Chapter Three

GEO-POLITICS OF ENERGY IN CENTRAL ASIA: INTERESTS IN KAZAKHSTAN
Outline

This chapter discusses the geo-political and strategic importance of the Central Asian region. It traces interests in Central Asia from history to current and analyses the possibilities and impact on the development of oil & gas industry with specific reference to the Republic of Kazakhstan. (States of Caucasus are integral part of the global politics in the region, hence covered for clarity of understanding)

3.1 Why Central Asian and Caucasus region?

Emergence of independent states in Central Asia and the Caucasus in 1991 have attracted keen interest from developed countries, neighbouring countries, corporations, academia and media. The growth in interest is primarily because of two key points.

- The countries around the Caspian have huge natural resources and strategic placing. These former Soviet republics link Europe and Asia geographically and Christianity and Islam culturally. They are flanked to the east by a rising great power (China); to the north by their former hegemon (Russia); to the south by a country collapsed in violent chaos (Afghanistan), a fundamentalist Islamic republic (Iran), and a fragile secular state in search of a greater regional role (Turkey)\(^1\).

- Eight fragile new polities (three in Caucasus and five in Central Asia) are, at present, in the absence of established government institutions, largely shaped by the vision and wisdom of their

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leaders. Now under construction, and a huge potential expanse has opened these republics to the pressures and perils of the international system. Players from around the globe are competing for a pie of the cake.

In the economic scene the most important piece of action is taking place in hydrocarbon sector. The region is expected to be the next frontier in the growth and development of the world hydrocarbon industry. This new region is defined less by demography or geographic proximity than by geology: Graham Fuller has aptly said, the Caspian is where the oil is.\textsuperscript{2}

The region is being perceived critical from the viewpoint of future security of energy supplies (as an alternative to Persian Gulf) mainly because of following developments.

- The first development has been the evolution of partnerships between some of these new states and foreign oil and gas companies—partnerships driven by the shared objective of producing and exporting the hydrocarbons of the Caspian Sea basin. For oil companies, it represents a huge opportunity, particularly because the bulk of the world’s oil reserves (most located in the Persian Gulf) are close to them. Three proven fields in the region, Tengiz and Karachaganak in Kazakhstan and the off-

\textsuperscript{2} Remarks by Graham Fuller at the seminar "American Business and Strategic Priorities in the Caspian Region: Oil, Security, and Democracy," held by the U.S.-Azerbaijan Council, Washington, DC, November 5, 1997.
shore Azeri-Chirag-Günesli complex in Azerbaijan, are undisputed giants, as is the Turkmen gas field Dauletbad-Donmez. Attracted by substantial proven reserves and by the promise of fabulous wealth from oil and gas fields that have yet to be explored fully, the world's oil bosses are falling over themselves to secure a piece of the Caspian action.

- The second development is the realization that the Caspian oil and gas is useless unless it reaches market. In an entirely landlocked part of the world, it is the route of potential export pipelines, more than anything else, that will determine regional alignments and outside influence. At present, Russia controls all export routes.

The consequences are summarised as below:

No wonder that the Caspian has become a magnet for geopoliticians. A slew of national-security experts—from Zbigniew Brzezinski to James Baker—are advising American oil companies. Central Asian presidents are feted in Washington, Bonn and Beijing with an enthusiasm quite disproportionate to their present economic firepower. Countries that few people had heard of two years ago make international headlines as journalists rediscover the Great Game, Rudyard Kipling's tag for the 19th-century struggle between Russia and Britain for influence in Central Asia.³

3.2 Comparison of Great Game with Today

The comparison with 'the Great Game' has become a cliché, but it is misleading. Where the old Great Game was rooted in tsarist expansionism, the new Great Game's origins lie in the collapse of the Soviet Empire. Where the 19th-century emirs and khans gradually fell under Russian control, today's regional leaders are asserting their independence. The original Great Game had only two big players, the empires of Russia and Britain. Today there are many more players, both outside and inside Central Asia. The region is caught in a complex web of power-game-flanked by neighbouring countries and a distant superpower (USA) seeking, if not dominance, at least influence. But what distinguishes the current 'Great-Game' is, the participation of several non-state actors like NATO and OSCE in the quest for influence.

Though the perception of present actors has changed in comparison to past players the basic objectives remain the same, namely gaining power and influence in this vast landmass with huge natural resources. From a historical and geographical perspective, the region's location and rich mineral resources had attracted many outside powers and at one point time this region was the "focal point" for different competing civilizations (Persian, Arabic, Chinese, European and Turkic). This is the landmass for which Britain's geo-political theorist of the 20th century, Mackinder coined the term "Eurasian Heartland". He was of the opinion that whosoever would control this region could control the
whole world\(^4\). Oil played a crucial role in the geo-strategic plans and actions of great powers like England, Turkey and Russia until the Second World War.

### 3.3 Diversity and Challenges

The new playing field is inherently complex and is further complicated by a vast array of problems. Within the region, these include intra-regional conflict, internal political instability, unscrupulous entrepreneurial operators, and a shortfall in commercial expertise.

Between the Black Sea and the Chinese border, more than 70 million people live in eight countries that did not exist in that form a decade ago. Yet culturally, linguistically and historically many of the borders between them are artificial. Iran is home to more Azeris than Azerbaijan; 1m Kazakhs live in China; Uzbeks form an important ethnic group in Afghanistan. Tajiks speak Persian, whereas Azeris, Turkmen, Uzbeks and Kazakhs speak Turkic languages.

Nor are the religious divisions neat. Azerbaijan is part of the Caucasus, yet its people are Muslim, like those in Central Asia. Georgia and Armenia are Christian. Nagorno-Karabakh, the much-disputed mountain enclave in western Azerbaijan, is full of Christian Armenians. The ethnic divisions are equally confusing. The Soviet planners who redrew the map in the 1920s divided Central Asia broadly along linguistic lines, hoping to construct nations from the various nomadic and


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Semi-nomadic tribes of desert and steppe by exaggerating the differences between their dialects. These divisions, imperfect to start with, were subsequently blurred further by heavy Russian immigration and Stalin's eastward push in the 1930s to ethnic groups such as the Volga Germans and Tatars. More than a third of the inhabitants of Kazakhstan are Russian, and so are around 18% of the people of Kyrgyzstan, despite a large exodus in recent years. One in five citizens of Tajikistan is an Uzbek.

Barring a few exceptions, these countries did not have a strong sense of nationhood. The Kazakh nomads fell under Russian domination early in the 19th century; the khanates of Khiva and Kokand and the emirate of Bukhara (loosely speaking, modern-day Uzbekistan) became “protectorates” of the Russian empire in the 1860s and 1870s; Turkmen lands fell a few years later. By the end of the 19th century, Central Asia’s emirates and khanates were all puppet fiefs under the Russian tsar. From this historical and cultural legacy, those countries will have to build modern nation-states to achieve the stability they need to make proper use of their oil and gas bonanza.

