

The ‘Transition impact’ of the EBRD Presence in Central Asia

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Abstract

Challenges of economic transition from the Soviet-type system to the market economy still exist in Central Asia. The thesis looks on the barriers that slow down the process of transition in the region, focusing its attention on the financial system as a foundation for the sustainable economic development. The study investigates the functioning of the EBRD, as a 'transition bank' in Central Asia, which helps to overcome these barriers. In the research cases of comparative analysis of banking reforms in Kazakhstan and Turkmenistan is presented. The research shows that the EBRD is an important agent in Central Asia that helps to improve financial system in the region and integrate it into global economy. The study is useful for understanding Central Asian economy, in particular, development of banking structure, as well as for understanding of the functions of International Financial Institutions in the region and, specifically, the work of the European Bank for Reconstruction and Development.

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Introduction

Two decades have passed since the abandonment of the planned economy structure in Central Asia and the adoption of the market economy structure for the achievement of sustainable development of the region. Integration into the world economy was crucial for the survival of the Central Asian economies. However, this region was not so interesting for the investors as other former-socialist countries due to the uncertainty in Central Asia caused by the lack of institutional apparatus and proper legislation.

The transition process has taken several distinctive features in Central Asia. At the breakthrough of the Soviet Union all five central Asian countries had almost the same characteristics, so one can talk about it as a region. First of all, the main economic sector in Central Asia is agriculture. These countries' economies are based on raw material export, predominantly oil, gas and nonferrous metals. The creation of a larger number of processing factories was a sign of transition. However, there is still high dependence on natural resources. Second, the markets were at an initial level of development, as well as the trade system, which was also characterized by no access to the sea. In addition, there was less interest in the region from foreign investors due to the lack of proper economic institutions and poor legal system. Third, the political structure consisted of a single party. During the transition some countries changed into a multiparty system. However, in Central Asia there is still a strong influence of the government on the economy of the state characterized more as an autocratic government, rather than democratic.

International Financial Institutions (IFIs) came to the region in order to help the countries by precise functioning and specific activities to pursue the common goal of an integrated stable economy. IFIs were created in majority after World War II to improve the

relationship between countries and stabilize world economy. Most of the IFIs work on the analogy with joint-stock corporation. A bigger percentage of the share in the institution allows to have more influence in the work of it.

All IFIs play essential functions for the countries, as their investments, loans and technical help open the opportunities for the member-country. They help to develop the member-country's economy by integrating it into the world economy and strengthening its relationship with the other countries. The same principles make the work of other countries understandable and transparent that foster trade, capital flows and mutual beneficial agreements between countries. During the transition period to the market economy, the IFIs are especially helpful as through their abilities, resources and multinational experience they can make up for the lack of human skills in a country, the shortage of significant institutions and the lack of financial resources.

The main advantages of the IFIs, as pointed out by Nicholas Stern on the annual meeting of the European Bank for Reconstruction and Development (the EBRD) in 2001, are knowledge about development and experience accumulated by work in many countries, well developed 'risk management', 'capacity building' of the member-countries to manage problems and function on its own, 'conditionality' ability to help to implement suitable effective reforms, and, finally, 'convening' ability to unite several countries and organizations for cooperation¹. In my opinion, all of these capabilities of the IFIs are due to their international origin, accumulation of a big amount of financial resources, independence from the particular country (conditions of the host country cannot influence significantly the functioning of the IFI) and bureaucratic institutional structure. These abilities of the IFIs help to unite various resources, like finances, human capital, knowledge and skills from the supra national level that have the best conditions for the successful completion of goals.

¹ Nicholas Stern, "Investment and poverty: the role of the international financial institutions," in *A strategy for development*, 173-185 (Washington D.C.: The World Bank, 2002), 181.

As it has previously been stated, IFIs are very useful in the promotion of the economic development of the countries. This study will look at their impact in Central Asia. Nicholas Stern views that the biggest impact IFIs can achieve by focusing on the stimulation of the private sector driven growth that at the same time reduces poverty². One of the IFIs in Central Asia that has the same vision of progress in the region is the European Bank for Reconstruction and Development (the EBRD). The EBRD has taken this path by helping to improve public sector instruments, yet, emphasizing its work on the private sector that is a key to the involvement of poor population into a country's economy, in other words, a key to poverty reduction.

