the world's production. The company claims to have the largest reserves in the industry.[16] Foreign companies also participate in Kazakhstan's uranium mining industry as partners of Kazatomprom. Multinational Orano owns a stake in Kazakhstan's largest uranium mining complex, Moinjum and Tortkuduk. Canada's Uranium One is a part owner of the Budenovskoye mine, while its counterpart Cameco holds a 60% stake in the Inkai uranium mine.[17]

The EU is Kazakhstan's largest investor, followed by the United States. EU countries accounted for more than half of Kazakhstan's $295.6 billion in total gross FDI from 2005 to 2019. The Netherlands holds a particularly large share, with over 800 Dutch-Kazakh joint ventures operating in Kazakhstan.[18] Despite strong political ties with neighbors China and Russia, both countries play more predominant roles as trade partners than as investors. China accounted for only $400 million in FDI in 2019, even while counting Kazakhstan as central in the Belt and Road Initiative.[19] Kazakhstan has actually aligned its own plans for infrastructure improvement with those of China through its own Nurly Zhol infrastructure program, which aims to repair nearly 50,000 km of roads by 2025.

As of November 2019, there were 55 joint Kazakh-Chinese projects worth $27.6 billion in various stages of implementation.[20] Since 2015, 15 projects have been completed with a cumulative value of $4 billion, including the Astana International Financial Center (AIFC), the Astana International Exchange (AIX) in 2018, and the Khorgos dry port on Kazakhstan's eastern border with China. Eleven projects, including newly operational wind and solar power plants as well as the groundwork for a light rail transit system in Nur-Sultan are valued at $3.7 billion. The other 29 projects are still in planning stages.

Kazakhstan has managed to successfully develop public-private partnerships (PPP). The country's Public Private Partnership Center (PPPC) lists over 800 projects worth $2.7 billion as of 2020. The PPPC follows a common law legal framework designed to attract and regulate foreign investment. However, Kazakh PPPs have received criticism for inefficiency and allegations of corruption, which President Tokayev acknowledged in 2019, stating that the government mechanism for PPPs had been discredited.[21] A new PPP legislative and regulatory framework needs to be developed and implemented immediately.

1.B. Gross FDI Inflows by Country of Origin, 2005-2019



Data sourced from Kazakh Invest National Company

The Astana International Financial Center was created with the goal of boosting Kazakhstan's position and reputation as a regional financial hub, operating within a special legal regime based on common law to facilitate cross-border contracts; it also has its own court, staffed by top international lawyers. Reforms have been undertaken to simplify the tax regime and expand investment tools for foreign companies investing through the AIFC and the AIX.[22]

As foreign investment in Kazakhstan has become easier and more secure, investment volume has also increased. From 2015 to August 2020, the Almaty-based KASE stock market's index rose 172%. The AIFC has grown to a list of 500 companies from 35 countries, 70 of which were registered during the pandemic period. Kazatomprom made its IPO on the AIX and London Stock Exchanges in 2019, raising $451 million. In October, Kazakh fintech company Kaspi opened on the AIX and London exchanges, hauling in $6.5 billion.[23] Despite the country's growing financial sector, action on domestic exchanges has slowed recently due to COVID-19. Major state-owned companies KazMunaiGas, KazakhTelecom, and Samruk Energy were all meant to sell shares on the AIX for the first time in 2020. However, none of the companies have announced a start date, and KazMunaiGas has postponed until 2022.[24]

Kazakhstan has 13 special economic zones (SEZs). SEZs offer exemptions from corporate income and land taxes for 10 years, 0% property tax for eight years, and investment subsidies of up to 30% for construction projects.[25] Each zone is equipped with sector-specific infrastructure assets, ranging across the agro-industrial, services, metallurgy, mining, and tech sectors, with the latter aimed at the formation of high tech and IT clusters that will accelerate innovation.[26]

International financial institutions play a prominent role in Kazakhstan's ongoing economic development. The European Bank of Reconstruction and Development (EBRD) has provided $12.3 billion across nearly 750 projects since the country's independence. The Asian Development Bank (ADB) had invested $5 billion in Kazakhstan as of 2019, with $2 billion invested in upgrading the country's transport infrastructure.[27] The World Bank maintains a portfolio of 13 projects worth $3.7 billion, in addition to $500 million allocated in October to support the development of Kazakhstan's livestock sector.

C. Outlook

Although great strides have been made in modernizing the Kazakh economy, challenges remain. Beginning with the most obvious, hurdles to overcome include rebounding from COVID-19, persistent low prices for fossil fuels, longstanding albeit declining corruption, and lingering deficiencies in human capital.

Kazakhstan's massive land area and inadequate infrastructure present investment opportunities, especially for institutional investors with tolerance for long-term project rewards. Challenges presented by rugged terrain, long distances, and lack of ocean access will likely become less significant in years to come. While not officially part of China's BRI project, the success of the Nurly Zhol infrastructure development program resonates with China's national interests, giving it a virtual guarantee of success.

Kazakhstan's GDP has grown at a vigorous rate since independence, outpacing its Central Asian neighbors. While having become an upper middle-income country is a great achievement, it also poses a substantial obstacle. To escape the middle-income trap and transform its economy from extractives-based to knowledge-based, Kazakhstan will need higher levels of technology and human capital. Pessimistic forecasts for the extractive sector of up to -70% earnings in 2020 should serve as motivation to accelerate economic transformation.[28] With this in mind, investment in Kazakhstan should be geared toward non-extractive industries and aligned with the government's stated diversification plans. Kazakhstan's 2020-2025 Strategic Plan outlines objectives to tap the manufacturing, agribusiness, and green energy industries as diversification champions.

Chemical manufacturing was named a priority sector in 2019 by the national investment company Kazakh Invest. The government aims to steer investment toward production of fertilizers, petrochemicals and household consumer chemicals by offering innovation grants of up to $450,000 as well as preferential lending conditions of up to $5.5 million for foreign companies investing in these areas.[29] In addition to government incentives, Kazakhstan can leverage its cheap industrial inputs and proximity to large export markets in Central Asia, Eurasian Economic Union (EAEU) member states, and China.

Kazakhstan's agricultural sector is resource-rich, and, if modernized, could be a boon for exports. Kazakhstan ranks 6th globally for its amount of arable land, yet only about 30% is dedicated to agriculture. Even so, Kazakhstan is one of the world's top per capita wheat producers.[30] Local production of agricultural machinery is insignificant and nearly 90% of machinery is at the end of its lifecycle.[31] With additional investment in agricultural technology, Kazakh food exports could experience a boom.[32]

The outlook for extractive industries overall is a guarded one, but the country's staples — copper and uranium — possess promising outlooks when viewed in isolation. Copper is the third most-used metal in the world, and Kazakhstan is conveniently located between the world's largest copper importers: China, Japan, India, South Korea, and Germany.