Equally important is the need to build market economies from the rubble of the Soviet regime. The collapse of the command economy is one thing that all the republics have in common. All of them suffer from industrial collapse, from collectivised and deeply inefficient agriculture, and from the environmental and economic follies of central planning. The precise circumstances differ: Uzbekistan, for instance, was never
closely tied into the Russian industrial complex; instead, its economy depends on an environmentally disastrous cotton monoculture. Most of Kazakhstan's oil is in the west of the country, but its refineries are in the east.

Resource-wise, Kazakhstan is a huge land mass with few people, full of oil, natural gas, gold, uranium, copper and many other minerals, and with vast agricultural potential. Azerbaijan and Turkmenistan have small populations, and lots of oil and gas, respectively. Uzbekistan has a sizeable population and is a big producer of cotton and gold. Kyrgyzstan has a bit of gold and lots of water—a resource that could conceivably become more important than oil within a generation. Tajikistan has some gold and not much else. Armenia and Georgia are short of natural resources, but are strategically placed for transport routes. These differences add up to an altogether more complicated game with higher stakes.

It is impossible to overestimate the difficulties these countries will face, but there are also grounds for optimism. Half a decade ago few outsiders expected these countries to remain independent; now their sovereignty is taken for granted. After years of runaway inflation and chaos, several of them have recently made great economic strides. Given enlightened policies, both outside and inside these countries, the Caspian region can prosper. In the absence of such policies, the new Great Game could become a great nightmare.
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It is easy to be pessimistic. To use natural-resource riches sensibly takes wise and stable government; yet wisdom and stability are in short supply. The Caspian’s infant states have authoritarian leaders, faltering economies and burgeoning corruption. Outside meddling, particularly from Russia, has been short-sighted and destructive. Ethnic tensions, overt in some places, simmer below the surface virtually everywhere.

This chapter will try to answer a simple question. How will resource wealth affect this region’s future? It could be an enormous opportunity to cement independence, to accelerate economic development and to build new inter-regional ties. Yet sudden riches also carry many risks. History is awash with examples of countries that have squandered their natural-resource wealth. A generation from now, will the resource-rich Caspian states look more like Norway or like Nigeria? Will the resource-poor share in any prosperity or be left struggling?

3.4 Interested Players
As one begins to address the issue of moving Caspian oil and gas to market, the zone of interest expands dramatically in all directions, stretching from China to the Black Sea and from Russia to the Persian Gulf. If one’s emphasis is the production of hydrocarbons, the Caspian region is a vaguely defined subset of Central Asia and the Caucasus. If the emphasis is on the exports of these resources, the Caspian becomes much larger.
Central Asia and the Caucasus would occupy an important position in the post-Cold War world even if they held no hydrocarbons. The Caspian basin happens to lie near the center of a huge area that in 1991 became, almost overnight, the world's most important and contentious geopolitical no-man's land. With the collapse of the Soviet Union, Central Asia and the South Caucasus emerged from direct subordination to Moscow for the first time in more than a century. A geographically vast and culturally diverse area was suddenly opened to geopolitical competition from all sides. The independence of the region's weak, uncertain, and fragmented new states is still fragile, and neighboring countries—China, Pakistan, Iran, Turkey, Ukraine, and of course Russia—cannot help but be interested and involved in its future, oil or no oil. Nor can the United States ignore Central Asia and the Caucasus as it continues to define its role as the one remaining superpower. From an international relations perspective, the Caspian energy rush is most significant as a playing field on which different states are trying to position themselves as a new balance of power in the region is established to replace the previous Russian hegemony.

It seems that the routing of new oil and gas pipelines from the Caspian basin will greatly influence the region's future geopolitical orientation. Trans-border pipeline infrastructure is a relatively enduring way to link countries together. This political aspect of pipelines is well understood by the countries that border on the Caspian region, as well as those inside it. Along with the states, domestic actors, ethnic groups, and
multilateral regimes, the politics of Caspian energy involves another group of important players: international oil and gas companies.

Foreign policy concerns related to the regional balance of power, national security, and potential economic benefit have led four external powers to strive for export pipelines to be built across their territory: Russia, Iran, Turkey, and China. A fifth country, the United States, has increased its own efforts to influence the pipeline race, while several other countries are vying to be involved more indirectly in the transportation of Caspian oil (this group includes Ukraine, Romania, Bulgaria, Macedonia, Albania, and Greece). In the middle are the Caspian states, seeking to take advantage of their influence over pipeline choices to advance their own prosperity, security, and independence. Meanwhile the companies that will actually finance, build, and use the pipelines are studying the technical and commercial details of the various options, and actively pursuing some.

**External State Actors**

1. **Russia**

Russia's perception of the region is based on its multiple interests. From the geopolitical standpoint this region is strategically located on strategically important Russia's southern periphery. Russia does not want to lose its influence in this region. The first crisis that it faced soon after the disintegration of the Soviet Union was the rise of secession of Chechnya in 1991. In an interview to *Rossiskaya Gazeta*, the then Minister of Nationalities, Abdulatipov summarised the Russian concern...
by saying, "Today there are forces, which want to separate Caucasus from Russia." High level Russian officials have stated publicly that since Russia developed the region's existing infrastructure under the Soviet Union, it owes Russia a debt for this service.

During the times of former President Boris Yeltsin, Russia exerted assertion on states in Caspian region through economic, political and sometimes military pressures. A series of agreements had been signed with Kazakhstan, Azerbaijan and other states to increase its sphere of influence. However, in view of recent experiences in Central Asia like conflicts in Tajikistan and Georgia, Russian leadership is beginning to pay more attention to the negative consequences of regional instability. Terrorism, religious extremism, ethnicity, arms and narcotics trade, military conflicts and inter-dependent economy are some of the factors common to all the states, including Russia.

Internally, there are two groups. There are those who believe that integration with the West rather than having entangled in Central Asia and Caucasus, will serve the country's interest better. But other factions believe linkages to the West will prove illusory and want Moscow to reassert control in its periphery. Despite the internal contradiction, Russia continues to exercise significant influence over the region. To date, Russia has attempted to retain influence over Caspian oil developments via three main policies:

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• Maximizing the role for Russian companies in the area
• Controlling transport out of the land locked region
• Using the uncertain legal status of the Caspian Sea to undermine confidence in or prevent unilateral offshore oil developments by arguing that resource development should not be advanced in the area unless sanctioned by all five surrounding states including Russia, Azerbaijan, Kazakhstan, Iran and Turkmenistan.

This three-pronged strategy can only be effective if domestic oil and gas companies, active in the Caspian, are willing to act as agents of government policy.

2. Iran

Like other regional powers, Iran also wants to maintain its historical relationship with the Caucasus and Central Asian countries. Iran pursues a policy of greater economic co-operation and joint ventures with all these states with specific goals of political influence, profitable economic and commercial relations, and procurement of former Soviet weaponry, including nuclear expertise and materials. In oil and gas resources, it has vision to become a oil transit point in short run and an independent gas exporter in the long run.

However, several factors constrain Iran’s efforts in building influences in the Caucasus and Central Asian region. Firstly, Tehran is currently focussing on its own economic reconstruction, thereby lacks the resources to become a major economic player. Second, it apprehends
danger to its territorial integrity, due to ethnic unrest among its Azeri population, nearly twice as many as in Azerbaijan. It, therefore, relies on Russia for controlling the secessionist activities.\textsuperscript{7} Third, the most important, US economic sanction has to date inhibited investment in an Iranian route. In 1997, however, USA cleared such route and disallowed swaps.