The EBRD is a unique international financial institution that provides its activities from Central Europe to Central Asia. Its headquarter is based in London. The EBRD was established in 1991 responding as a tool to help post-Soviet countries in their transformation from command economy to market economy. The Bank is owned by 61 countries and two IGOs: the European Community and European Investment Bank³. It is also the largest financial investor in the region⁴. The EBRD provides direct financing, assistance to small businesses, consultations and other forms of investments⁵.

The EBRD is "the world's only transition bank"⁶. Its specialization is precisely on the assistance to transition from planned economy in post-socialist countries structure to the market economy with democratic principles. This transition is seen by the Bank in the support of private sector and the focus on small and medium businesses. Through various tools of

² Nicholas Stern, "Investment and poverty: the role of the international financial institutions," in *A strategy for development*, 173-185 (Washington D.C.: The World Bank, 2002).

³ The EBRD, *About us*, 2010, <http://www.ebrd.com/pages/about.shtml> (accessed January 14, 2011).

⁴ The EBRD, "About the EBRD," *European Bank for Reconstruction and Development*, January 2011, <http://www.ebrd.com/downloads/research/factsheets/about.pdf> (accessed February 2, 2011).

⁵ The EBRD, *Our services*, April 6, 2010, <http://www.ebrd.com/pages/about/what/services.shtml> (accessed January 20, 2011).

⁶ The EBRD, *Our history*, April 8, 2010, <http://www.ebrd.com/pages/about/history.shtml> (accessed January 14, 2010).

investment the Bank supports privatization and private sector development⁷. This principle appears in the Agreement, establishing the EBRD and shows the uniqueness of the institution. Therefore, it is seen as being able to understand the conditions of the Central Asian transition and help with investment injections in the form of concrete projects to make the economy of the region more stable. Its role as an agent in the transition economy of Central Asia will be discussed in this study.

Activities of the EBRD in transition constitute a special place in the sphere of economics. Transition economics is a part of development economics, where in the case of EBRD, it works with countries that used a planned economy with different levels of development⁸. Since the Bretton Woods agreement in 1944 the notion of ‘development’ got a meaning of “the process where poor countries and communities are able (from within their own resources) or enabled (by others) to improve their situation economically, socially and culturally⁹”.

The EBRD, unlike other IFIs, preserves political goals. It believes that without democracy in the political sphere it is impossible to build full market economy. The Bank works only in those countries that are “committed to the fundamental principles of multiparty democracy, the rule of law, respect for human rights and market economics”, which is indicated in the Agreement establishing the EBRD¹⁰. Many debates occur on the democratic commitment of Central Asian countries. Thus, this region will be able to illustrate more the ‘transition impact’ of the EBRD, particularly, the ways to promote its goals.

⁷ The EBRD, *Privatization*, May 19, 2010,

<http://www.ebrd.com/pages/about/what/evaluation/privatisation.shtml> (accessed April 20, 2011).

⁸ Fabrizio Saccomanni, "The Role of the European Bank for Reconstruction and Development (EBRD) in the Transition of the Banking and Financial Systems," *The EU and the Economies of the Eastern European Enlargement*, 2008.

⁹ Frederick Nixon, "Development," *Routledge Encyclopedia of International Political Economy [A-F]*, Vol. 1, ed. R.J. Barry Jones (London: Routledge, 2001).

¹⁰ The EBRD, "Basic Documents of the European Bank for Reconstruction and Development," *European Bank for Reconstruction and Development*, November 2006, <http://www.ebrd.com/pages/research/publications/institutional/basicdocs.shtml> (accessed February 18, 2010).

