

# Pipelines and Pipe Dreams: Energy Development and Caspian Society

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It is time to develop a new conventional wisdom to apply to the eight states of the Caspian Basin region,<sup>1</sup> one that better recognizes the region's implicit social weaknesses as well as its potential economic strengths. While the Caspian Basin states do have considerable oil and gas reserves, and while they are likely to eventually benefit from foreign direct investment in their energy sectors, the development of these sectors will take longer than was anticipated only a few years ago. This means that there is an increasing risk that the region's numerous social and economic problems will fester before adequate resources can be applied to remedy them.

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While no one thought the economic transition necessitated by the end of Communist rule would be easy, the citizens of these states expected that the oil and gas beneath their feet would alleviate most of the pangs of that transition. In addition, they believed that their governments would make an honest attempt to provide for their basic social needs and that children would be able to live better than their parents had.

In many of the Caspian Basin countries these dreams no longer seem likely to be realized. Numerous obstacles to extracting the region's energy have dulled visions of energy-generated wealth. As dreams of petrodollars fade, most of the states of the Caspian region have come to know the harsh realities of independence. During the Soviet era, Moscow policymakers drew the boundaries of the Caspian region's republics so that each was too weak to

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<sup>1</sup> The Caspian region consists of the three states of the south Caucasus (Armenia, Azerbaijan and Georgia) and five Central Asian states (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan).

stand on its own. The political vacuums left in the wake of the Soviet Union's collapse have highlighted these weaknesses and made these states breeding grounds for ethnic rivalries and extreme nationalist and religious groups. While the hot wars that characterized the region—Georgia-Abkhazia, Armenia-Azerbaijan and the civil war in Tajikistan—have all cooled, the area's potential for violence is not yet exhausted.

Disappointment over the decreasing prospect of oil windfalls has exacerbated some of the problems that independence has brought, decreasing the region's ability to realize its energy potential. Major Western oil companies are willing to do business with dictators, but they don't like making major investments in war-torn states. Developing oil and gas reserves in the landlocked Caspian region is challenging even under the best conditions. Serious social and political instability could result in oil companies choosing not to exercise their rights of deposit exploitation and withdrawing after the exploration stage. While all of these states have plans to develop diversified economies, economic recovery is still proceeding slowly, and even the partial withdrawal of Western oil companies would serve as a serious blow to the economic reform prospects of the region.

Moreover, the region is heavily interconnected, and problems in one state spread easily to another. This is especially true within the two sub-regions of the Caspian Basin—the south Caucasus (Armenia, Azerbaijan and Georgia) and Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan). Trans-Caspian ties are rapidly growing stronger, driving all eight to greater interdependence. More than ever before, the solution to one state's problems will likely involve all the others.

## THE CASPIAN CRAZE

The international community has intuitively recognized these interconnections, and the fear that these make the region highly unstable helps to explain why energy companies did not immediately see the collapse of the Soviet Union as a potential bonanza. In 1991, when it first looked like these states were about to become independent, the international community was frightened by the likelihood of instability in the region. In all three south Caucasian states violent inter-ethnic disputes erupted, and several other potential conflicts were simmering. The five Central Asian states were considered even more fractious. Boundaries had been drawn to create diaspora communities throughout the region,

and fears were rampant that radical Islamic elements could further destabilize the situation. Islamic groups were already active in Central Asia, and their numbers were sure to grow due to the more fluid borders that independence was certain to bring.

Several factors began to change this perspective, and by late 1993 interest in the Caspian region was on the rise in most Western countries. Although independence brought renewed violence to the region, outside observers began to see that the risk of widespread civil unrest could be contained. This seemed especially true if Russia's role could be restricted. Moscow appeared as a strongly biased party in the Armenia-Azerbaijan dispute over the status of Nagorno-Karabakh,<sup>2</sup> and even more so in the struggle between Georgia and the breakaway region of Abkhazia.<sup>3</sup> Only in Tajikistan did Russia appear to be making a genuine contribution to peacemaking efforts, but the price Moscow was extracting was high—a continuous military presence in the region.<sup>4</sup>

A few years earlier Russia's meddling would not have seemed so troubling, but by this time Western oil companies were becoming keenly interested in the development of the Caspian Basin's oil and gas reserves. The first post-independence estimates of these reserves indicated that the region was likely to be a "new" North Sea.<sup>5</sup> In 1993, for example, Kazakhstan's state statistics

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<sup>2</sup> In 1989 the soviet of the Nagorno-Karabakh autonomous region (situated within the Azerbaijan Soviet Socialist Republic) declared its autonomy, with the support of nationalists in Armenia. After the collapse of the Soviet Union, tensions between the Armenians and Azerbaijanis developed into open warfare between the two states. By October 1993 approximately one-fifth of Azerbaijani territory was under Armenian control. Since that time a cold war has continued between Armenia and Azerbaijan, and the conflict is currently under adjudication by the Minsk group of the Organisation for Security and Cooperation in Europe, which includes both the United States and Russia.

<sup>3</sup> In 1989 there were violent clashes between Abkhaz and Georgian nationalists. The conflict between the two groups sharply heightened after nationalist figure Zviad Gamsakhurdiya came to power as president of Georgia in 1991. The Abkhaz people—who had an autonomous republic that was part of Georgia—sought independence. Since 1993 the Abkhaz have enjoyed de facto independence while Russian-sponsored peace negotiations between the two sides have failed to break the impasse.