Despite these limitations, in the recently held Eurasian Summit at Almaty, the Iranian Vice President Hasan Habibi claimed that "Iran has the necessary infrastructure, pipelines, refineries, and export terminals, having ample capacities to transport huge amount of raw material".\textsuperscript{8} However, if proposed pipeline in co-operation with Turkmenistan do not come up, Iran may become a potential competitor for Turkmenistan as it is already opening up sizeable gas fields to foreign investment and keenly eyeing Pakistan and India as markets.

3. \textit{Turkey}

Turkey has had strong ties to the Caspian region, particularly due to presence of Turkic ethnic groups. These ties, considerably weakened during the Soviet period, have got renewed after the Soviet break-up. Newly independent Caspian states regarded Turkey as a "model of development" and Western powers encouraged it, due to it being democratic and NATO member, to play an important role in the region. As a result, Turkey, at the expense of Russia and Iran, concluded a number of strategic agreements with Caspian states, especially with

\textsuperscript{7} Daniel Smith, "Central Asia: A New Great Game," Asian Affairs, Fall, 1996, p.161
Georgia and Azerbaijan. It argued, in light of Russian role in removal of Ajerbaijan's president Elchibey, Nagarno-Karabakh issues and Abkhaz separatist rebellion in Georgia, in favour of oil export route without Russia.

Despite Ankara's keenness to route pipeline through its own territory, several factors have hindered the movement in this direction. First, Turkey's geographical distance from the region weakened the influence and its role as a "bridge" to the west as countries of this region have developed their own relations with the western countries. Second, any route from Kazakhstan or Ajerbaijan has to pass through Iran and/or unstable Armenia or Georgia to reach Turkey. Thirdly, Turkey's review of limit on tanker traffic through the Bosphorous Straits for reasons including safety and environment have affected transport routes.

4. China

Like Turkey and Iran, China also want to enhance its sphere of influence in the region. The Chinese model holds appeal for the region's more conservative and authoritarian leaders who wish to reform economically without doing so politically. Chinese interest is because of following reasons:

- China has become one of largest trading partner of Kazakhstan, Kyrgyzstan and Uzbekistan during the last decade.

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8 SWB, 27 April, 2000.
• To maintain its territorial integrity by ensuring that the Xinjiang-Uighur Autonomous region, historically a venue of Turkic and Muslim separatist agitation, remain firmly under Beijing control.
• To retain buffer zone in the form of Central Asia against eastward expansion of NATO.

China expansion as an economic and military power, requirement of large supplies of energy resources, and close cultural and economic ties with Central Asian states have enhanced its aspirations in this region. However, linking China requires huge investment because of distance and difficult terrain. In recent years, though, the China National Petroleum Corporation (CNPC) has acquired a large stake in the oilfields of Kazakhstan.

5. USA
The United States, following an active and coherent foreign policy towards this region, has three main goals.

• Support for sovereignty and independence of the states in the region.
• Support for the market economic reforms in the region where the US has significant commercial interests particularly in the oil and gas sectors with a view to further increasing its potential for economic interaction with it.
• Support for diversification of world oil supplies to reduce over dependence on the Persian Gulf oil.
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The US, apart from having strategic interest, has declared its intention to pursue cooperation in the development of energy resources amidst peaceful regional environment. In pipeline diplomacy, the US is for lesser role of Russia and Iran. It wants pipelines, even costlier, to go through Georgian and Turkey.

A study published by Heritage Foundation outlined the following policy options for the US to follow in the region:

- Promote and strengthen independence, sovereignty and democratic government in the region.
- Increase its diplomatic involvement in the resolution of regional conflicts such as those in Nagorno-Karabakh and Abkhazia.
- Promote market economic reform and assist in harnessing energy resources, communication and transportation links to create a viable east-west axis.¹⁰

Also, the study recommended special emphasis in the South Caucasus as it helped in American investment in the region.

6. Other Countries

Other Western and developed countries like the UK, France, Japan and Italy, share policy goals with the US, including encouraging stable, independent, secular, democratic and market-oriented countries in the Caspian region and pursuing profitable commercial deals that would
benefit their own domestic firms.\textsuperscript{11} Pakistan, among Asian countries, nostalgic about recreating Silk route, does not evoke much commercial interest with respect to linkage with the region because of unstable conditions in Afghanistan and lack of expertise. India, on the other hand, having historical linkages and shared interests in containing Islamic Fundamentalism, possesses skills and scientific know-how in hydrocarbons as well as huge market for oil and gas. However, the fact that all potential pipelines have to pass through Pakistan make them politically undesirable.

\textit{Non-State Actors}

Of late NATO, OSCE, The World Bank, EBRD and European Union have also started playing an important role in this region. Post the Washington Summit of 1999, NATO has initiated a number of programmes for Central Asian and Caucasian states within the framework of its Partnership for Peace (PFP) Programme. Joined by countries like Kazakhstan, Kyrgyzstan, Uzbekistan and some Caucasian countries, it worked in conversion of military industries to consumer industries and wants to deploy peace keeping forces in the region for enhanced security. Russia, for obvious reason, has opposed all moves of NATO in the region. Similarly, post Istanbul in 1999, OSCE started intervening in the region for peace. Initially approved by Russia, OSCE is now being seen as western attempt to interfere in its domestic affairs after an OSCE team went to Chechnya. However,

\textsuperscript{11} Rosemarie, F., 'The Politics of Oil in the Caucasus and Central Asia', Adelphi Paper, May 1996, p.28

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Central Asian states consider OSCE as balancing force reducing their dependence on a Moscow sponsored collective security mechanism.

The World Bank, EBRD and European Union, so far provided assistance in enhancement of infrastructure, technical know-how and humanitarian aids, may increase their role in future.

The analysis of energy politics among above mentioned players, with experts opinions, is covered in section 3.5.

3.4 Contentious Issues in the Region

Caspian Reserves and World Energy

Oil and gas are crucial to the global economy, and accordingly a great deal of emphasis has been placed on the importance of Caspian resources to world energy supplies and energy security. However, an accurate and methodologically valid comparison of Caspian energy reserves with the world's total resource base, with rare exceptions, is missing. The result has been a dramatic overestimation of the scale of the region's resources—and thus an overstatement of the likely importance of the Caspian to future global oil supplies.

One reasonably authoritative public accounting of the total proven reserves of the Caspian region is provided in a report delivered by the
State Department to the United States Congress\textsuperscript{12} in early 1997. The term "proven reserves" is defined in the oil business as the quantity of oil which can be produced profitably, given current prices and technology, from a proven field, i.e., a field where the existence of oil has already been confirmed through the drilling of successful exploration wells. According to US Energy Information Administration (May 2001), at least 18 billion barrels\textsuperscript{13} of proven oil exists in Caspian region (consisting of Kazakhstan, Turkmenistan, Uzbekistan and Azerbaijan). A figure overleaf shows the comparative perspective.