Another point that differs the EBRD for other IFIs in the region is its temporal presence in its member-countries. As soon as the Bank accomplishes its objectives in the country, it leaves. The transitory features of the EBRD can be illustrated by the case of the Czech Republic, where at the end of 2007 the Bank left the country after working there for 15 years¹¹. No new investments were needed from the Bank because the Czech Republic has achieved advanced stages of transition and established a democratic country with a market economy. So, the goal of the EBRD was achieved and the Bank focused its activities to other countries. This feature is very important in the evaluation of the Bank and understanding its ‘transition impact’ to Central Asia because by staying in the region after the transition period, it may lose its mission and perform the same activities as other development banks. The benefit from it to the region will diminish.

Debate

In the broader debate, there are different views on the effectiveness of foreign aid institutions on the economic growth of developing countries. Easterly claims that there is no relationship between foreign aid and the number of international institutions and economic growth¹². On the other hand, Dalgaard and Hansen see the positive effect of foreign aid on the receiving country’s economy¹³. In spite of this, the scale and targeting should be pointed out that lacks foreign aid explanation. The EBRD, unlike the IMF, does not fund the whole countries, it focuses mostly on small scale private businesses. In addition, the Bank provides technical assistance and has specific evaluation of projects that would lead to the accomplishment of the transition. Working on a microlevel and mostly on short, medium-

¹¹ Anthony Williams, *Czech graduation*, October 23, 2007, <http://www.ebrd.com/pages/news/press/2007/071023.shtml> (accessed February 18, 2011).

¹² William Easterly, "Can foreign aid buy growth?," *The Journal of Economic Perspectives* 17, no. 3 (2003): 23-48.

¹³ Carl-Johan Dalgaard and Henrik Hansen, "On aid, growth, and good policies," *Journal of Development Studies* 37, no. 6 (2001): 17-41.

term projects makes the Bank very flexible to the changes in the economic environment and help vulnerable industries.

On a more specific level, the main debate within the topic occurs on the degree of the importance of international institutions to the economic development of the host countries. Neoliberal theorists believe in the successful cooperation between institutions in the promotion of stability and peace, as opposed to the neorealist approach, which sees rivalry between states¹⁴. The econometric research of Valeriya Dinger analyzed the advantages of foreign banks in decreasing the local market risks¹⁵. She found out that foreign banks help countries to avoid severe liquidity shortages, which lead to the problems of maintaining cash flow in the banks, by increasing their liquidity assets during crisis times. This helps also to maintain international trade on the sufficient level.

Eventhough, neoliberals see necessity of the IFIs, they undermine the role of a state in contribution to the development. East Asian tigers, such as Japan, South Korea and Taiwan, provided the evidence by their active economic growth in 1980s and 1990s of how government policies can foster development. Therefore, the liberal institutionalism approach will be used that sees successful complementary work of the government, domestic institutions and international institutions in the promotion of economic growth.

On the examples of game theory and collective good theory, Keohane states that there is a possibility of cooperation even between self-interested states only with the presence of particular international institutions¹⁶. Keohane, Macedo and Moravcsik argue that multilateral institutions can help in promoting democracy¹⁷. Yet, they do not point out specific cases and regions. However, in characterizing the degree of influence, Keohane states that the degree of

¹⁴ Robert Jackson and Georg Sorensen, *Introduction to International Relations: theories and approaches* (Oxford: Oxford University Press, 2007).

¹⁵ Valeriya Dinger, "Do foreign-owned banks affect banking system liquidity risk?," *Journal of Comparative Economics* 37, no. 4 (December 2009): 647-657.

¹⁶ Robert Owen Keohane, *After hegemony: cooperation and discord in the world political economy* (Princeton: Princeton University Press, 1984).

¹⁷ Robert O. Keohane, Stephen Macedo and Andrew Moravcsik, "Democracy- enhancing multilateralism," *International Organization* 63 (winter 2009): 1-31.

effectiveness of international institutions vary. The reasons can be the degree of common interest, distribution of power among members, and domestic politics¹⁸. Anders Aslund was more specific, arguing through the revision of the postcommunist countries that international organizations are important actors in transition due to their functions of providing relevant policy advice, setting standards and measuring outcomes for a better future performance¹⁹. The case of the EBRD functioning in Central Asia will be an excellent illustration of the work of the international financial institution in the specific region, which has its own characteristics of government, power and interests.