<sup>4</sup> Tajikistan was a member of the Commonwealth of Independent States (CIS) throughout its civil war. By contrast, neither Azerbaijan nor Georgia were members of the CIS until 1993; they joined in part to give Russia a new incentive to develop a more neutral position.

<sup>5</sup> North Sea output rose from roughly 2 million barrels a day in 1980 to 6.1 million in 1998—about 8 percent of world demand. (Data provided by Petroleum Market Intelligence published by Energy Intelligence Group.) Proven oil reserves in the Caspian Basin are currently estimated at 15 to 31 billion barrels, about 2.7 percent of total world proven reserves. Individual country reserves in billion barrels are estimated at 3.6 to 6.3 for Azerbaijan, 10 to 22 for Kazakhstan, 1 to 1.5 in Turkmenistan and less than 1 in Uzbekistan. Future exploration may show that the

committee predicted that the country's natural gas production would reach 22 billion cubic meters by 2000 and 28.4 billion by 2010.<sup>6</sup> This increased the potential strategic and economic interest of the region to Russia as well, which only frightened Western leaders about Moscow's intentions. Not only did the Russians harden their position in negotiations over transit routes for pipelines, but they also claimed that the Caspian Sea reserves could not be developed without the consent of all parties.

This combination of developments made the Caspian Basin region more strategically important for the United States and other members of the North Atlantic Treaty Organization (NATO) nations. Western oil companies became increasingly attracted to the region as well, especially since they continued to be frozen out of new projects in both Iran and Iraq. Energy development came to dominate Western discussions of the region.

From the onset, analysts from international financial institutions understood that income from oil and gas development projects alone would not be sufficient to create the desired economic turnarounds in these countries. International financial assistance was made available for a host of economic projects with the goal of creating diversified and sustainable economies. Whenever possible, this aid was targeted toward stimulating macroeconomic reforms, which were seen as a necessary first step for even the richest states. Another priority was investment in transportation and communications, as their development potentially reduced dependence on Russia. However, outside donors assumed that time was on the side of the oil- and gas-rich states, and that the region as a whole could develop enough of an economy so that the other Caspian Basin states' economies would recover as well.

Everyone recognized that the amount of money given to these states was only sufficient to jump-start the process. At the same time, the international community underestimated the risks that would be incurred if these countries failed to maintain adequate social protection for their populations. Failure to meet the

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region holds more substantial oil reserves, potentially as high as 60 to 140 billion barrels. Proven natural gas reserves of 230 to 360 trillion cubic feet represent about 7 percent of total world proven gas reserves. (Figures cited in Martha Brill Olcott and Amy Myers Jaffe, "The Geopolitics of Caspian Energy," in *The Euro-Asian World: A Period of Transition*, ed. Yelena Kalyuzhnova and Dov Lynch Macmillan [London: Macmillan, forthcoming 1999]). Foreign firms began to get involved in the development of the region's energy resources as early as 1990 when Chevron began negotiating rights to develop Kazakhstan's vast Tengiz oil field. Complications delayed the deal's finalization until 1993.

<sup>6</sup> Thomas Land, "Huge Reserves Attract Billions of Dollars," *Gas World International*, 199, no. 4905 (June 1994) p. 16.

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demands of these populations could cause enough social conflict to put the ruling regimes and even the continued existence of the states in danger.

Yet most observers sought ways to transport oil and gas. If this could be done with reasonable speed, most of the other challenges of transition would be manageable. Thus, despite the warnings of some international financial advisors, there was no sense of panic when Turkmenistan made little progress in developing the legal infrastructure necessary to support macroeconomic reforms and continued to maintain a largely state-regulated economy.

Political reforms received significantly less attention than economic ones. In part, this was a product of the international community's greater capacity to engage in economic reform projects. Donor states ante-up far more quickly for economic projects than for social or political ones. While states that seemed receptive to democracy-building efforts, such as Georgia or Kyrgyzstan, were rewarded with more than their "fair share" of assistance, those that were less willing to accept foreign influence over their domestic political institutions were not treated very differently. It seemed Western advisors believed the leaders of states like Turkmenistan and Uzbekistan when they claimed that their populations were ill-suited to democracy. Additionally, it seemed that dealing with familiar leaders was more reassuring to investors than the risk that a genuine political opening would produce leaders with aims antithetical to Western interests.

Often this reluctance was justified by the argument that economic reform had to precede political reform. Of course, regimes that succeeded in securing their economies could buy time before the costs of failed political reforms caught up with them. As estimates of Caspian oil and gas reserves began to grow, most Western leaders became far more interested in securing positions for their oil and gas companies than grappling with the difficult issues of long-term stability in the region.

While it was clear that almost all of the region's leaders were in some way corrupt—or at least spending vast sums of money on personal tributes like ornate presidential palaces—it was less obvious that this would have political repercussions. Leaders assured the West that their populations had always lived badly, and thus their patience was strong. Such assumptions demand closer examination.