While the uranium market has been depressed for years, prices are up 18.7% for 2020.[33] Demand for uranium is projected to increase by 25% by 2025 due to Asia's growing nuclear energy industry. New nuclear power plants are planned in Russia and throughout Asia, which will require Kazakhstani uranium. Furthermore, attitudes about nuclear power plants in the rest of the world are changing due to its potential to generate zero emissions energy. The U.S. DFC recently aligned its definition of renewable energy with that of the U.S. Energy Information Administration. The policy shift means the DFC could begin supporting nuclear energy, ending a legacy prohibition on support for nuclear power projects.

Production of renewable energy is possible in Kazakhstan, as high solar irradiance and strong winds across the Kazakh Steppe make the country well suited for the deployment of renewable energy technologies. Estimated potential for wind power is 920 billion kWh/year, and solar power could provide 2.6 billion kWh/year, with another estimated 4 GW of geothermal power that could be drawn from water in artesian pools.[34]

To maintain the solid growth trajectory Kazakhstan has built since independence, leadership must prioritize a speedy and efficient transition away from a fossil fuel-based economy. Capital should be directed to areas in which Kazakhstan can compete regionally and globally, including agriculture, food processing, chemical manufacturing, and renewable energy production. Considering the country's already well-developed mining industry, resources should be dedicated to modernizing mining equipment and practices to align with sustainability benchmarks.

Kazakhstan must assert its role in global value and supply chains through smart investment and reforms, charting a path that will position its economy for success as the world emerges from the global pandemic. By aligning its goals with those of its established investment partners, Kazakhstan will be able to maintain these ties throughout the energy transition and economic diversification and restructuring.

Updating its infrastructure in line with the goals of the BRI will also reaffirm Kazakhstan's value as a key link in regional and global supply chains. While Kazakhstan still ranks 124th in Transparency International's Corruption Perceptions Index, recent reforms and the peaceful transition of power to President Tokayev should serve as reassurance that a politically stable future lies ahead. Kazakhstan has proven relatively resilient in the face of COVID-19 and the resulting economic recession. If it can maintain this pace throughout the recovery period, it will come out ahead of regional competitors and will have demonstrated its commitment to the government's goal of becoming one of the world's 30 most developed nations by 2050.

2. Turkmenistan

A. Overview

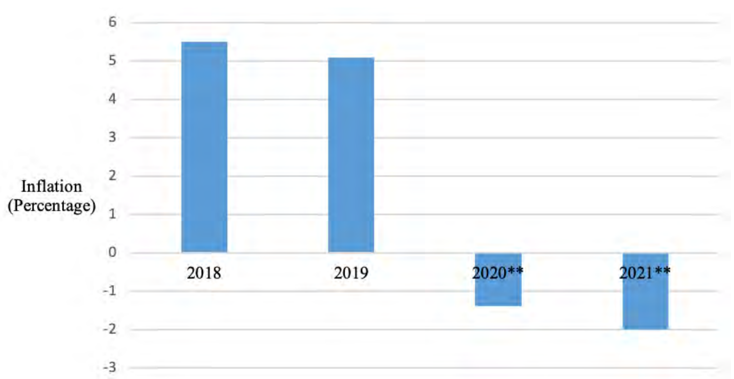
While Turkmenistan's overall economic profile suggests an economy potentially capable of attracting significant FDI inflows, the government's near-totalitarian rule and endemic corruption continue to discourage investors. The country currently holds the second highest GDP per capita in Central Asia, and it is forecasted to grow by 3.2% by the end of 2020 and 5.8% in 2021.[35] These macroeconomic indicators are appealing on the surface, but Ashgabat's announcement that exports are likely to decrease by 25% this year in light of falling oil exports serve as a major blow to national revenue.[36] Constraining political and economic conditions amplified by COVID-19 pose significant obstacles to moving forward.

The primary challenge facing Turkmenistan is its heavy reliance on exports. Ninety one percent of its national exports are from extractive hydrocarbons, mainly natural gas; 83% of exports are directed to China, with gas exports to the PRC making up 80% of Turkmenistan's GDP.[37] This high level of dependency on a single sector and a single trading partner for generating economic revenue is monopsonic.[38] In March 2020, PetroChina, a major buyer of natural gas from Turkmenistan, cut planned gas purchases after China issued a *force majeure* note in order to free the oil giant of all liabilities.[39] High budget deficits and a dependency on China suggest Turkmenistan will be incapable of meeting payments for prospective investments. Barriers to further investment opportunities remain high, and comprehensive economic reforms are necessary but unlikely in the near future. In order to benefit from FDI inflows, Turkmenistan's government must demonstrate better governance, cut red tape, ensure diversification and suitable funding distribution, and lower risks for not meeting payments for finished contracts.

B. Turkmenistan's FDI Profile

The energy industry dominates Turkmenistan's large-scale infrastructure plans, with 66% of $32.3 billion in investments dedicated to natural resource extraction projects this year.[40] Manufacturing and transportation accounted for 25% and 9% of funding investment respectively, exemplifying the significant imbalance in sector funding within the country. More and more companies have been forced to leave the market due to government defaults on accounts payable. In 2018, Cakiroglu Grup (Turkey) stopped operating in Turkmenistan due to the government's inability to pay for completed contracts.[41] This incapacity is a result of poor financial discipline, including a five-year budget deficit that reached -1.4% of GDP in 2020.[42]

2.A. Turkmenistan: Current Account Balance by Inflation (Percentage), 2018-2021



Data sourced from Asian Development Outlook (ADO) 2020 Update

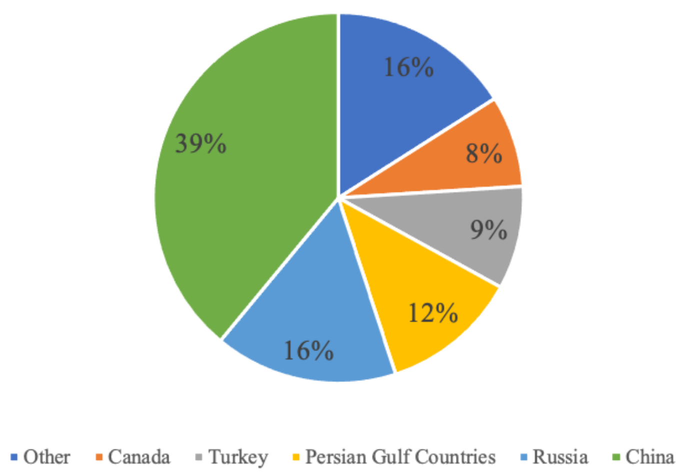
*** Forecasted*

With this in mind, the government is seeking ways to diversify its economy, with the hopes of cultivating foreign technology and investment of up to $10 billion for the development of petrochemical and other industrial facilities. The state-owned chemical company Türkmenhimiya has created a five-year development program and intends to invest $2 billion in the production of nitrogen and phosphorus fertilizers, caustic soda, chlorine, iodine, and bromine products.[43] The private company Türkmen also intends to invest $4 billion in a large-scale polyolefin plant in the village of Kiyanly, the site of the country's first gas-chemical complex.