These relationships of the government, IFI with their home countries politics and domestic enterprises form their own “international regime” structure. Krasner defined regimes as “principles, norms, rules, and decision-making procedures around which actor expectations converge in a given issue area”²⁰. Regimes are formed to bring mutual benefits to all actors and lead to better international cooperation. The research will attempt to see how the EBRD fits into the international regimes formed in Central Asia. Activities, strategies, achievements will tell us what role the Bank plays in that particular structure.

The interaction between the international financial institution and the local government are part of the ‘international regimes’ system. The example of the relationship between the IMF, as a IFI, and the government in Central Asia was illustrated in the book “The currency of Power: the IMF and monetary reform in Central Asia” written by André Broome²¹. He contributed to existing literature with a positive perception on the IMF power over the borrowing member states. The author demonstrated a different vision on the functioning of IMF, as an intellectual actor, which tries to spread global economic policy

¹⁸ Robert Owen Keohane, *Power and governance in partly globalized world* (London: Routledge, 2002).

¹⁹ Anders Aslund, *How capitalism was built: The Transformation of Central and Eastern Europe, Russia, and Central Asia* (New York: Cambridge University Press, 2007).

²⁰ Stephen D. Krasner, *International regimes* (Ithaca, NY: Cornell University Press, 1983), 1.

²¹ André Broome, *The currency of power: the IMF and monetary reform in Central Asia* (Basingstoke: Palgrave Macmillan, 2010).

norms for the benefit of global market economy. The IMF also helps to promote globalization through spreading liberal economic ideology as a form of global economic policy norm. Yet, there is a fear of the IMF intervention by Central Asian governments and not being able to control the economic situation within the country. Governments do not want to lose their power over the state. Therefore, the IMF uses its resources, tools and persuasion to come into mutual agreement about structural reforms in the country²². Working in the same region, does the EBRD has problems with its functioning? The important pattern to investigate is the Bank's relationship with government in Central Asia.

The EBRD is not only a political and economic institution. It is a knowledge institution that spreads its expertise to the countries of operation. Suzan Ilcan and Lynne Phillips claimed that international institutions could form a network system²³. Spreading knowledge through this network as a source of power they were able to govern and promote development. More precisely, Asuncion Lera St. Clair talked about the World Bank, emergence and distribution of knowledge²⁴. She emphasized the monopoly on knowledge that the World Bank had taken. Clark Miller also claimed that "international knowledge institutions" can act as an alternative to a government in democracy development²⁵. The peculiarity of the EBRD as a transition bank will be demonstrated by its knowledge transmitting function, and not only a financial institution. The works of Suzan Ilcan, Lynne Phillips, Asuncion Lera St. Clair and Clark Miller show that knowledge in institution can promote development and be a power tool. The EBRD as a knowledge transmitting institution assumed to be able to perform its tasks for democratization and development.

²² André Broome, *The currency of power: the IMF and monetary reform in Central Asia* (Basingstoke: Palgrave Macmillan, 2010).

²³ Suzan Ilcan and Lynne Phillips, "Governing through global network," *Current Sociology* 56, no. 5 (September 2008): 711-734.

²⁴ Asuncion Lera St. Clair, "The World Bank as a transnational expertised institution," *Global Governance* 12 (2006): 77-95.

²⁵ Clark Miller, "Democratization, International Knowledge Institutions and Global Governance," *Governance* 20, no. 2 (2007): 325-357.

Moreover, the EBRD is also “an agent of change”²⁶. Stern argues that the World Bank and the EBRD can help to change the economic structure of the country to one that would decrease poverty and promote growth. For instance, in terms of the EBRD, he states that the Bank’s investment strategy helps poor people to broaden their economic activities and foster the GDP. The target of the Bank’s investment helps to improve productivity of the companies, giving priority to rural areas and small, medium firms. In addition, the project-oriented lending helps to minimize the spillovers, especially financial ones, due to the direct usage of money. Also, the successful projects can act as an example for the development of other similar companies, in other words, having a snowball effect.