## **THE REALITIES OF ENERGY DEVELOPMENT**

The region's oil is real, but so are the difficulties of developing

it. It has been nearly 10 years since Chevron and the Soviet government started to negotiate for the rights to develop Kazakhstan's Tengiz field—and almost six years since Chevron and the Kazakh government signed an initial agreement regarding the field. Yet there is still no new pipeline built to move oil from the region. A group of companies and governments have formed the Caspian Pipeline Consortium (CPC) to construct a new pipeline along the existing route from the Tengiz field to Russia's Black Sea port of Novorossiysk.<sup>7</sup> The group is hoping that the pipeline will be completed in 2001, but further delays are possible. No other pipeline project is even in serious planning stages yet. The U.S. government is still pushing hard for an east-west pipeline that would pass through Azerbaijan, Georgia and cross Turkey to the Mediterranean Sea (along the Baku-Ceyhan route), but there is considerable resistance to this from the oil companies due to the high cost of construction and operation.<sup>8</sup> Routes through Iran are currently blocked by the United States, and the path southwest through Afghanistan is not viable because of that country's lingering civil war. The Chinese have promised a pipeline running east that would be functioning by September 2002, but the high cost of the project—\$7 billion—means that delays are likely.

Even if the pipeline route is settled, the exploitation of the Caspian Basin reserves is going to be a very slow process because of the technical difficulties of working in a remote inland sea.<sup>9</sup> At

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<sup>7</sup> The Caspian Pipeline Consortium includes Russia with 24 percent interest, Kazakhstan with 19 percent, Oman with 7 percent, Chevron with 15 percent, Mobil Oil with 7.5 percent, Oryz with 1.75 percent, Russian-American Lukarco (a partnership between Lukoil and ARCO) with 12.5 percent, Russian-British Rosneft-Shell Caspian Ventures with 7.5 percent, Agip with 2 percent, British Gas with 2 percent and Kazakoil-Amoco with 1.75 percent. (Interfax Petroleum Report, 27 March-3 April 1998).

<sup>8</sup> The Turkish government and the companies of the Azerbaijan International Operating Company (AIOC) are still studying the feasibility of this project, though some progress appears to have been made in March 1999 when Turkey agreed to cover any construction expenses that exceeded the estimated \$2.5 billion. "Agreement Reached on Financing of Azerbaijani Pipeline," Radio Free Europe/Radio Liberty Newline, 16 March 1999, at <http://www.rferl.org/newsline/1999/03/160399.html> (16 March 1999). The AIOC includes Penzoil, Unocal and Exxon of the United States; British Petroleum/Amoco and Ramco of the United Kingdom; the State Oil Company of Azerbaijan (SOCAR); Lukoil of Russia; Statoil of Norway; Itochu of Japan; and Turkish Petroleum Company and Delta Hess of Saudi Arabia.

<sup>9</sup> For an excellent account of these difficulties, see Amy Myers Jaffe and Robert A. Manning, "The myth of the Caspian 'great game': The real geopolitics of energy," *Survival*, 40, no. 4 (Winter 1998/1999) p. 112; and *Unlocking the Assets: Energy and the Future of Central Asia and the Caucasus* (Houston, TX: Rice University, James A. Baker III Institute for Public Policy, April 1998) at <http://riceinfo.rice.edu/projects/baker/publications/efcac8.html>.

the moment there is only one operational semi-submersible platform in the region, while two others are being refurbished. In addition, only two assembly yards in the area, at Astrakhan in Russia and Primorsk near Baku, are capable of building the equipment needed to extract the region's oil.<sup>10</sup>

These difficulties magnify the complexity of both oil exploration (the preliminary assessment of the size of a deposit) and oil exploitation (the actual development of these deposits). Thus it will take comparatively longer to develop Caspian oil than that of regions easier to work in, and when a proposed well site proves to be dry, the losses will be that much greater. In other words, oil companies may abandon projects more rapidly when they encounter exploration difficulties than would be the case elsewhere. This problem has already appeared in Azerbaijan, where companies such as Pennzoil, Lukoil, Agip and the State Oil Company of Azerbaijan (SOCAR) disbanded the Caspian International Petroleum Company (CIPCO) consortium in December 1998. The project—a planned \$3 billion, 25-year development of the Karabakh deposit—was halted after the exploration phase yielded three dry wells.

The declining world price of crude oil may have only a marginal effect on strategic planning by the oil companies, but it will affect the speed with which some of these deposits will be developed. Even more importantly, the drop in wholesale crude oil prices has cut directly into the oil revenues generated by Kazakhstan and Azerbaijan, both oil-exporting states.

Such developments mean that high-end projections of income from oil and gas projects will not be flowing into the region's government coffers any time soon. Yet the economic development and social welfare projects that politicians and ordinary citizens expected would become possible through royalties, income tax and transit fees still have not been realized. For all the publicity that has been given to the oil and gas reserves of this region, all the Caspian states are going to be forced to stabilize their economies by relying heavily on non-energy sectors. The economic transformation occasioned by the collapse of the Soviet Union has affected all sectors of the economy and society, creating burdens on governments that cannot be put off until energy companies solidify their plans. In the meantime, sole reliance on the energy sector is compromising the economic health of the Caspian states.

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<sup>10</sup> Myers Jaffe and Manning, p. 117.