\textbf{Figure 3.1: The World's Proven Oil Reserves (billion of barrels)}

<table>
<thead>
<tr>
<th>Region</th>
<th>Proven Oil Reserves (billion of barrels)</th>
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<tbody>
<tr>
<td>Rest of the World</td>
<td>250</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>300</td>
</tr>
<tr>
<td>Iran</td>
<td>200</td>
</tr>
<tr>
<td>Venezuela</td>
<td>100</td>
</tr>
<tr>
<td>Russia</td>
<td>50</td>
</tr>
<tr>
<td>Caspian Region</td>
<td>10</td>
</tr>
</tbody>
</table>


\textsuperscript{12} US Department of State, 'Caspian Region Energy Development Report', delivered to Congress as required by H.R. 3610, April 1997.

Based on these numbers, total proven reserves in the Caspian are less than one quarter of Venezuela's and one-seventeenth of Saudi Arabia's. The figure of 18 billion barrels cited above is somewhat conservative; most geologists would currently classify between 25 billion and 35 billion barrels of Caspian oil reserves as "proven." Furthermore, the reserve numbers for the Caspian region are likely to show significant growth as new areas are explored (just as exploration is steadily adding to the proven reserves of many other oil regions around the world). The report to Congress cited above uses a figure of 145 billion barrels as an estimate for the additional "possible reserves" of the four Caspian states. This estimate, which assumes that truly gigantic resources will be discovered in the as yet undrilled Kazakhstani sector of the North Caspian Sea, is far more optimistic than most of the internal geological analyses done by oil and gas companies, which tend to estimate the ultimate reserves of the Caspian (including reserves already proven) at somewhere between 40 and 75 billion barrels.

However, all of these numbers are speculative as significant risk remains that it may not contain oil. Preliminary drilling offshore in the South Caspian has already yielded some disappointing results. At the same time, it is certainly possible that the Caspian basin could hold 75 billion barrels of oil, or more. For the time being, however, it is important to keep in mind that Central Asia and the Caucasus at this point have been demonstrated to contain no more than two to three percent of the world's proven oil reserves. As Geoffrey Kemp
emphasizes, in terms of energy resources alone, it is impossible to make the case that the Caspian region is an area of global strategic importance on the scale of the Persian Gulf\textsuperscript{14}.

This important point is muddied in most research on the Caspian. With a handful of exceptions, the literature tends to cite reserve figures that range from optimistic to unrealistic\textsuperscript{15}. The most commonly used estimate for the region's oil reserves is 200 billion barrels, with no distinction made between "proven" and "possible" reserves: in a July 1997 address, the U.S. Deputy Secretary of State Strobe Talbott referred to "as much as two hundred billion barrels of oil\textsuperscript{16}." One article states that the Caspian region holds "oil reserves estimated to be at least as large as those of Iraq and perhaps equal to those of Saudi Arabia\textsuperscript{17}." Former U.S. Secretary of State James Baker goes further: "Caspian oil may eventually be as important to the industrialized world as Middle East oil is today\textsuperscript{18}.

This exaggeration may seem unimportant, but in some cases, it can result in misleading conclusions. These statements are unsupportable

\textsuperscript{14} Geoffrey Kemp, Energy Superbowl, pp. 14, 62-63. Geoffrey Kemp is director of Regional Strategic Programs at the Nixon Center for Peace and Freedom.


\textsuperscript{17} Richard Pipes, "Is Russia Still an Enemy?" Foreign Affairs, vol. 76, no. 5 (September/October 1997), p. 73.
for commercial as well as geological reasons: Saudi Arabia can add a marginal barrel of oil production at a fraction of the cost to a company working offshore in the Caspian Sea. Strong emphasis on energy security as the region's geopolitical significance, therefore, is not at the core. Energy security is perhaps the only U.S. policy objective in the region that is uncontroversial on both the domestic and international stages. Hydrocarbons alone, as an end in themselves, have brought oil and gas companies to the Caspian, but they cannot account for the importance accorded to the region in the foreign ministries and intelligence agencies of much of the world. There is another dynamic at work here. Oil is an important piece of a larger picture: the balance of power in Eurasia.

Export Economics

The landlocked geography of the Caspian Basin region creates serious logistical impediments to speedy exploration and development. The region is distant from major supply centres for exploratory equipment and faces a crippling shortage of modern drilling platform and other related materials. Technical and geographical impediments act as a major constraint on oil and gas development. For example, a well completion that takes 2-3 months in Gulf, North Sea or US would take almost 2 years in Central Asia.

All talk of energy politics will be useless if enough oil and gas are not there to fill up the pipelines proposed. An examination of purely economic factors reveal following observations:

- Given drilling, transportation and other logistical constraints, export volumes from the region is not likely to reach significant levels for the next two to three years. This mean that there will continue to be pressure to develop more limited make-shift option.

- Given reasonable expectations for economic recovery and growth, the littoral states of the Caspian Sea such as Ukraine, Romania, Bulgaria and Turkey can absorb much of the projected export surplus of Caspian oil. Oil demand from these countries, combined with possible demand from refineries in Grozny, Russia and northern Iran could absorb as much as 900,000 BL/d to 1.4 million BL/d by 2010. This development will help alleviate congestion in the Bosporus, but also reduce the volumes available to fill on-land pipeline routes beyond the Black Sea\(^{20}\).

Therefore, many envisaged pipeline routes may not be viable. Details on number of pipelines required are provided in Appendix Two.

### 3.6 Understanding Pipelines Politics

From the many diverse approaches on Caspian energy politics, two distinct schools of thought, whose adherents might be referred to as “Great Gamers” on one side and “Oilers” on the other, must be

\(^{20}\) Central Asia 2010, UNDP, September 1999, p.25
combined in order to gain a full understanding of the Caspian pipeline politics.

1. The "Great Game" Revisited?

Analysts who view Caspian energy geopolitics through the lens of classic balance-of-power politics often emphasize the historical resonance between today's situation and the "Great Game" of the nineteenth century, in which Britain and Russia competed for influence in Central Asia, Afghanistan, and Persia. For the Great Gamers the competition over pipelines boils down to the question of whether Russia will be able to maintain its current near-monopoly on the transport of oil and gas from the region. If new oil and gas pipelines flow only through Russia, then Russia might be able to increase its hegemony in Central Asia and the Caucasus. If new pipelines are built in other directions, however, Russian predominance in the region will be undermined. After a tendency early in the post-Soviet period to focus on Iran and Turkey as Russia's chief competitors for influence, the consensus among many of this school has moved toward the view that "the Caspian area may prove to be one in which a true incompatibility of U.S. and Russian interests will become pronouncedly manifest." Accordingly, a growing number of Great Gamers are now

21 Small volumes of oil from Kazakhstan, Azerbaijan, and Turkmenistan have been exported via tanker, rail, and swap arrangements through Iran, Georgia, and even China. But pipeline exports can be made only through Russian pipelines. For gas, however, the first crack in the Russian pipeline monopoly has appeared with the December 1997 completion of a small pipeline connecting Turkmenistan to the Iranian gas pipeline system.

focused on Russian-American rivalry in Central Asia and the South Caucasus.