Research question

Most of the researchers state that there are advantages of the IFIs’ presence in the country. The study will look more precisely at the functioning of the IFIs in the Central Asian region that has an unstable fragile economy and will decide whether the imitation of other countries’ economies is useful or it is better for Central Asia to seek its own path in the development of their economy. The study of IFIs will be narrowed down to the EBRD because of its narrow mission of supporting transition to market economy and democratic goals that are loosely followed by the Central Asian government.

This study will look at the impact of the EBRD in the Central Asian region and the degree of implementing their objectives. Also, it would be interesting to see the development of the Bank through two decades of its work and explore whether the Bank succeeds or fails in achieving its goals. Usage of different strategies and methods for implementing the goals from the other financial institutions in the region and the success of the EBRD there would tell us about its necessity in the area.

²⁶ Nicholas Stern, "Investment and poverty: the role of the international financial institutions," in *A strategy for development*, 173-185 (Washington D.C.: The World Bank, 2002).

Therefore, the main purpose of the study is to understand *how the EBRD was achieving its main transition goal by supporting the development of the financial system in the Central Asian region*. In other words, the research will see the place and functions of the EBRD in the financial system of Central Asian countries. Taking Krasner's theory, how the EBRD fits into the "international regime" of Central Asian countries and how it tries to improve it.

In order to explain the functioning of the EBRD as an international financial institution in Central Asia, the liberal institutionalism approach will be used. It views the possibility of positive influence of international organizations on the country's economy. The framework of the "international regimes" theory will examine the topic through the position of the EBRD in the system of interconnections of the political structure, economic structure and cultural/historical structure in the Central Asia.

However, this perspective lacks the vision of the regimes in a temporal context. The study will look at changes of the Bank's operations as an attempt to fit into the system. Also, the changes in the regimes from the participation of the EBRD will be examined, in other words, what benefits the Bank has brought to the countries of the Central Asia.

Methods

In order to show the uniqueness and complementary position of the EBRD towards other international and investment institutions in the region, the comparative analysis method of the EBRD activities and other IFIs' and domestic investment banking system's activities in Central Asia will be done. From the official websites of the four IFIs in the region the activities that they perform will be compared. Then the linkages of these activities will be drawn to establish whether these institutions perform the same services and can be substituted on the market. In the case of domestic investment banks the differences and similarities in the

EBRD activities and their functions will be shown, specifically, taking an example of the Halyk Finance Bank in Kazakhstan. The Halyk Finance bank in Kazakhstan was chosen as a representative of a domestic investment bank, while it is a leading investment bank in Central Asia in 2011 named by the Global Finance magazine²⁷.

The content analysis method will be applied to the case study of the EBRD. Its activities in the two Central Asian countries would be examined and then generalized to the whole region. The last two last decades will be taken for the analyses from 1991 to January, 2011. These dates are taken because the USSR did not participate in IFIs due to cold war rivalry based on different ideology. Nevertheless, the collapse of the Soviet Union and integration into the world economy became the reason of the emergence of IFIs on the territory of post socialistic countries.

Out of the five Central Asian countries, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan, two countries, where the EBRD achieved the biggest progress and the smallest progress, will be chosen. For this study Kazakhstan and Turkmenistan were chosen. Kazakhstan is the country where the EBRD was the most active. Turkmenistan is the country where the EBRD was the least active. As of January 2001, working for two decades in the region, in Kazakhstan there were 140 projects accomplished, in Turkmenistan 28, in Kyrgyzstan 72 projects, in Uzbekistan- 57, and in Tajikistan- 55 projects (see the EBRD Kazakhstan 2011²⁸, the EBRD Kyrgyzstan 2011²⁹, the EBRD Tajikistan 2011³⁰, the EBRD Turkmenistan 2011³¹, the EBRD Uzbekistan 2011³²). The EBRD activities in those two

²⁷ Global Finance, *World's best investment banks 2011*, February 22, 2011, <http://www.gfmag.com/tools/best-banks/11097-worlds-best-investment-banks-2011.html#axzz1JLg5sQrp> (accessed April 12, 2011).

²⁸ The EBRD, "Kazakhstan," *European Bank for Reconstruction and Development*, January 2011, <http://www.ebrd.com/downloads/research/factsheets/kazakhstan.pdf> (accessed March 10, 2011).