## GROWING ECONOMIC TROUBLES

It is a very difficult task to decide how good or bad the economies of these states really are. Until the financial crises of 1998, it appeared that the economies of all eight Caspian states had bottomed out: since 1996 all had been showing signs of economic growth. In virtually all cases, however, 1998 was a disappointing year, with growth figures falling short of expectations and budget deficits higher than anticipated. In Kazakhstan, fears that the deficit would reach 5 percent of gross domestic product (GDP) nearly led to the suspension of an International Monetary Fund (IMF) extended fund facility of \$440 million.

TABLE I  
Gross Domestic Product, Annual Percentage Change

	1994	1995	1996	1997
Armenia	5.4	6.9	5.8	3.3
Azerbaijan	-18.1	-11.0	1.3	5.8
Georgia	-11.4	2.4	10.5	11.0
Kazakhstan	-12.6	-8.2	0.5	2.1
Kyrgyzstan	-20.1	-5.4	5.6	6.2
Tajikistan	-21.4	-12.5	-4.4	2.2
Turkmenistan	-18.8	-8.2	-7.7	-25.9
Uzbekistan	-4.2	-0.9	1.6	2.4

Source: *World Economic Outlook*, May 1998 (Washington, DC: International Monetary Fund, 1998).

Economic performance figures for 1999 will likely reflect the downturns of late 1998. Yet it is important to keep in mind that figures for economic growth can be misleading. For instance, Georgia's GDP increased by more than 11 percent in 1997, but Georgian industry still was only working at 30 percent of capacity. Georgia's economy was doubly crippled, as it suffered the general vicissitudes of the post-Soviet collapse and experienced further disruptions during the civil war years (1991 to 1993). The country's economic decline was so spectacular that subsequent increases in economic performance considered more modest elsewhere showed up as double-digit improvements. Even with the current improvements, these economies have generally not recovered to pre-independence levels.

This does not mean that Georgia has not made striking gains in recent years, especially if one's criterion is governmental support



for macroeconomic reforms. By this standard Georgia is a real success, and has begun to attract significant Western investment to its own small oil and gas sector. Yet the country's long-term economic recovery will not be assured unless it becomes a viable transit corridor for the region's oil and gas reserves. Politically, this will not be possible if the country remains internally destabilized.

Thus it is important to note that economic performance figures here and elsewhere can be misleading. Growth in economic production leads to an improved per-capita standard of living, at least on paper. But the inequalities implicit in most post-Soviet transformations make gross economic statistics somewhat misleading. For example, the average standard of living can improve even while the percentage of the population living in poverty increases.

Moreover, economic recovery is not occurring evenly across all sectors in these states. Concentration on the region's energy potential has diverted attention from the region's agriculture, which may be more economically valuable than its oil and gas reserves. Agriculture is a critical sector in each country of the Caspian Basin, and its success or failure plays a much greater role in affecting the stability of these societies than developments in the energy sector. Investment in agriculture is especially important if these states want to avoid developing the "Dutch Disease," which comes from the state becoming overly dependent on "rents" from the oil industry.<sup>11</sup>

All of the states in the region have large rural populations.<sup>12</sup> While the agricultural sector is being reorganized and privatized, improved purchasing power for those who work in the agrarian sector has not followed. Even though most of these countries have been able to hold inflation in check since 1995, cash income

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<sup>11</sup> Economists use the term "Dutch Disease" to describe the disruption in secondary sectors of a country's economy caused by a boom in one major sector. An oil boom, for example, generally leads to accelerated growth in petroleum-related activities but a decline in agriculture and secondary industry. Scholars like Terry Lynn Karl maintain that the phenomenon is not purely economic, as it is due in part to political decisions about how to use oil revenue. See Terry Lynn Karl, *The Paradox of Plenty: Oil Booms and Petro-States* (Berkeley, CA: University of California Press, Ltd., 1997) pp. 5-6.

<sup>12</sup> As of 1997 rural dwellers made up 31 percent of Armenia's total population, 44 percent of Azerbaijan, 41 percent of Georgia, 40 percent of Kazakhstan, 61 percent of Kyrgyzstan, 68 percent of Tajikistan, 55 percent of Turkmenistan and 58 percent of Uzbekistan. International Bank for Reconstruction and Development/World Bank, *World Development Report 1998/99* (Washington, DC: International Bank for Reconstruction and Development/World Bank, 1999) pp. 192-193.

increases have not kept pace with consumer prices, which have risen faster than commodity purchase prices. Adding to the region's difficulties is the fact that there have been several bad years for cotton harvests, and 1998 was considered by some to be Kazakhstan's worst grain harvest in 40 years.<sup>13</sup>

This crisis in agriculture has reverberated throughout entire economies, leading young people to leave their homes and move to the cities. Those who leave often have difficulty finding jobs, and too often they have no choice but to turn to crime. The problem of gangs is a growing one in Kazakhstan, making the country less attractive for foreign investors and local residents alike. There is also a serious youth culture problem in Azerbaijan, stimulated in part by the large population living in refugee camps as a result of the conflict with Armenia over the Nagorno-Karabakh region.<sup>14</sup> While these problems do not bear directly on the oil industry, they have indirect consequences. An inhospitable atmosphere will make it harder to attract investors toward the secondary—and less lucrative—industries that are necessary to support the infrastructure required for the development of oil.