Many commentators urge a more assertive and more coherent Russian policy toward Caspian energy while decrying what they perceive as Western encroachment in the region. The prevailing tone is one of gloom over the ineffectiveness of Moscow's current tactics and over the growing likelihood that Russia will lose the pipeline derby—thus losing, it is assumed, influence over the southern tier of its former empire as well.

Policy advocates on the American side are not nearly as confident that U.S. policy is having the powerful effects ascribed to it in this passage. Increasingly, however, their approach is characterized by an emphasis on Russian neo-imperial behavior in the South Caucasus and Central Asia and a conviction that the United States must become more engaged in the area to counter Russian ambitions. Frederick Starr, Ariel Cohen, and Sheila Heslin, among others, support their case by pointing to a large body of evidence that suggests Russia's hegemonic designs on the Caspian region and its energy resources²³. Often cited are the destabilizing role of the Russian military in regional military conflicts; Russia's covert intervention into Azerbaijani and Georgian

domestic politics; the Russian Foreign Ministry's attempt to hinder offshore energy development by questioning the legal status of the Caspian Sea; and the successful entrance of the Russian oil company Lukoil into several projects in Azerbaijan and Kazakhstan.

This anti-Russia line would appear to contradict official U.S. policy, which is characterized by nothing stronger than the stated objective of "promoting the independence and sovereignty of the Caspian states" by supporting a diversification of pipeline routes away from the monopoly control of any one state. The distinction between these two views—official and unofficial—is, however, one of nuance and degree rather than fundamental principles. Russia is the state that currently holds near-monopoly control over Caspian pipeline routes. It is also the only state that could reasonably abrogate the sovereignty and independence of the states to its south in the foreseeable future. Therefore, the Great Gamers usually end up in the same place that the government does, recommending U.S. support for non-Russian pipelines, and specifically for the initiative which did indeed become the centerpiece of U.S. policy toward Caspian energy in the second half of 1997: an "east-west transportation corridor" consisting of a Baku-Ceyhan oil pipeline as well as trans-Caspian oil and gas pipelines.\(^24\)

\(^{24}\) See Ariel Cohen, "U.S. Policy," p. 2 and passim, and Sheila Heslin, "The New Pipeline Politics." Ceyhan is a Turkish port on the Mediterranean Sea which is one of the possible endpoints for a large-capacity pipeline from Azerbaijan; this pipeline as now conceived would pass through Georgia along the way, although the U.S. government has not given up hope of it transiting Armenia. Trans-Caspian pipelines in Washington's vision would collect oil and gas from Kazakhstan, Uzbekistan, and finally Turkmenistan before crossing beneath the Caspian Sea into Azerbaijan, heading thenceforth to Turkey along the Baku-Ceyhan route.
Iran is another important concern from a balance-of-power perspective, but there is a sharp divide over how it fits into the picture. One school of thought considers the existing U.S. policy of containing Iran to be a major obstacle in the struggle of the Caspian states to resist Russia—Starr even sees it as “forcing them into Russia’s arms.”25 Iranian export routes from either side of the Caspian Sea have the advantage of directness; they do not pass through areas where Russia can bring substantial political or military pressure to bear. In this view, reliance on pipelines to Turkey—which must transit Georgia and (from Central Asia) the Caspian Sea—leave too many cards in Russia’s hands. This argument has also been marshaled in recent criticisms of the Iran containment policy that are not primarily driven by Caspian concerns.

Other Great Gamers who view the situation from an American perspective, believes Iran should be prevented from gaining the sort of political and economic influence in the Caspian region that an export pipeline would bring. To some extent, this perspective simply reflects the realities of U.S. policy toward Iran, which is likely to change very slowly if at all: if containment of Iran is abandoned, it will not be primarily due to U.S. interests in the Caspian region.

Some observers have also commented on the increasing cooperation between Russia and Iran on several issues, including arms sales, the legal status of the Caspian Sea, support for anti-Taliban forces in Afghanistan, and in one instance cooperation in applying military

25 Frederick Starr, “Power Failure in the Caspian,” p.29
pressure on Azerbaijan. From this point of view Iran is cast not as a road away from Russia for the Caspian states, but as Russia's partner in seeking to hem them in and prevent them from realizing full independence. Indeed, on three fundamental questions, Russian and Iranian interests are very much aligned. Neither wants to see the United States increase its influence in the South Caucasus and Central Asia; neither is keen on seeing Azerbaijan flourish as an independent state (Iran for fear that Azerbaijan would exert a pull on Iran's own sizeable Azerbaijani minority); and neither wants to accept the current de facto division of Caspian sub-sea energy resources into five sovereign sectors, which according to current geological wisdom would leave the vast majority of the Sea's hydrocarbons in the hands of Azerbaijan, Kazakhstan, and Turkmenistan.

As Robert Freedman\textsuperscript{26} has pointed out, the question of pipelines, and more broadly of transportation, represents the primary obstacle to long-term partnership between Russia and Iran. Despite their tactical alliance on the issues cited above, the interests of the two states diverge when it comes to trade, transit, and pipelines. Booming cross-border trade with Iran in non-energy sectors has already made the economies of Azerbaijan and Turkmenistan largely independent of Russia outside the realm of oil and gas. Turkmenistan's recently completed gas pipeline link with Iran is intended as a first step toward eventual access to the Turkish market. Such access would put it in direct competition with Gazprom, Russia's natural-gas monopoly, for

\textsuperscript{26} Robert O. Freedman, "Russia and Iran: A Tactical Alliance," S A I S Review, vol. XVII, no. 2
which Turkey represents a crucial growth market. For oil, every barrel of Caspian crude committed to an Iranian export route will be a barrel that is not committed to a Russian route, and vice versa.

Turkey is another key player in the regional balance of power. In the period immediately after the Soviet collapse, Turkey was seen as a secular model—and an alternative to Iranian-style Islamism—for the five Turkic newly independent states\(^{27}\). Turkish President Turgut Özal set aside the core Kemalist principle of disinterest in the affairs of Turkic peoples beyond the borders of modern Turkey and worked to cultivate relationships with these new states, particularly Azerbaijan, to which it is most closely connected both geographically and linguistically. Özal's vision benefited from strong American support; with the Gulf War fresh in their minds, Washington policymakers viewed Turkey as a crucial ally and a country of considerable strategic importance in the post-Cold War world. But Turkey's early ambitions were quickly scaled back for a number of reasons, including Özal's death in April 1993 and the fall of Azerbaijan's pro-Turkish president, Abulfəz Elchibey, two months later. Yet Turkey remained engaged in the region, including Chechnya, where the alleged presence of Turkish intelligence operatives prompted Russian President Boris Yeltsin to say in one particularly candid (one might say overly candid) speech, "The Turks have always threatened us; now they are helping the Chechens."\(^{28}\)
One idea conceived during Elchibey's brief period in power— that an oil pipeline be built from Baku to Ceyhan—survived its creators, and it has gradually grown into a top foreign-policy priority for Turkey. Such a pipeline would not only bring economic and political benefits, but it would also divert new Caspian oil away from Black Sea ports, thus preventing the possibility of a large increase in tanker traffic through the Turkish straits, the Bosporus and Dardanelles. While Turkey has legitimate environmental concerns about the capacity of the straits to handle more traffic, its regulation remains subject to the Montreux Convention of 1936, which gives the Bosporus the status of an international waterway. Steady growth in tanker traffic through the Bosporus would give Turkey two choices, neither of which is appealing: first, standing by while the environmental risks escalate; or second, picking an open fight with Russia by challenging the Montreux Convention directly. Already the Bosporus has become a point of contention between Russia and Turkey, and one of the focal points for their rivalry in the Caucasus. Russian diplomats tend to see Ankara's Bosporus gambit as nothing more than an attempt to win the Baku-Ceyhan line.