Turkmenistan's investment climate poses significant barriers to entry, primarily due to complex regulations and unfavorable business practices. The Heritage Foundation's research reveals that FDI restrictions in Turkmenistan are the highest in Central Asia and openness to foreign investors is low; the country was ranked 164th worldwide in terms of economic freedom in 2019.[44]

Restrictions on FDI inflows come from exhaustive state control over markets and draconian restrictions on exchange rates. In January 2013, the government founded the Agency for Protection from Economic Risk to oversee international investments and review foreign companies wishing to enter Turkmenistan's market.[45] The government's failure to respect contract law and inability to convert local currency for repatriation of profits have also led foreign businesses to balk on investment. In September 2017, telecom provider MTS suspended its operations after the state-owned company Turkmen Telecom cut it off from the network over an alleged expired license.[46] The government similarly expropriated the only foreign-owned grocery store in Ashgabat without compensation or other legal remedy in 2016.

2.B. Contribution to Turkmenistan FDI by Country (Percentage), 2012



Data sourced from Asian Development Bank Institute

Turkmenistan's largest share of investments belong disproportionately to China, followed by Russia and the Persian Gulf countries. The extent to which Turkmenistan relies on China goes beyond trade as the country plays a key role in the Belt and Road initiative, with Chinese investment primarily pouring into the gas sector, co-financing pipelines and refineries.

China National Petroleum Corporation (CNPC) signed a production sharing agreement in 2007 to explore and develop gas fields on the right bank of the Amu Darya, as well as a natural gas sale-and-purchase agreement with the Turkmen State Agency for Management and Use of Hydrocarbon Resources. The agreement requires Turkmenistan to export 30 billion cubic meters of natural gas to China annually for 30 years through four pipelines, meeting Chinese demand to engage in the gas-for-coal power generation transformation strategy to reduce its air pollution.[47] The volume of investment projects in Turkmenistan by CNPC, the only foreign company that has direct access to the country's on-shore gas fields — including Galkynysh, the second-largest gas field in the world — amounts to $7 billion.[48]

Japan and South Korea have begun to invest in Turkmenistan, signaling a step closer to diversification of FDI inflows. These investments are primarily in industrial facilities for processing petroleum products, in which the Japan Bank has invested a total of $1.7 billion.[49] Furthermore, Kawasaki Heavy industries has launched the world's largest gas-to-gasoline (GTG) plant in Turkmenistan in June 2019.[50] Increased economic diversification will be necessary to attract more FDI inflows, as the failure to meet payments for finished contracts is expected to worsen throughout the pandemic.

C. Outlook

COVID-19 has stressed the deficiencies that exist within Turkmenistan's investment climate, amplifying the need for macroeconomic reforms which would reduce constraints on investment activities. Reliance on Chinese investment as the principal contributor to FDI inflows makes Turkmenistan vulnerable to any disruption to that singular relationship, further made clear by recently delayed Chinese outbound investment and construction.[51] While Chinese demand has rebounded to some extent, gas exports are still down 30% year-over-year, posing a significant challenge for Turkmenistan's management of its budget deficit.

In order to avoid such circumstances moving forward, Turkmenistan needs to cultivate FDI inflows from other sources such as the U.S., the EU, ASEAN, and the Gulf States. Competition in the transportation and digitalization sectors is relatively low and could potentially be expanded. Without such diversification, continued proclivity to corruption and government incompetence would further cripple the economy, turning Turkmenistan into an unviable investment destination. While Ashgabat seeks western corporate investments for credibility purposes, such endeavors can only occur through established partnerships with local firms who understand the cultural and bureaucratic landscape of Turkmenistan's business climate. Turkmenistan will have great difficulty attracting new FDI inflows if it does not decisively address the vagaries of its state-run economy.

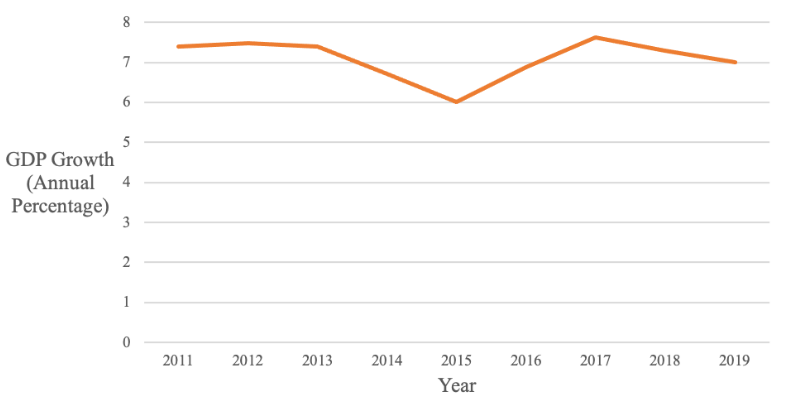
3. Tajikistan

A. Overview

The twin shocks of post-Soviet transition and a devastating civil war led Tajikistan's economy to contract by 60% in its first five years of independence.[52] Three decades later, enduring poverty and instability, limited agricultural and industrial production, low wages, and a deeply corrupt economic system continue to plague the nation's economic prospects. As such, the isolated country has struggled in vain for three decades to achieve economic independence, with its rise as a remittances-based major exporter of labor serving as a substitute for domestic production of goods and services.

Tajikistan's economy is perilously reliant on remittances, which amounted to roughly $2.5 billion and 33% of GDP in 2019.[53] The December 2014 collapse of the Russian ruble, a result of the war in Ukraine, the annexation of Crimea, and ensuing western sanctions contributed in part to reduced financial inflows. The crisis resulted in Tajikistan's increased reliance on China.

3.A. Tajikistan: GDP Growth (Annual Percentage), 2000-2019



Data sourced from World Bank Open Data, 2020

Tajikistan's GDP growth rate has remained at around 7% for the past decade.[54] The National Bank stated in July that, due to COVID-19, GDP growth had only risen to 3.5% in the January-June period, down from 7.5% in the same period in 2019. The government has also reduced its annual growth forecast for the year from 7.8% to 4.7%.[55] Tajikistan's market remains highly dependent on government spending and state-backed infrastructure projects, with the private sector contributing to only 13% of formal employment and 15% of total investments – a laggard in the region.[56]

Tajikistan presents challenges to Western investors in comparison to other CARs, having relatively low private investment rates and a weak local currency. The somoni depreciated by 57.1% against the U.S.

dollar since 2015. Others regard this as an opportunity, noting that the relative strength of the dollar makes exports less expensive. Tajikistan has worked hard to raise its population's living standards and improve conditions for investors; the nation's poverty rate fell over the last decade from 83% to 27.4%.[57] Leading investment opportunities include natural resource extraction, metalworking, and textiles — which alone accounted for 94% of global exports from Tajikistan in 2019 — but choice projects remain under the president's control.[58] While China and Russia have already tapped into these markets, western investment has opportunity to flourish.