The region has also been negatively affected by the wave of global economic crises. First, the Asian financial crisis negatively affected investment in the region, and the subsequent Russian economic collapse cut into trade and reduced remittances from family members sending funds from Russia. Declining trade with Russia caused major industrial stoppages in Kazakhstan and Georgia, while the cutback of remittances was especially troubling in Armenia and Azerbaijan. In fact, it is estimated that one out of every three Azerbaijani males of working age is employed in Russia.<sup>15</sup>

Russia's economic meltdown has triggered a series of smaller financial crises throughout the Caspian region. These crises were not predicted and they came on the heels of slower than anticipated investment in the oil and gas sector. The Kyrgyz currency, the som—considered by the international financial community to be the most stable currency in the region—has lost half its value since the end of 1993, while Turkmenistan's currency,

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<sup>13</sup> E.P. Ionova, "Ekonomicheskaya situatsiya v Kazakhstanye i puti preodoleniya finansovogo krizisa," *Economy and Politics of Russia and Near Abroad*, Institute of World Economics and International Relations (December 1998).

<sup>14</sup> At the end of 1997, 550,000 Azeris were internally displaced within Azerbaijan. The country also hosted 244,000 refugees, including 188,000 ethnic Azeris from Armenia. U.S. Committee for Refugees, *Country Report: Azerbaijan 1999*, at <http://www.refugees.org/world/countryrpt/europe/azerbaijan.htm> (10 June 1999).

<sup>15</sup> See Sabit Bagirov, "Sotsialno-ekonomicheskiye aspekti perekhoda k rinku v Azerbajjanye," unpublished paper (Baku, Azerbaijan: 1999).

the manat, went into virtual free fall in early 1998.<sup>16</sup> While Azerbaijan's currency—also the manat—has remained relatively stable, the Kazakhstan tenge suffered sharp losses in 1999.

## LABOR'S PAINS

These recent economic problems mean that the governments of the region are likely to feel increasingly constrained from adding expenditures in the social service sector. The governments of all eight countries are already reducing their social service obligations to their populations, increasing the disappointment among people who expected to reap the benefits of energy wealth. Even in Turkmenistan and Uzbekistan, which have the most generous social policy regimes in the region, the government has accepted the idea that the state must restrict its fiscal obligations. In gas-rich Turkmenistan, the government may have to renege on its founding commitments to provide generous social services to its population, an action that would be of considerable embarrassment to the current Niyazov government.

Plans to raise minimum wages and pensions throughout the region are likely to be delayed or to result in less substantial increases than officials initially deemed desirable. For example, in Uzbekistan the minimum wage is only \$6 per month, while in Kyrgyzstan this figure is \$6 per week.<sup>17</sup> Neither of these represents a livable wage. In fact, the European Bank for Reconstruction and Development (EBRD) estimates that between 1993 and 1996—a period of economic “take-off”—the proportion of the Kyrgyz population living on less than \$40 per month increased from 40 to 60 percent.<sup>18</sup>

Rising unemployment is another sign of growing social dislocation. Unreliable official unemployment statistics make examination of the problem difficult. While the EBRD claims that

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<sup>16</sup> The Kyrgyz som dropped from 8.030 to the U.S. dollar at the end of 1993 to 24.378 to the U.S. dollar at the end of October 1998. International Monetary Fund, *International Financial Statistics, January 1999* (Washington, DC: International Monetary Fund, 1999) pp. 430-431. Between February and June 1998, the Turkmen manat slid from 4,165 to the U.S. dollar to 5,200 to the U.S. dollar. *Interfax Banking and Finance Report*, 25 February 1998, as translated in *Foreign Broadcast Information Service Daily Report*, SOV-98-056, 3 March 1998; *Interfax Financial Report for 26 June 1998*, 24 June 1998, as translated in *Foreign Broadcast Information Service Daily Report*, SOV-98-175, 26 June 1998.

<sup>17</sup> European Bank for Reconstruction and Development, *Transition Report 1998* (London: European Bank for Reconstruction and Development, 1998) pp. 175 and 199.

<sup>18</sup> *ibid.*, p. 175.

19.3 percent of Azerbaijanis are unemployed,<sup>19</sup> official statistics claim that this figure only amounts to 0.48 percent.<sup>20</sup> The problem of documenting unemployment exists in every country in the region. Experts at the Washington consulting group PlanEcon suggest calculating unemployment by finding the difference between the number of people listed as working and the number of economically active members of society. Using this method, they estimate Kazakhstan's unemployment at nearly 1 million people, almost four times more than the official figure of 269,343.<sup>21</sup> (PlanEcon's calculations, though, would include all those with "hidden" employment, and so are likely to be as seriously inflated as official unemployment statistics are deflated.)

Throughout the Caspian Basin region, the industrial workforce is still experiencing layoffs in virtually all but the oil sector, and the newly unemployed industrial workforce generally lacks the skills necessary to find employment in the energy sector. In most countries there has been an increase in production in the food-processing sector, and in Turkmenistan and Uzbekistan the textile industry has witnessed growth. However, these increases will not create nearly enough jobs to compensate for those lost through the near-total collapse of heavy industry. Consequently, the population remains demoralized and disaffected—a situation ripe for civil unrest.