With U.S. support for Baku-Ceyhan at the center of Washington's new activist policy toward the Caspian—as the best way to prevent either Russian domination of, or Iranian inroads into, the Caspian pipeline derby—the Turkish-American partnership in the South Caucasus and
Central Asia has solidified, helping to encourage "Moscow's perception that Turkey is a major threat to Russian interests."29

China is the final external player whose position in Central Asia (though not the Caucasus) warrants attention from the Great Gamers. It is a relatively new entrant into the pipeline competition, which China joined in earnest in 1997 when China National Petroleum Corporation (CNPC) won a privatization tender enabling it to purchase a majority stake in one of Kazakhstan's oil-production subsidiaries; won exclusive rights to develop another Kazakhstani oil field; and pledged to do a feasibility study for a new oil pipeline to be built from Kazakhstan's western oil fields to the Chinese border, and presumably beyond. While these developments caused some amount of surprise and alarm among American observers, and probably among Russians as well, the Great Gamers are only beginning to conceptualize China's new position in Caspian energy. This debate reflects great diversity of opinion. Ross Munro, while acknowledging that "China is focused more to [its] south" than toward Central Asia, nonetheless argues that it will eventually exert "tremendous influence" over the region, particularly Kazakhstan.30 Justin Jon Rudelson has gone so far as to say that "China will win the Great Game."31 Meanwhile, Graham Fuller argues that nationalism and separatism in western China, encouraged by the example of Central Asia's independence, will lead to "the diminution of the size and

influence” of China while Rajan Menon makes a solid case that “China has conceded Russia’s preeminent role in Central Asia.”

Three characteristics define the approach of the Great Gamers to the geopolitics of Central Asia and the South Caucasus.

- First, they adopt one of the basic principles of realist analysis of international relations: the assumption of the unitary state. Russia, in particular, is treated as a single actor, one with many tentacles to be sure, but with all of the tentacles working more or less together to pursue something resembling a Russian national interest.

- Second, the emphasis is on competition between states rather than cooperation. The partnerships that do arise—Russia and Iran, the United States and Turkey—are forged by competitive forces, by the need to counterbalance rivals. The “Great Game” is thus conceived of primarily as a zero-sum game. Here too this school has implicitly adopted a fundamental tenet of realist thinking.

- A third characteristic is that one of the most important players in the Caspian oil rush—the oil companies themselves—tend to disappear from the picture. The status of the largest oil and pipeline projects is tracked, and the role of the companies is superficially recognized as being important, but in conceptual terms the role of the companies themselves in the Caspian pipeline derby is generally given short shrift.

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32 Graham Fuller, “Russia and Central Asia: Federation or Fault Line?” in Michael Mandelbaum, Central Asia and the World, p. 125.
2. The Oilers's Perspective

Contrasting with the approach of the Great Gamers to Caspian pipeline politics is a second perspective whose adherents might be called "Oilers." The Oilers' view of the situation is in fact informed by a logic that is fundamentally different. Theirs is an economic logic based in commercial and financial analysis rather than a geopolitical logic rooted in competition among states and the balance of power. Oilers begin by putting companies at the center of their analysis. This judgement is grounded in the fact that energy companies rather than states are the prime forces behind the technical study, planning, financing, and eventually the operation and utilization of new pipelines from the Caspian. States can certainly block or complicate pipeline projects. But in the environment of the late-twentieth-century global economy and the discipline of world financial markets, states have little capacity to push projects forward on their own. With the possible exception of the Chinese alternatives, none of the pipeline projects that have been proposed are likely to have states or state-owned companies rather than private companies leading the financing and construction efforts.

An approach that focuses on the decisive role played by the oil companies in choosing pipeline routes is strengthened by the fact that the Caspian states themselves, contrary to conventional wisdom, have thus far been more observers rather than the central actors in the pipeline derby. The governments of Turkmenistan and Kazakhstan have focused primarily on near-term efforts to get more of their current
oil and gas production exported through Russia using the existing Soviet-era infrastructure. The impetus for exploring various pipeline routes for the future, however, has come from external actors.

- The Caspian Pipeline Consortium project, which plans to build a new pipeline from northwest Kazakhstan to the Russian port of Novorossiysk, has been a public-private partnership with private oil companies taking the lead and providing the financing.
- The same is true for the proposed oil and gas pipe-lines from Turkmenistan to the Pakistani market and the port of Gwadar.

Chinese and Iranian pipelines have so far been promoted primarily by those two governments, although the private sector will play a more active role in these projects if the pipelines are indeed to materialize. Azerbaijan is a partial exception, as its government has worked in close cooperation with the AIOC to pursue export solutions. But even in this case, Baku’s role has been primarily one of close consultation with ultimate, though as yet unused, veto power, while the AIOC is responsible for studying, recommending, and eventually financing all export pipelines.

The objective of oil companies is well known: to make money. For the part of the company’s activity that concerns oil production, its primary goal is to maximize the “netback value” of its crude. The producer

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33 The netback Value normally includes consideration of market prices for the refined oil products from a given barrel of oil.
seeks to sell its oil on an ongoing basis to oil refineries or traders for the highest possible net price, i.e., the price received minus all transportation costs to the point of sale. In its other role as an investor in new pipeline infrastructure, that same company is driven first and foremost by the goal of securing export access for its crude. And given its interest in maximizing netback values, it will be motivated to set a transit tariff as low as possible. But here the realities of project finance and ownership structure intrude. Often, ownership in a pipeline will be shared with the states through which the pipeline passes. These states would generally prefer high pipeline tariffs. Also, most large energy-sector projects are financed by a combination of equity and debt. In order to have any hope of attracting project loans, the tariffs must be high enough to generate a rate of return for lenders that—after it is adjusted downward to reflect perceived risk—is comparable to the returns available for other investments around the world.

Taking all this into consideration, the pipeline contest suddenly appears much more complex than it does from a Great-Game perspective. A host of commercial and technical issues emerge as important factors affecting corporate decisions on pipelines.

- From a producer’s perspective, seemingly obscure market issues, such as the projected price differential between oil sold in the Mediterranean Sea, the Persian Gulf, and the Russian domestic market, become crucial. Different financial and tariff structures for
pipeline projects can result in divergent alignments of interests among shippers, lenders, and host governments.

- Moreover, the relationship between different oil companies and consortia is dynamic: What one group of companies in one part of the Caspian chooses to do with its production can dramatically change the playing field for other producers in the region.
- Finally, the concept of time-discounting and net present value, central to all financial analysis, creates a bias against the expensive, large-scale pipelines that are envisioned in much of the Caspian energy literature.