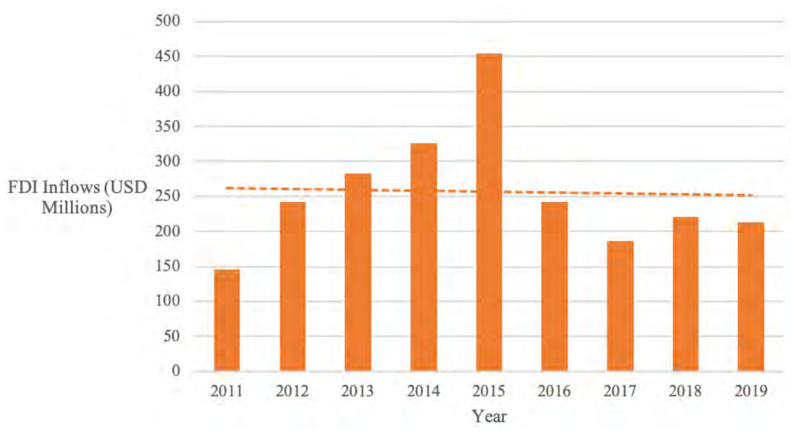
B. Tajikistan's FDI Profile

Tajikistan's three main strategic goals are energy independence, transportation connectivity, and food security. The Tajik government has made some progress on these fronts, mostly with grant support from the ADB and the EBRD.[59] Tajikistan has benefited greatly from infrastructure projects supported by China's BRI, but China's support comes with increased financial dependence. The terms of these loans remain opaque, and the international community has expressed worry about Tajikistan's ability to manage its increasing debt burden. Beijing holds more than half of Tajikistan's $2.8 billion external debt, which is equal to 35.9% of its GDP. In the past, Tajikistan has paid off debts to China by ceding mining rights and even 0.7% of its land.[60]

Advancing these strategic goals would make Tajikistan a more competitive investment destination. Private sector investments from domestic and international resources (respectively 16% and 4% of GDP) continue to be constrained due to the overall business environment. Priority areas of government investment remain in hydropower, infrastructure, mining, extractives, and the processing sectors.

Chinese infrastructure investments account for more than 75% of the nation's total FDI. The largest of these infrastructure projects has been completing the Rogun Dam. Work on the hydroelectric project began in the 1970s but fell into disrepair following the fall of the Soviet Union. The project was restarted by the Tajik government with Chinese help in 2017.[61]

3.B. Tajikistan: FDI Inflows (USD Millions)



Data sourced from World Bank Open Data, 2020

Tajikistan's government tends to award large, government-initiated projects to regional powers such as China, Russia, and Iran. China has invested over $2.25 billion over the last decade. Despite large Chinese investments in Tajik infrastructure, including a striking $360 million grant for highways in 2019, projects often go unrealized because of the lack of local capacity.[62] Beijing previously pledged to provide $350 million for the construction of a new parliament and government complex in Dushanbe. The proposed building site was cleared in 2018, but no construction had begun prior to the outbreak of COVID-19.

Dozens of foreign-owned companies in Tajikistan have complained to resident European and U.S. officials about arbitrary and discriminatory application of the tax code exacting burdensome payments. There are no U.S. or European banks in Tajikistan, and Tajik banks have not had correspondent banking accounts at U.S. or European banks since 2012. Russian and Kazakh banks clear virtually all of Tajikistan's international payments.

The Tajik government has been implementing reforms in recent years, among them making it simpler to access credit.[63] In practice, these reforms have not transformed into significant investment packages from western-aligned firms and corporations. Tajikistan continues to present itself as a particularly challenging environment for business. Most concerning are the lack of property rights and minimal transparency in the country's court systems, issues which have dramatically increased the country's risk profile and the costs of doing business for both domestic (16% of GDP) and foreign investment (4% of GDP).[64]

C. Outlook

Rising emigration, instability of the remittances cash flow, and the government's increasing reliance on regional powers to fund critical infrastructure projects portend a precarious economic future for Tajikistan. The country's business sector is dominated by members of President Rahmon's family, who use their links to the levers of power to extract money from successful entrepreneurs. The tax system is unnecessarily complex, and the Tajik government has been unwilling to change a hostile domestic business environment for the investment of remittances.

Tajikistan's National Development Strategy through 2030 places emphasis on diversifying emigrant destinations beyond Russia and developing programs to protect worker rights abroad but does not outline any strategies to make remittances more productive.

Aside from its poorly designed migration policy, the Tajik government's continuing shift towards the east puts western investors at a disadvantage, particularly those who wish to tap into the country's lucrative natural resources. These resources — including gems and ores — are entirely owned by the government and are contracted to the most favored businessmen or their wealthy Chinese associates.[65] The Yakjilva mine, which has 415 tons of silver deposits and is situated roughly 4,500 meters above sea level, was given to China after less than 30 minutes of debate in the country's parliament in October 2019.[66] China was further given a 7-year exemption from paying taxes on any revenue and equipment brought into the country to service the mine. China's mining companies are also major stakeholders in Tajikistan's largest gold mines in the Panjakent, Aini, and Vahdat regions.

Iran, the second largest investor in the country, sees the small Central Asian nation as a way to raise revenue while under increasingly intense U.S. sanctions. In July 2019, Tajikistan and Iran agreed to invest $8 million more into construction of the Istiqlol tunnel, which will cut travel time between Dushanbe and Khujand dramatically.[67] Geopolitical realities are pushing Tajikistan and Iran together, a bad sign for western investors moving forward. As ethnic Persians, Tajiks are regarded as distant cousins by the Iranian world. Combine that with the recent policy of the Trump administration in Afghanistan toward a one-sided deal with the Taliban — destroying the system of checks and balances between ethnic groups in the region — and the ties between the two nations are likely to grow. Political and economic cooperation between Dushanbe and Tehran will likely increase as a result of informal negotiations amongst leaders of the Collective Security Treaty Organization as the Afghan situation pans out.

China's increasing stranglehold on Tajikistan's debt and the government's reliance on foreign-funded projects have made it nearly impossible to forecast a scenario where the country's economy becomes more open to western investment. Furthermore, as long as Iran continues investing in Tajikistan's infrastructure, western investors will have to remain vigilant so as to not inadvertently violate U.S. sanctions policy. Tajikistan currently has bilateral agreements to avoid double taxation with many members of the EU and the UK, but notably not the U.S.

Tajikistan's economic outlook is further dampened when one considers that Tajik law does not allow the sale of land; all land is the property of the state, and if leaseholders do not use land in accordance with the purpose of the lease, the authorities can revoke the lease.[68] This effectively means that if a western investor does not have sufficient ties with the government, their investment could be seized at any time with no legal recourse. Tajikistan will require substantial effort at economic reform and administrative revitalization to garner increased FDI inflows.