One important group that is excluded from any discussion of employment is the multitude of refugees and other displaced persons who live in the region. Refugees, particularly those fleeing from Abkhazia, comprise a significant population in Georgia, and those displaced by inter-ethnic conflict and the fight over Karabakh make up an even greater portion of the population in both Armenia and Azerbaijan. In fact, in Armenia one out of 17 people is a refugee, and in Azerbaijan that figure is one in 31. These figures do not include those fleeing from their homes and relocating within the country. There are nearly twice as many people who fled from Armenia-occupied Azerbaijan than from Armenia proper. None of these governments have done a good job of accommodating the needs of these populations, as it is often easier to keep them as political hostages than to help them find jobs.

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<sup>19</sup> *ibid.*, p. 153.

<sup>20</sup> This percentage is based on 1997 population figures. See International Bank for Reconstruction and Development/World Bank, *World Development Report 1998/99* (Washington, DC: International Bank for Reconstruction and Development/World Bank, 1999) p. 190.

<sup>21</sup> PlanEcon, *Review and Outlook for the Former Soviet Republics, October 1998* (Washington, DC: PlanEcon, 1998) pp. 122-123.

## THE DETERIORATING QUALITY OF LIFE

Employment is only one of the challenges governments confront with refugee populations. Lack of housing also represents a critical problem: five years after fleeing their homes, thousands of Azerbaijani refugees are still living in freight cars. Meeting the education and health needs of this segment of the population is also a big challenge. Even when intentions are good, resources are lacking. In fact, the situation has gotten so bad that representatives of the United Nations High Commissioner for Refugees in Kyrgyzstan threatened in January 1998 to cut aid from donor countries if the Kyrgyz government failed to improve educational and health standards.<sup>22</sup>

The problem of Nagorno-Karabakh—and hence the fate of the refugee populations in Armenia and Azerbaijan—has become intertwined with the development of Caspian oil reserves. Both countries have used the dire conditions of their refugees to press for advantage with U.S. policymakers. Much of the wrangling has been over Section 907 of the Freedom Support Act of 1992, which restricts U.S. assistance to Azerbaijan.<sup>23</sup> While the Armenian lobby has generally had the upper hand in influencing U.S. lawmakers, the growing political influence of U.S. oil companies in Azerbaijan has leveled the playing field somewhat and has led to modifications in these restrictions. Nonetheless, Section 907 did seem to work to the detriment of American oil interests.

Finding employment, even for those whose lives have followed their normal course, has proven difficult. The eight countries of the region had the highest birth rates in the former Soviet Union during its later years, rates that were high by any standard. Population growth has slowed markedly in recent years, but throughout the Caspian Basin region the workplace has to absorb tens of thousands of young people each year. This is virtually impossible in the current economic situation. These chronically

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<sup>22</sup> “Kyrgyzstan Grapples with Refugee Problem,” *Radio Free Europe/Radio Liberty Newsline*, 21 January 1999, at <http://www.rferl.org/newsline/1999/01/210199.html> (21 January 1999).

<sup>23</sup> The official title of this legislation is the Freedom for Russia and Emerging Eurasian Democracies and Open Markets Support Act. Section 907 prohibits any U.S. aid to Azerbaijan, with the exception of nonproliferation and disarmament assistance, until the president reports that Azerbaijan has lifted its blockade on and ended hostilities toward Armenia and the Armenian-controlled Nagorno-Karabakh region. Proposals to repeal section 907 have failed, but the idea of lifting the ban on U.S. aid to Azerbaijan is still being discussed.

unemployed young people tend not to be included in unemployment statistics.

Even today societies in Central Asia and the Caucasus are having substantial difficulties meeting the basic education needs of the population. Official figures show substantial declines in the enrollment rate in primary, secondary and in some cases higher education. Anecdotal evidence suggests that the declines were even greater than what the governments reported, whose figures were in any case incomplete. In most countries, higher education has been an area of particular focus of state investment; new elites are being fostered to succeed in the competitive global economy. So while investment in basic education stagnates, special elite schools and academies have been opened throughout the region, and government-sponsored scholarship programs have been organized to send able youth abroad.

TABLE 2  
Educational Enrollment, Percentage of Relevant Age Group

	Basic		Secondary		Tertiary	
	1989	1995	1989	1995	1989	1995
Armenia	98.8	84.4	35.9	29.1	3.6	11.2
Azerbaijan	90.6	86.7	33.0	25.8	8.0	8.0
Georgia	90.5	86.1 <sup>a</sup>	38.8	26.6 <sup>a</sup>	14.7	16.4 <sup>b</sup>
Kazakhstan		86.0 <sup>a</sup>		90.0 <sup>a</sup>		42.0 <sup>a</sup>

<sup>a</sup> Data from 1993

<sup>b</sup> Data from 1994

Source: UNDP Regional Bureau for Europe and the CIS, *Poverty in Transition?* (New York: UNDP, 1998).