If a collection of smaller, cheaper solutions—including those that are aimed at local and nearby markets for crude oil—can together meet the requirements of oil producers operating in the Caspian region, then there is no reason for these producers to build a long, multi-billion dollar, large-capacity pipeline. Upto this point, politics has been conspicuously absent from the above discussion of the oil-company perspective on Caspian pipeline choices. In fact, politics is incorporated into the commercial logic of the companies through its effect on the perceived risk of various transportation options.

In each of the two approaches described above—the netback-value analysis of producers and the rate-of-return analysis of pipeline investors—political risk is incorporated into all economic calculations. When the AIOC made its decision in October 1995 to use two pipelines to ship its early volumes of oil from offshore fields, it made a conscious
decision that sole reliance on either a Russian route or a Georgian route would be too risky on a number of counts. Given the high levels of political risk associated with the choice of a single route, a two-pipeline solution was commercially optimal. This mechanism of risk adjustment gives the companies an analytical approach that can, in principle at least, subsume within it all of the region’s geo-political intricacies.

The oil-company perspective on political risk also includes an interactive component. It acknowledges that the companies themselves can affect the levels of political risk associated with a given transportation solution through their commercial strategies and tactics. The hydrocarbon reserves of the Caspian basin (using current proven reserve figures) are worth approximately $850 billion. Whereas the Great Gamers tend to see these hydrocarbons as the prize at the center of a de facto zero-sum game, companies see them having a serious independent effect on the geopolitics of the region by providing a powerful incentive for cooperation. The way that this value can be mobilized to reduce political risk accounts for the other major difference between the Great-Game and Oiler perspectives on pipeline politics: their differing positions on whether to perceive the surrounding states as unitary actors or collections of interest groups and other sub-state actors. From the perspective of an energy company seeking to mitigate political risk, viewing the states surrounding the Caspian region as unitary actors would not be useful. There is no way to give “Russia” a stake in Caspian oil development. Oil companies active in the Caspian
have instead perceived Russia in a more pluralistic way, and focused on specific, tangible actors within Russia that can be mobilized in support of their commercial agenda. The behavior of these companies fits closely with Michael McFaul's perspective on Russian foreign policy, which sees economic interest groups playing a central role in policy formation.\footnote{Daniel Yergin and Thane Gustafson, ‘Evolution of an oil Rush’, The New York Times.}

The most important actor within Russia has been Lukoil. Lukoil is often portrayed as being one of the main instruments of Russian policy in the Caspian region, a “Soviet-style” cartel that acts as the “long arm of the Russian government” to “obstruct progress” in Caspian oil development and help Russia pursue a unified “carrot and stick approach” toward the region and its resources. There is a grain of truth at the center of this depiction: Lukoil did enter the consortium that was later to form the AIOC on the strength of lobbying by the Russian Ministry of Fuel and Energy, as well as the assumption on the part of both the government of Azerbaijan and its Western partners that it would be wiser to let Lukoil into the project than to make a point of excluding it. But since that time, Lukoil’s activity in the Caspian has been less characteristic of an instrument of Russian national interests than of a private company, which should come as no surprise, considering that only 15 to 20 percent of its shares are still owned by the Russian state.

In Azerbaijan, Lukoil was a founding partner in the AIOC, where it participates on the same basis as the other partners. As a 10- percent
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stakeholder in the AIOC, Lukoil has invested its fair share of the consortium's expenditures, over $100 million so far. Its de facto recognition of Azerbaijan's right to develop the AIOC oilfields has been crucial in undermining the Russian Foreign Ministry's position, which argues that Azerbaijan's unilateral development of the fields is illegal.

Its support for the project in Moscow has played a central role in shaping Moscow's increasingly constructive approach toward the AIOC, best symbolized by the Foreign Ministry's gradual slide toward its current position on the Sea's legal status—which accepts the principle of median-line division for subsea resources. Privately and publicly, Russia's foreign-policy elite has criticized Lukoil for acting in its own selfish interests rather than the broader interests of Russia. Nor is it lost on either the Russian or Azerbaijani sides that Lukoil's president and founder, Vagit Alekperov, a Russian citizen, is also an Azerbaijani who was born, raised, and educated in Baku.

Lukoil's very different fortunes in Kazakhstan suggest that Lukoil's success in Azerbaijan cannot be attributed simply to pressure on the part of the Russian government. In Kazakhstan, where Russian influence is notably stronger than in Azerbaijan, Lukoil has for the most part been denied entry into the oil-production sector—despite its intensive efforts to convince Kazakhstan to cede part of its share in the Tengiz project and the Offshore Kazakhstan International Operating Company (OKIOC) exploration and production venture. Lukoil did
manage in 1997 to purchase a 5 percent stake in the Tengiz project through its joint venture with Arco, which owns approximately 8 percent of Lukoil, but this share was purchased from Chevron for a non-concessionary price after Kazakhstan refused to part with any of its own stake.

**Blending the Two Approaches**

The Oilier perspective on Caspian energy development and transportation is a useful, and indeed necessary, supplement to the currently predominant Great-Game approach. At the very least, a more complete understanding of the commercial realities is the outcome. Moreover, any examination into the state of play regarding the likelihood of various pipeline options must start with the oil companies, netback values, and rates of return. China’s rising geopolitical clout notwithstanding, if an oil pipeline from western Kazakhstan to China does not offer netbacks that are superior to other available options then non-Chinese companies producing oil in Kazakhstan will not use it to ship more than token quantities of oil.

At the same time, a full understanding of the international politics of Caspian energy development must start from the perspective of the Great Gamers that emphasizes the inter-state competition taking place in Central Asia and the Caucasus. A pluralist approach to the various states can be useful, but the heuristic assumption of a unitary state can also play an important role in drawing out the areas of mutual and divergent interests among various states and in understanding patterns
of alliance and rivalry. The competition for power and influence in this region, much of which is currently focused on the routing of pipelines, will have broad and lasting implications for the balance of power in much of Eurasia. For external powers, energy increases the stakes in the Caspian region, while pipelines provide a clear focal point for competition among these states. Indeed, as competition between states becomes more established and active over time, the capacity of states to affect Caspian energy development appears to be growing—at the expense of the flexibility and the relative autonomy that has been enjoyed thus far by oil companies in the region.

3.6 The Domestic Implications of the Caspian Energy Boom

In the initial interest in the energy resources of Central Asia and the Caucasus, one unstated assumption lay beneath much of what was written: that the money earned from oil and gas exports would be a boon for the economies of the region. More recently, however, an increasing number of authors are questioning this assumption, largely through an application of the lessons learned in other countries where resource exports have led to revenue booms. The assumption that oil leads to prosperity turns out to be highly problematic: in fact, the empirical evidence shows that resource wealth tends to have a negative effect on economic growth, and on other economic indicators as well. The effect of the expected windfall on domestic politics in Azerbaijan, Kazakhstan, and Turkmenistan is also attracting some preliminary analysis. On this point too, a growing consensus suggests that a Caspian energy boom, if and when it takes place, may well have
pernicious side effects on the prospects for domestic stability and the development of civil society and democracy in these three states.