4. Kyrgyzstan

A. Overview

Kyrgyzstan's recent political turmoil, set into motion by the illegitimate results of early November 2020 parliamentary elections, have thrown the country into upheaval. The elections, rife with fraud and corruption, resulted in widespread civil unrest. The situation further deteriorated upon the resignation of President Sooronbay Jeenbekov. Economic stability has also suffered as a result of the COVID economic downturn and the collapse of remittances. Strict lockdowns implemented since March have severely inhibited economic growth and resulted in unemployment rates projected to climb as high as 21%.[69] In April, the World Bank approved a $12.15 million aid package for the Kyrgyz Republic Emergency COVID-19 Project, with an additional $9 million to be invested in healthcare infrastructure and equipment.[70]

While the country joined the EAEU early on in 2015, border snarls with Kazakhstan have inhibited trade from taking off, with a 10.5% drop in export revenue between 2018 and 2019.[71] Kyrgyz trucks are often held up at the border due to what Bishkek refers to as unjustified customs checks.[72] Kazakhstan has responded to this issue, raised before Moscow, by calling out the non-EAEU-sourced contraband filtering through loose Kyrgyz checkpoints, depriving the EAEU as a whole of customs revenue. The Eurasian Economic Commission estimates that collective GDP will contract this year somewhere between 3.2 and 7.2%, adding to the dire outlook for Kyrgyzstan.[73] As the country deals with a health emergency in the midst of ongoing political and economic crises, Kyrgyzstan's economic future remains tenuous.

B. Kyrgyzstan's FDI Profile

In the past few years, FDI in Kyrgyzstan has risen quickly — with inflows increasing by roughly 50% from 2019 to 2020 — projecting promising economic development.[74] The leading sectors of foreign investment have primarily been in the manufacturing industry, with some financial sectors also attracting attention. As a result of the pandemic, Kyrgyzstan's FDI fell by 22% from the previous quarter by March of 2020.[75] According to UNCTAD's World Investment Report 2020, FDI inflows in Central Asia are expected to decline a total of 38% this year.[76] These inflows are not predicted to recover until 2022.

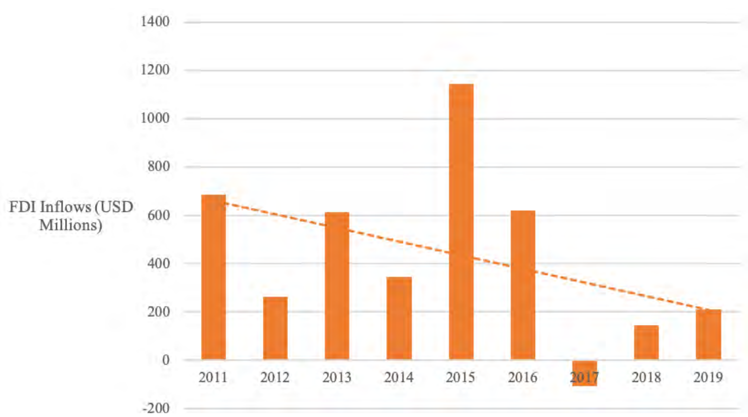
Plagued by corruption and stagnation, the Kyrgyz Republic was ranked the 81st freest economy in the world in 2020.[77] Lack of advancements in economic freedom can be attributed to endemic internal issues including corruption, red tape, insufficient economic policy planning, excessive government spending, organized crime connected to the country's split into northern and southern clans, and weak protection of property rights.

The leading countries driving foreign investment in Kyrgyzstan include Canada, China, the United

Kingdom, Russia, and Kazakhstan. China's efforts to improve its own market access have been apparent as a result of its growing investments in Kyrgyzstan, primarily via loans from the Export-Import Bank of China.[78] China was Kyrgyzstan's largest investor in 2017, with cumulative FDI totaling $3.86 billion.[79] Although Chinese investment has been overt and encouraged by the Kyrgyz government, it has also been met with resistance by anti-Beijing protestors. This past February, Chinese company One Lead One (HK) Trading Ltd. pulled out of a $280 million project intended to build a logistics center after local protests made the project untenable.[80] China has persisted in its efforts to begin a railway project in Kyrgyzstan, though these efforts have also been postponed due to increasing Kyrgyz nationalistic sentiment.[81]

Anti-Chinese Kyrgyz are joined by Russia in opposition to the railway initiative as Putin sees China's investment in the region as geopolitical encroachment. China's efforts to construct railway projects through Central Asia is in a strategic effort to cut Moscow out of Beijing-dominated trade routes between Asia and Europe. In 2019, Russia committed $123 million in FDI to Kyrgyzstan, in addition to being an important source of remittances.[82] Remittances have dropped 25% since COVID-19 began.[83]

4.A. Kyrgyz Republic: FDI Inflows (USD Millions)



Data sourced from World Bank Open Data, 2020

Another important investor in Kyrgyzstan is the OPEC Fund for International Development, which has committed $34.13 million to projects in the country.[84] Among these recent projects are the Energy Access SMEs Development Project, approved in 2017, and the ongoing Issyk-Kul Ring Road Project.

United States FDI in Kyrgyzstan was $38 million in 2019, a 40.7% increase from the previous year.[85] This upward trajectory in partnership with western firms is a positive sign, especially when considering that Canada and the United Kingdom serve as the Kyrgyz Republic's third and fourth greatest sources of FDI, respectively.[86] The Kyrgyz government has a strong relationship with Centerra Gold (Canada), the single largest source of FDI in the country. Centerra recently joined the Coalition of Energy Efficient Comminution as a new sponsor, which can potentially bring about new infrastructure investments that will accelerate energy and water efficiencies in its Kyrgyz operations.[87]

Kyrgyzstan additionally hosts the World Bank, the International Finance Corporation, ADB, EBRD, the Islamic Development Bank, and the Arab Coordination Group. Other IFIs, including the Asian Infrastructure Investment Bank and the Eurasian Fund for Stabilization and Development, have been critical in alleviating the drastic effects of COVID-19 in Kyrgyzstan, with each bank approving a $50 million loan and $100 million loan respectively.[88] Overall, however, the Kyrgyz Republic's widespread corruption — in which an estimated 60% of economic activity occurred in the unregulated grey and black market economy last year — remains a major deterrent to potential investors.[89] The World Bank has outlined a number of objectives to diversify and sustain private sector-led growth within the country moving forward, focusing on fiscal stability, risk reduction, and improvements to the regulatory environment for businesses.[90]

C. Outlook

In spite of promising trends, the recent revolution and ensuing political instability, as well as the COVID-19 crisis, suggest a worrisome economic outlook for the country, with GDP expected to drop as much as 10% in 2020.[91] Regional corruption and poor infrastructure in conjunction with the chaos induced by the recent election foreshadow the retreat of potential investors who will perceive the instability as too risky to pursue meaningful business endeavors.

Although China will remain interested in Kyrgyzstan, populist anger in the state has already impeded Chinese investment and will likely create further obstacles. On the other hand, Russia will look to be on good terms with the new leader of the Kyrgyz Republic, thus creating potential for investment as well as economic and security influence in the long term. That being said, the Russian Federation lacks the requisite economic strength for significant investment and will most likely focus on multilateral economic institutions (particularly the EAEU) rather than FDI.