The crisis in education is sure to have implications for the development of Caspian energy reserves, as Western oil companies will have an increasingly difficult time meeting their technical manpower needs with local hires. If these countries are forced to depend upon outside labor, they will inevitably develop into "rentier states."<sup>24</sup>

The health system, like the education system, is in a desperate state. With states facing increasingly limited means to provide

<sup>24</sup> According to Terry Lynn Karl, a rentier state is an oil-exporting developing country in which all oil revenues accrue directly to the state. These states' "economic power and ultimately their political authority rest on their dual capacity to extract rents [i.e., investment] externally from the global environment and subsequently to distribute these revenues internally." Karl, p. 49.

public health benefits, the health care system slips into even greater disarray, deteriorating markedly even in comparison to its sorry condition in the late Soviet period. Free universal health care is becoming a thing of the past, although it remains a right to which most people still feel entitled—one that they would have enjoyed had the energy dollars flowed in as predicted. Eventually, health care will be replaced by subscriber-supported health insurance programs. In most places, the number of physicians and hospital beds available are declining. Basic inoculations are becoming more difficult to come by, especially those considered “non-essential,” like measles. Incidents of hepatitis and tuberculosis are reaching near-epidemic proportions in some of these places. In much of the region, basic pharmaceuticals are reported to be either expensive or in short supply. In general, anecdotal evidence suggests that these official statistics paint a rosier picture than is actually the case.

Some place partial blame for these dire health statistics on the lack of energy investment in the region, but foreign oil companies themselves have inadvertently created another health care-related problem. These companies are being pressed to build quality health care facilities at their exploration sites. These facilities will benefit the people in those specific areas, but it causes resentment among people in other parts of the region who lack access to decent care. This phenomenon contributes to the polarization and conflict within these societies.

The dire economic conditions faced by many of the region’s residents presents a stark contrast to earlier predictions of energy-based prosperity. As the disparity between expectations and reality increases, so does the possibility for social unrest. The question of what percentage of the population in these states lives in poverty is contentious; the answers speak directly to the prospects for stability. The EBRD estimates that 48 percent of the population of Turkmenistan lives in poverty, as do 44 percent of the population of Armenia and 50 percent of the population of Kazakhstan.<sup>25</sup> These figures, however, may be overly optimistic.

#### **SOCIAL INSTABILITY AS AN IMPEDIMENT TO ENERGY INVESTMENT**

It is hard to know just how poor these societies have become, and even harder to assess the potential consequences of their growing impoverishment. It is clear, however, that growing

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<sup>25</sup> *ibid.*, pp. 151, 173 and 195.

instability in the region is one of those consequences, and this creates a vicious cycle in the game of energy investment. The lack of petrodollars contributes to the region's poverty, which in turn fosters instability, which in turn discourages investment in these countries. What makes the region even more unstable is that these states are all closely intertwined with the countries on which they border. Unrest in one place is likely to quickly reverberate. This has serious potential implications for the development of oil and gas reserves in landlocked countries, with the transit of several states necessary to get resources to the market.

In the end, much of the future stability of the Caspian region depends upon the confidence that the leadership enjoys. Popular support of the elite is something that one can only estimate due to the fact that in most of these societies, those in power have been unwilling to submit themselves to democratic tests of public approval. President Heydar Aliev of Azerbaijan, for instance, was reelected by a wide margin in October 1998, but most of the popular opposition leaders declined to run against him. Nevertheless, there were numerous charges of election fraud, and Aliev's principal opponent, Ektibar Mamedov, claims that he was robbed of the opportunity to take the election into a second round.

The future of Azerbaijan—as both an important oil producer and the linchpin to plans bypassing Russia and shipping oil and gas from Central Asia—remains clouded. Shortly after his election in October 1998, the 75 year-old President Aliev fell ill and was rushed to Turkey for emergency medical treatment. While the president wants to be succeeded by his son Ilham, the head of Azerbaijan's state oil company (SOCAR), the country's major opposition leaders are unlikely to acquiesce quietly to being once again edged off the political stage.

In Kazakhstan, potential investors may also find the political environment increasingly fragile. The election law passed before Kazakhstan's January 1999 elections effectively barred all serious opponents from being listed on the ballot and ensured President Nursultan Nazarbaev's victory. Here too, there were still many reports of election fraud, and the Organisation for Security and Cooperation in Europe (OSCE) offered an extremely critical assessment of the election.<sup>26</sup> The criticism was serious enough that the government was compelled to register the Republic Party, led by President Nazarbaev's chief opponent, former prime minister

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<sup>26</sup> Organisation for Security and Co-operation in Europe/Office for Democratic Institutions and Human Rights, *Preliminary Statement: Election Assessment Mission, Republic of Kazakhstan 1999* (Almaty, Kazakhstan: Organisation for Security and



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Akezhan Kazhegeldin. Kazhegeldin's stated goal is to win seats for his supporters in the 1999 legislative election, but he is also reportedly interested in making Nazarbaev's presidency as ineffectual as possible.

Charges of election fraud have already driven one other Caspian Basin president from office. President Levon Ter-Petrosian of Armenia resigned from office in 1998, less than two years after his election. Presidents Niyazov of Turkmenistan and Karimov of Uzbekistan have yet to face meaningful opposition in their contestation for office. Both are said to have rebuffed attempts on their life. The attempts on Niyazov are only rumors, but a wave of powerful explosions went off in Uzbekistan's capital city of Tashkent on 16 February 1999, one narrowly missing the Uzbek president.