One need not be an optimist about the scale of Caspian reserves or ultimate oil and gas production in the region to conclude that energy revenues will have a dramatic effect domestically. The following table represents a snapshot of what the energy export revenues of the three richest hydrocarbon states might look like in 2010, relative to their GDP, even under pessimistic assumptions for energy development:

**Table 3.1: Kazakhstan, Azerbaijan, and Turkmenistan 2010:**

<table>
<thead>
<tr>
<th>Combined GDP</th>
<th>$52.4 billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil Exports</td>
<td>2.7 million barrels per day</td>
</tr>
<tr>
<td>Gas Exports</td>
<td>63 billion cubic meters per year</td>
</tr>
<tr>
<td>Revenue from Exports</td>
<td>$15 billion</td>
</tr>
<tr>
<td>Energy-Export Revenue as Percentage of GDP</td>
<td>29 percent</td>
</tr>
</tbody>
</table>


This ratio of 29 percent puts these three countries in the ranks of the major energy-producing countries, somewhere between Iran (about 17 percent) and Saudi Arabia (about 45 percent). The hydrocarbons of the Caspian basin may not end up being overwhelmingly important to global markets, but they will certainly have huge effects on the domestic economies of the states which export them.
Common sense suggests that, other things being equal, a national economy with energy revenues flowing into it will be better off than that same economy without energy revenues. But, as one cogent overview of the issue points out, “The trouble is that other things never are equal.” Resource booms introduce distortional effects into an economy and create a series of problems that, if they are not managed very carefully by policymakers, can more than undo the positive effects of energy exports. One such problem is the phenomenon known as the “Dutch disease,” so called because it was first identified when the Netherlands became a major exporter of natural gas in the late 1950s.35

- Rapid increases in a state’s resource exports generally lead to a substantial appreciation in the real exchange rate of its currency. This makes it more difficult for producers of any other traded goods to export their wares or compete against imports. The result is often a contraction of the manufacturing sector of the economy.
- A second problem is that oil booms link a country’s economic prospects closely with the volatile world oil market. In theory, this should not be a problem; in practice it almost always is. The windfalls brought during high-price periods tend to be wasted or misspent, whether by an authoritarian elite or by democratic politicians seeking votes. When drops in the oil price produce

35 'A Caspian Gamble', Ibid.
revenue shortfalls, the result is usually huge budget deficits, macroeconomic instability, and high inflation.

Another pernicious effect of resource booms is particularly salient for Azerbaijan, Kazakhstan, and Turkmenistan, all of which are still at varying stages of their post-Soviet transition to the market. This is the tendency for resource revenues to lead to the expansion of the public sector and to increased state intervention in the economy. This trend contradicts directly what is perhaps the most important goal of the current stage of reform for these states: "a dramatic reorientation of government away from commanding and controlling economic activity. . . ." Yet oil and gas are generally considered strategic resources, and with a handful of exceptions the state plays a leading role in energy sectors all across the world. Kazakhstan may avoid this effect to some extent, as it has already privatized certain parts of the domestic oil industry by selling many of its regional production subsidiaries to foreign investors. But the more usual pattern of state ownership can be seen clearly in both Azerbaijan and Turkmenistan.

Another side of this same issue centers on the fact that hydrocarbon revenues need to be spent or invested somehow, and in many boom states they are channeled by the government into domestic investments that would not attract capital in a free-market financial environment. This is hardly a problem if these investments are being used to build schools and hospitals; the more common pat-tern,
however, is for petrodollars to flow into huge industrial projects that will never turn a profit. This process is often less than transparent and based on criteria that can be highly subjective. An abundance of low-quality public investment of this sort tends to engender rent-seeking behavior. With cheap capital flowing from the state on the basis of the subjective decisions of government officials, it becomes rational at the micro level for individual entrepreneurs to spend their time and effort lobbying those officials rather than devoting it toward economic activity that would increase productivity. If this continues to the point where the state becomes a generally more promising source of wealth than the market, then the situation becomes quite grim. Rather than seeking to build a bigger pie, individuals are instead simply competing to get the largest possible share of the existing pie—a pie made up of oil rents.

In theory, this rent-seeking dynamic can emerge even without any corruption on the part of government officials. But corruption fits quite neatly into the scenario described above, and makes the entire picture even worse. Many observers emphasize the danger that the Caspian oil boom will feed and expand the corruption that is already common in Central Asia and the South Caucasus. Corruption, of course, was a pervasive part of the Soviet system; by the late 1970s as much as 15 to 18 percent of the economic activity taking place in the USSR was in the illegal “second economy.” Furthermore, illegal economic activity was even more common in the southern Soviet republics. In the centrally planned economy, bribes and “unofficial” payments of all sorts
played a crucial role in bringing price signals and individual incentives into an economy that in theory had done away with both.

Perversely, the most blatant form of corruption associated with hydrocarbon revenues—out-and-out embezzlement—might actually help to mitigate some of the negative economic effects of a Caspian oil boom. Oil money that flows directly into a Swiss bank account cannot trigger the Dutch disease. Of course, this would be small consolation next to the potential political effects of corruption on these developing states. Corruption exacerbating the region's "dicey combination of increasing economic inequality and surging popular expectations" is a main concern of several observers. Expectations in the Caspian states are clearly high, partly due to government rhetoric, which has sought to downplay current hardships and emphasize instead the prosperity that lies ahead. If this prosperity does not materialize over time while a narrow elite appears to be enriching itself, the consequences could be serious. Possibility of an Iranian-style revolution or an anti-Western back-lash, given the fact that the West will be so closely associated in the minds of most Azerbaijanis or Kazakhstanis with an oil boom.

These analyses assume autocratic government, and the possibility that resource wealth may encourage authoritarianism is another concern for domestic politics in the Caspian hydrocarbon states. Is Thomas Goltz right when he suggests that "oil and civil society"— or oil and democracy— "don't mix"?37 Goltz wonders whether Azerbaijan will

37 Thomas Goltz, 'Oil and Civil Society Don't Mix', War Report, no.45 Sep 1996, p.41

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become a "second Norway" or a "second Kuwait," turning on its head the more usual formulation which portrays a dichotomy of Norway or Nigeria. The difference is revealing. From an economic perspective, both Kuwait and Norway are relatively successful; in fact, one is more likely to hear a politician from the Caspian region talking about his state as a second Kuwait than a second Norway. In any case, Norway was a thriving democracy long before the hydrocarbons of the North Sea were discovered, and its example therefore may not be particularly relevant for the prospects of democracy in Central Asia and Azerbaijan. Certainly the transition toward democracy and civil society has been slow in the Caspian states. And, while it seems unlikely that any sort of causal relationship can be established between resource wealth and authoritarianism for the period 1991 to 1997—for this region and this period, authoritarianism seems to be overdetermined—a case could be made that some correlation does exist. Turning to the future, both experience and common sense suggest that moving further down the path toward democracy and civil society will not be made any easier by booming energy exports.

To conclude, it becomes clear that Kazakhstan's fortunes depends on the outcome of ensuing oil-politics, and internal leadership. In next chapter, Kazakhstan's internal developments and their outcomes are discussed in details.