Kyrgyzstan will require a substantial recovery effort prior to again becoming a suitable foreign investment location. The government has in recent years articulated a promise to make the state safe for investment, and acting President Sadyr Japarov has launched an anti-corruption initiative, a campaign which saw the detainment of two notorious kingpins.[92] The interim government is unlikely to push forward on any infrastructure upgrades until the political situation settles, but anti-corruption efforts are a clear invitation for U.S. and EU governments and IFIs to contribute in this regard. Future commercial deals will not come without potential for risk, but former and current government leaders remain interested in modernization projects in IT, education, air monitoring, and food processing, the latter being a particularly attractive investment area considering the agricultural sector's stability throughout the pandemic.

It is unlikely that the Kyrgyz Republic will experience a prominent increase in foreign investment in the near future given the uncertain and dynamic political situation. However, continued efforts by the current leadership have the potential to put Kyrgyzstan on a positive trajectory and attract foreign interest sooner than otherwise might be expected.

5. Uzbekistan

A. Overview

The most populous country in Central Asia is opening its double landlocked doors to investors and is amid a system-wide overhaul of its economy. After taking the reins in 2016, President Shavkat Mirziyoyev proposed an ambitious reform strategy for Uzbekistan, covering areas including economic development, education, and government transparency. Since then, a majority of these reforms are underway, but COVID-19 unsurprisingly derailed coherent implementation. Add to this weak oversight and an inconsistent quality of governance, especially in the provinces, and one gets a mixed picture of success with remaining challenges.

Significant gaps exist between the ambitious reforms advertised by the top and the results on the ground. Underdeveloped human capital, corruption, red tape, and entrenched resistance at the lower levels of a culturally risk-averse and rent-seeking civil service steeped in Soviet era bureaucratic practices have resulted in uneven implementation. While Uzbekistan's economic development trajectory pre-COVID is positive, with FDI inflows more than tripling in 2019 (up 266% to $2.3 billion), this will not be enough to propel the country into the high middle-income bracket, as its neighbor Kazakhstan has achieved.

While the ADB forecasts Uzbekistan's pandemic-afflicted GDP growth at 0.5% in 2020, it expects a rebound to 6.5% in 2021.[93] With 33 million people, Uzbekistan has struggled to secure basic living standards and provide work for its youthful population. However, the country's 93% recovery rate for COVID-19 demonstrates the government's drive to protect its people and preserve its rising international standing in this key period, where Uzbekistan must avoid falling behind and facing unrest.[94]

Much will depend on the speed of COVID vaccine penetration into the country as well as the development of infrastructure needed to store and transport doses and administer inoculations. Banks likewise project exports and remittances to recover in 2021 as travel restrictions continue to be lifted and migrant workers in Russia resume their labor.

Conscious of the need to retrain and attract foreign investors, the Mirziyoyev administration has proposed key steps to reform Uzbekistan's legal landscape and make it more investor friendly. These reforms are critical to Mirziyoyev's political future and also present an existential question for the future of Uzbekistan's investment profile.

Furthermore, the promise of peace in Afghanistan and the emergence of north-south transportation routes allow Uzbekistan additional opportunities, with its geography potentially transforming it into a regional hub for Central and South Asian economic collaboration. Uzbekistan has taken a key role in the Afghanistan peace negotiation process. President Mirziyoyev addressed the United Nations in late September 2020, calling for the establishment of a permanent committee on Afghanistan to ensure the region is not forgotten once NATO troops withdraw completely.[95] Citing geographic barriers to transport links across Central Asia — a hindrance as Uzbekistan attempts to enter wider markets — he likewise proposed a Regional Centre for the Development of Transport and Communications Connectivity. Implementation of these plans within the framework of the Belt and Road initiative along with the less-developed U.S. New Silk Road program will create massive investment opportunities for the rising nation's economy.[96]

B. Uzbekistan's FDI Profile

While third overall in net FDI inflows, Uzbekistan leads its Central Asian neighbors in its rate of growth in foreign investment, rising from \$625 million in 2018 to \$2.3 billion in 2019.[97] The country's sizable domestic market, its strategic position between China and Europe, its abundance of diversified natural resources, and its relatively low foreign debt serve as key assets for attracting foreign investment. FDI traditionally arrives from Russia, South Korea, China, and Germany, with Canada and the Gulf States recently increasing their financial presence. Leading investment sectors include agriculture, mining and natural resources, and transportation.

Agriculture's share of GDP in Uzbekistan is 32%, second only to Tajikistan in Central Asia.[98] Investment in agribusiness is promising due to the combination of high-quality raw materials available (cotton) and the established position of Uzbek products in foreign markets. Leading manufacturers of agricultural machinery in the country include CLAAS and LEMKEN (Germany), Case New Holland (Italy) and John Deere (U.S.).[99] The government plans to establish market prices for products like cotton and grain in order to develop a more competitive foreign market-oriented sector that complies with international norms against the use of forced and child labor.[100]

Foreign investors who have been successful in the fruit and vegetable subsector include Marvel Juice (Netherlands) and Demir (Turkey).[101] There is a growing interest from multinationals such as Coca Cola (U.S.) and Nestlé (Switzerland), which have participated in a joint venture with the government to support farmers, providing educational programs and training and setting up a plant for producing drinking water in Tashkent.[102]

Uzbekistan has considerable gold, uranium, coal, copper, and silver reserves, with mineral rents accounting for 7.4% of the country's GDP in 2018.[103] That year, the U.S. Geological Survey ranked Uzbekistan as the world's seventh largest gold producer.[104] Experts estimate the value of metallic and non-metallic mineral resources of Uzbekistan at $11 trillion.[105] A government reform has promoted privatization of the mining industry's crown jewels, Navoi Mining and Alamyk Mining, which produce 86% of the country's gold.[106] Caterpillar (U.S.) has been active in Uzbekistan since 1992, constructing mining equipment for Navoi and Alaymyk.[107] The French company Orano holds 51% equity in joint venture Nurlikum Mining LLC's uranium exploration and development.[108]

With 65 trillion cubic feet, Uzbekistan ranks third in the CIS and 18th worldwide in natural gas reserves, exporting a majority to Russia and China.[109] The biggest foreign investor in natural resources is the Russian corporation Gazprom, who has worked closely with Uzbekneftegaz since 2002. In 2018, Gazprom invested $700 million in a joint venture in northwestern Uzbekistan for exploration and development of gas fields.[110] Altmax Holding, registered in Cyprus but owned by Russian businessman Andrei Filatov, is a co-founder of the venture, and recently invested $1.8 billion in the construction of a gas thermal power plant in southern Uzbekistan.[111]

Uzbekistan is also the third largest oil producer in Central Asia at 71,471 barrels per day.[112] While ExxonMobil (U.S.) and Uzbekneftegaz recently signed a cooperation agreement to implement a joint oil refining project, Russia's Lukoil remains the country's largest investor in oil refining.[113]

Transport not only remains a pillar for Uzbekistan's economy but also for neighboring countries dependent on Uzbekistan's extant infrastructure network to move goods and people. Railways are the dominant mode for freight transport and account for a large share of domestic long-distance passenger transport.[114] However, logistical bottlenecks are a major impediment to connectivity, putting a damper on economic pursuits. Transport infrastructure projects consist primarily of railway development plans, accounting for 71% of a total of $8.3 billion of investments in the sector.[115] Highway projects account for the remaining 29% or $2.4 billion, focused mainly on rehabilitating regional roads. Most of these projects are brownfield investments driven by regional efforts, such as the Central Asia Regional Economic Cooperation Corridors, which are coordinated by the ADB and through which co-financiers such as the World Bank and China's Export-Import Bank are actively involved in financing parts of the regional roads. Most of these projects are brownfield investments driven by regional efforts, most notably the Central Asia Regional Economic Cooperation Corridors, which are coordinated by the ADB, the World Bank, and China's Export-Import Bank.