In Georgia, President Eduard Shevardnadze has narrowly escaped assassination on a number of occasions and successfully defused a small army uprising in the country's second-largest city of Kutaisi in October 1998. For all its democratic inclinations, Georgia is still the most fractured of all the Caspian Basin states. In addition to a stalemate in Abkhazia, center-periphery relations have not been resolved with the ethnic enclaves of Adjara and southern Ossetia. In general, the population in most of the region shows great signs of tolerance, even though officials have chosen lavish lifestyles in the face of economic strain. President Niyazov of Turkmenistan is rumored to have seven palaces, while Kazakhstan's President Nazarbaev has four lavish official residences, two in each of the nation's capitals.

The region's rulers are fond of telling Western politicians that their people are culturally disposed to like a strong hand and to be supportive of their authoritarian leaders.<sup>27</sup> The test will come when these men begin to pass from the scene.

In none of these countries is there a legitimate heir-apparent, notwithstanding President Aliev's efforts to promote his son Ilham. As leaders begin to falter, there will be a struggle for power

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Co-operation in Europe/Office for Democratic Institutions and Human Rights, 11 January 1999) at <http://www.osce.org/indexe-se.htm> (30 January 1999).

<sup>27</sup> Following a referendum in 1995 that extended Nazarbaev's term in office through 2001, a Western correspondent asked the Kazakh president to respond to charges that the referendum had authoritarian overtones. He replied that "Kazakhstan and our neighbors...are situated in Asia, and we have a certain mentality. If the West is really interested in democracy being victorious here, then we have to admit that...there could not be the kind of democracy they have in Britain. ...So let us have an end to mourning something that has never existed here." Kazakh Television First Program Network, 30 April 1995, as translated in *Foreign Broadcast Information Service Daily Report*, SOV-95-083, 14 November 1995.

in each of the oil- and gas-rich states, and existing elite are likely to try and solve things behind closed doors. But those who have been closed out of power should try to take advantage of deteriorating social conditions and growing popular dissatisfaction.

How the inevitable succession struggles will play out is a question for speculation. But there are dangerous developments brewing in the region. Young people who see no future for themselves are natural allies of populist demagogues, whether they be nationalist or religious extremists. Radical Islamic groups have been active in Central Asia since the 1970s, and they are already credible political actors in post-civil war Tajikistan.

Criminal elements are more prevalent in the region than before. Murders and other violent crimes are on the rise in many parts of the region, with the increase in crime reflecting the activities of organized gangs as well as frustrated individuals. Organized protection rackets are now commonplace, contract killings are relatively easy to arrange and there are even reports of child slave-traders becoming active in the region.

More frightening still is the growing role of narco-business. Each year tons of opium pass through the region. Recently, a substantial heroin traffic has developed as well. The Caspian Basin states are becoming more efficient in controlling their borders, and stories of sizeable drug busts are now commonplace.<sup>28</sup> However, effective border controls are still a prospect for a more distant future. With the low salaries in the region, drug traders have little difficulty buying local officials,<sup>29</sup> and as heroin production within the area increases, the power of the narco-mafia will increase as well.

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<sup>28</sup> In May 1998 over 500 grams of heroine and approximately 90 kilograms of raw opium were found in a vehicle at the Kabul guard post in Tajikistan's Pendzhikentskiy Rayon, which lies on the border with Afghanistan. In February of that year, Kazakh officials seized 30 kilograms of raw opium, worth \$60,000 wholesale, from a hidden compartment in the trunk of a car in East Kazakhstan. In Uzbekistan, the Interior Ministry carried out the "Black Poppy-98" operation from April to June 1998, in which almost 2 hectares of poppies were destroyed, 500 criminal cases were opened and 250 foreigners were detained on drug charges. Over the course of 1998, 24 metric tons of drugs, including hashish, marijuana, heroine and opium were intercepted in Turkmenistan en route from Afghanistan. *Pravda*, 14 May 1998, as translated in *Foreign Broadcast Information Service Daily Report*, TDD-98-138, 21 May 1998; *Kazakhstanskaya Pravda*, 5 February 1998, as translated in *Foreign Broadcast Information Service Daily Report*. TDD-98-040, 12 February 1998; *Interfax*, 22 June 1998, as translated in *Foreign Broadcast Information Service Daily Report*, TDD-98-173, 23 June 1998; *Interfax*, 15 January 1999.

<sup>29</sup> In March 1998 Kyrgyzstan began the trial of a group of police officers charged with operating a drug-smuggling network. One of the accused was the former head of the anti-drug trafficking section of the Osh internal affairs department. *Vecherniy Bishkek*, 19 March 1998, as translated in *Foreign Broadcast Information Service Daily Report*, TDD-98-082, 25 March 1998.

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None of this means that the states of the Caspian region will implode any time soon. However, any time an educated population has difficulty finding work—not to mention feeding and educating their children—there is a substantial political risk. The fact that these states have weak political institutions and no predictable pattern for succession further magnifies this risk.

If oil and gas riches begin pouring in soon, the Caspian Basin states could well face a bright future. But promises of riches do not translate readily into security. The slower-than-anticipated development of the region's energy export potential means that negative scenarios for the future must be considered as well. It also means that the states of the region must deal with their social problems first, instead of waiting for energy revenue to solve those problems for them. ♣



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