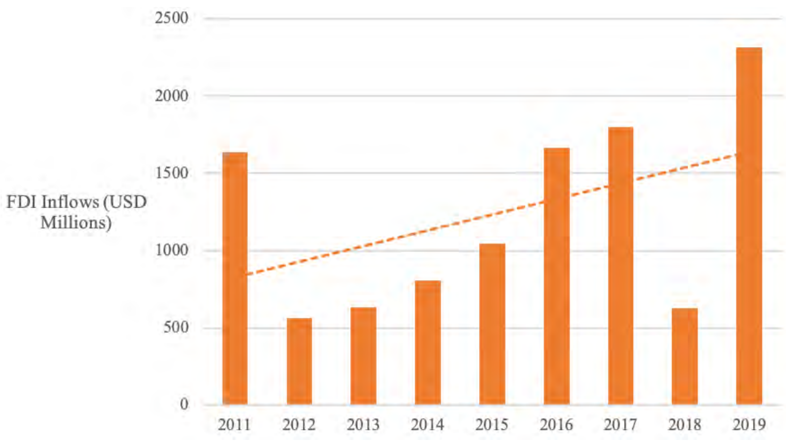
With its historical, archeological, and natural treasures, Uzbekistan has exceptional potential for tourism. The number of foreign tourists in Uzbekistan in 2019 rose to 4.9 million people (an increase of 26.1% since 2018), and is expected to reach 7 million by 2025, producing economic growth of roughly $2 billion.[116] The first International Investment Forum in tourism took place in 2018, attracting more than 300 delegates, experts, and business leaders from 48 countries and regions. Tashkent will have implemented a total of 14 projects in the field of tourism by the end of 2022 funded by $420 million in FDI.[117] Most recently, H.I.S. Hotel Holdings Co. Ltd. of Japan laid the groundwork of a $13 million hotel in the city's center, and the Andorra-based company PGI management opened a $117.6 million modern ski resort complex in the western Tien Shan range.[118] Increased FDI in Uzbekistan's tourism sector will enable needed infrastructure development and increase employment to further diminish poverty.

Uzbekistan recently resumed negotiations to join the WTO, furthering its integration into the global economic community and the multilateral trading system.[119] However, WTO membership requires substantial economic and political reform that may preoccupy Tashkent leadership in the next several years. Western businesses remain cautious of investing in Uzbekistan, but the country's renewed push to join the WTO suggests an inclination toward increased economic alignment with the U.S. and EU.

Membership in the EAEU is an easier course, as it would not require reforms likely to ruffle the interests of entrenched oligarchs. However, aligning too closely with Russia could bring economic and political risks. In April 2020, Uzbekistan's parliament voted to become an observer of the EAEU, enabling Tashkent to participate in its meetings when invited though excluded from the positive outcomes of full membership such as increased export opportunities, decreased transportation costs, and the elimination of working permits for migrant workers.[120] This largely token status does little for Uzbekistan's economy and coincides with its bid to join the WTO, showing a lack of clarity as to the best economic and geopolitical path forward.

A fourth party in this courtship is China, which surpassed Russia as Uzbekistan's largest trading partner in the first half of 2019, operating roughly 1,000 companies within its borders.[121] Against this backdrop, Washington and the EU must devise stronger, well-funded strategies for economic partnership opportunities if they wish to increase their presence on the ground and curtail the diplomatic and economic hegemony of the Russia-China duopoly. Geoeconomics is about putting your money where your mouth is, after all.

5.A. Uzbekistan: FDI Inflows (USD Millions)



Data sourced from World Bank Open Data, 2020

International financial institutions contribute heavily to Uzbekistan's long-term, sustainable development plans by supporting water management, agricultural modernization, infrastructure development, and capacity building. The Ministry of Finance recently announced that all IFI-financed projects approved prior to July 1, 2020 will not be subject to value-added or excise taxes.[122] This move is intended to support and strengthen private businesses as the nation's economy recovers from COVID-19.

Presently, 11% of Uzbekistan's arable land is used for farming, increasing the pressure for adequate management of soils and efficient agricultural infrastructure.[123] More than $2.4 billion in water projects are being financed with support from the ADB, EBRD, EIB, and the World Bank, with roughly 63% in water supply and sanitation and the remainder in irrigation and water management. Comprehensive water management reform with drip or pulsar irrigation will modernize the country's agricultural sector. Upgrading agricultural machinery remains an open sector for foreign investment and is of particular importance for Uzbekistan after continued allegations of forced labor.

Both the ADB and USAID are investing substantial sums into the enhancement of regional power grids to improve energy security.[124] These investments are intended to strengthen government capacity to carry out energy market reforms and attract private investors, foster consumer awareness for energy efficiency, and increase Uzbek women's participation in the energy sector.[125] The ADB is additionally the financial backer of several infrastructure projects, including the reconstruction of a climate-resilient highway in semi-autonomous Karakalpakstan that serves as a key trade route into neighboring countries.[126]

Mirziyoyev has been energetic in revitalizing relationships with other Central Asian leaders, while simultaneously strengthening relations with Russia and China – primarily through the EAEU and the Belt and Road – along with potential western partners. There remain some obstacles ahead given the regulatory requirements of EAEU membership despite Tashkent recently joining as an observer. Other Central Asian members have expressed dissatisfaction with the Moscow-dominated trade block, claiming it is intended to encourage trade flow to and from Moscow rather than across borders in Central Asia.[127] Unlike Russia, China has been proactive in providing COVID-19 and other development-related aid to Uzbekistan.[128] Already a crucial economic player in the region, Xi's China has taken advantage of the crisis to expand its role into political areas previously seen as securely in Moscow's sphere of influence.[129]

Some say that U.S. and European strategic interest in Uzbekistan and the Central Asian region has dwindled, particularly following the drawdown of forces in Afghanistan. This is not so, given increasing geostrategic competition with China. Western interest remains, particularly amongst the European states, but the political drift has been palpable. In 2019, both the U.S. and the EU released new Central Asia strategies, reflecting a stated desire to increase their presence on the ground and provide alternate diplomatic and economic outlets to Russia and China.[130] While Uzbekistan clearly desires new investors and market access, a combination of past neglect and geographic distance ensures that the U.S. and EU are unlikely to become major players without further effort. Time will tell what actions the impending Biden Administration will take, and whether this activity will significantly go beyond the C5+1 confabs and modest investment.

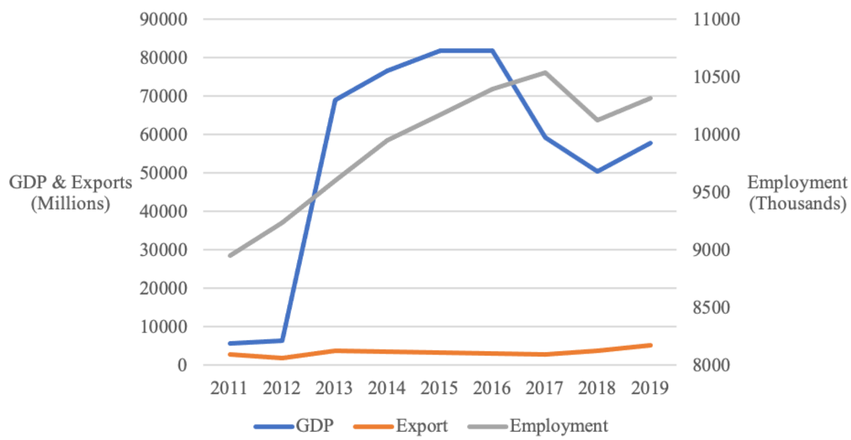
C. Outlook

Uzbekistan's economic reforms over the past four years have opened new pathways of development. Success is largely due to the country's opening to the world, including a lift on travel restrictions, currency liberalization, and an improvement in international banking procedures. Abandoning stifling Soviet-style practices and liberalizing regulation also helped. President Mirziyoyev introduced the Government Service Development Agency in 2019, which offers professional development programs for civil service workers.[131] Despite these steps, more work will need to be done in order to prepare the large amounts of unskilled and inadequately educated workers joining the workforce.

Success can also be attributed to the effective organization of the investment ecosystem and the establishment of a public policy framework to support it. Uzbekistan has applied successful environmental policies, improving infrastructure so as to develop renewable energy technologies. Under current circumstances, FDI prospects will hinge on Uzbekistan's capacity to attract more diversified financial inflows, as investment into the country's renewable energy sector will likely slow down until the COVID-19 storm is weathered.

Ongoing large projects in oil and gas by Lukoil and a series of projects in chemical production of raw materials with Chinese, Russian, United Kingdom, French, and United States firms have contributed to improving exports in these sectors. Current reforms have also largely targeted the development of small businesses and private entrepreneurship. The rise of SMEs in Uzbekistan between 2001 and 2016 in many ways contributed to a 33.6% decline in the country's poverty rate over this period, with SMEs' contribution to GDP increasing to 58.4% in 2017 from 38.2% in 2005.[132] SMEs accounted for 27.2% of Uzbekistan's exports in 2019 and remain the largest source of employment, accounting for 78% of jobs.[133]

5.B. Uzbekistan: SME Contribution to GDP, Exports, and Employment, 2011-2019



Data sourced from The State Committee of the Republic of Uzbekistan on Statistics

Notwithstanding these positive developments, Uzbekistan faces substantial structural challenges in its transition to a sustainable market economy. Significant institutional reforms will be necessary to retain momentum. A greater openness by the state to market diversification and a clear commitment to support small businesses and entrepreneurship and ease access to credit will create jobs and foster a more hospitable investment climate.

The case for reform of Uzbekistan's public sector to socially productive outputs is overwhelming. At present, only a third of Uzbekistan's poorest people receive some manner of social assistance.[134] Significant overstaffing is apparent in multiple areas of the public sector, with poor institutional coordination and data quality across the country's 24 ministries, 10 state committees, and eight state agencies. Social protections through pension reform, social safety nets, a revamped healthcare and education system, as well as a revitalized judicial system are crucial next steps to increase productivity and participation in the labor market.

The labor market is hindered by a skills gap and limited availability of training in technical skills. State personnel must be educated in both economics and policy to fully understand the reform agenda and effectively and equitably implement it. To build stronger capacity and to free up state funds for competent staff recruitment, there must be expanded opportunities for skills training, financial literacy, and sustained private sector growth, providing jobs for workers unsuitable to be redeployed within the public sector.

For the time being, Uzbekistan's rich natural resource reserves and its anti–crisis policies, along with its efforts for political and economic cooperation with its neighbors, will maintain the country's appeal to foreign investors. President Mirziyoyev's continued pursuit of reform will heighten Uzbekistan's appeal to IFIs and the business community.

III. Conclusion

COVID-19 is expected to exacerbate the slowdown in regional GDP, and we can expect a sustained period of lackluster FDI inflows to Central Asia.

Significant disruptions within the region's supply chains and a temporary collapse in travel and transport, as well as the effects of a large drop in energy prices, may make it difficult for firms to quickly regain the volume of output they had prior to the pandemic. A large number of multinational enterprises have warned of profits falling below management or market expectations, which are expected to dampen reinvested earnings – an important source of FDI for CAR economies. At the same time, the pandemic is likely to result in long-term setbacks for human capital development as the education for millions of students is disrupted and COVID-19 survivors begin to suffer from chronic complications.

Smart economic restoration and reform packages are needed to catalyze productivity growth. Any such agenda must boost public investment in both human and physical capital, coupled with efforts to stimulate innovation in firms. Reforms to promote private sector development and the transition to competitive and inclusive markets are required to attract private investment and capital flows to Central Asia. Non-tariff barriers and arcane trade rules remain structural bottlenecks to additional outside financing.

The outsized share of state-owned enterprises in the region's national economies, compounded by limited competitiveness and unchecked corruption, have led to low innovation rates. This reduces the attractiveness of Central Asia's business environment and hinders investment, particularly in the absence of progress on other reforms. Kazakhstan and Uzbekistan, while not immune from these conditions, do show positive trends in competitiveness and innovation relative to their neighbors.

If the CARs embrace the following five strategies, there could be a return to pre-2014 levels of FDI growth from all sectors, while increasing insulation from commodity cycle volatility:

1. Add 'green growth' investment projects to the energy sector development programs (while maintaining investment in promising hydrocarbons, minerals, and metals including those needed to power the energy transition);
2. Invest in human capital through education and skills training; improve public service skillsets;
3. Accelerate regulatory and policy reforms to support foreign and domestic investment; privatize state-owned enterprises; boost SME and PPP development; massively cut red tape; combat corruption;
4. Grow knowledge-based services (such as Kazakhstan's AIFC); and
5. Mass digitization, both hardware and innovative work practices, including "virtual government;" remote education; and telecommuting.

While major reforms are needed in Kyrgyzstan and Tajikistan for those countries to become competitive for foreign investment, the economies of Kazakhstan and Uzbekistan (and depending on commodity prices, Turkmenistan) will maintain their positions as the region's largest magnets for FDI in the post-COVID-19 era.

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