²⁹ The EBRD, "Kyrgyz Republic," *European Bank for Reconstruction and Development*, January 2011, <http://www.ebrd.com/downloads/research/factsheets/kyrgyzrepublic.pdf> (accessed March 10, 2011).

³⁰ The EBRD, "Tajikistan," *European Bank for Reconstruction and Development*, January 2011, <http://www.ebrd.com/downloads/research/factsheets/tajikistan.pdf> (accessed March 10, 2011).

³¹ The EBRD, "Turkmenistan," *European Bank for Reconstruction and Development*, January 2011, <http://www.ebrd.com/downloads/research/factsheets/turkmenistan.pdf> (accessed March 10, 2011).

countries will be examined, looking at the achievements of the Bank and the accomplishments of its strategies.

Each project in the EBRD is evaluated according to its ‘transition impact’ as a step towards the decision of taking the project or not³³. The ‘transition impact’ includes seven sources that are promotion of competition within the sector of operation and other sectors, privatization, market principles, spread of knowledge, innovation and high standards of operation. Risks to the impact are also evaluated³⁴. As a consequence, the transition strategy of the Bank is being followed. In addition, the Bank also evaluates the transition of each member-country by nine indicators, which are “large-scale privatization, small-scale privatization, enterprise restructuring, price liberalization, trade and forex system, competition policy, banking reform, non-bank financial institutions, infrastructure reform”³⁵. For the comparative analysis the “banking reform” indicator will be taken as a main sector for the financial sustainability of the country and a core of the EBRD activities.

Key attention will be given to the analysis of the banking reform in Kazakhstan and Turkmenistan. This analysis will be based on the transition indicators of the EBRD. The transition indicator “Banking reform”, as other indicators, is measured by the EBRD on the scale from 1 to 4+³⁶. 4+ is used a sign that there is no ‘pure’ market economy structure with the level of 5, rather the transition of banking reform is compared to the performance of the developed EU countries.

³² The EBRD, "Uzbekistan," *European Bank for Reconstruction and Development*, January 2011, <http://www.ebrd.com/downloads/research/factsheets/uzbekistan.pdf> (accessed March 10, 2011).

³³ The EBRD, *Transition impact*, October 19, 2010, <http://www.ebrd.com/pages/research/economics/transition.shtml> (accessed February 18, 2011).

³⁴ Ibid.

³⁵ The EBRD, “Transition report 2010: recovery and reform,” *European Bank for Reconstruction and Development*, November 2010: 100, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

³⁶ The EBRD, *Transition indicators methodology*, April 29, 2010, http://www.ebrd.com/russian/pages/research/analysis/surveys/ti_methodology.shtml (accessed February 19, 2011).

Particularly for content analysis, the institutional documents, for instance transition reports and annual reports of the Bank, journals and newspapers, bank descriptions (organizational and policies structure), statistical data about macroeconomic indexes of Central Asian countries will be used. The main difficulty of the generalization of two countries to the whole region is that both of their economies are based on hydrocarbon exports, unlike Kyrgyzstan and Tajikistan. If the peculiarities of the economies of the five Central Asian countries are excluded, the same patterns may be seen.

Structure

The introductory chapter of the research is devoted to the debate around the impact of IFIs in the development of the country. Here several roles of IFIs have been discussed and the role and functions of the EBRD. Also, in the introduction the justification of Central Asia as a region for research is provided. At the end of the section the research question and methods for its analysis are described. Chapter one will discuss from the view of banking system development the economic transition of Central Asia in the early years of independence and the impact of foreign banks on the economy. Then in chapter two the discussion will be narrowed to the distinctive functions of the EBRD in Central Asia from the other IFIs functioning there and domestic investment banks. Chapter three will deal with the work of the EBRD in Kazakhstan and Turkmenistan, specifically its support of the banking reforms. In chapter four generalizations of the financial system of Central Asian region will be made with consideration of the financial crisis of 2007. Also it will be devoted to the discussion of the EBRD role in Central Asia. After that, conclusions of the research will follow.

Chapter 1: Banking activities in Central Asia

1.1. Privatization and banking sector reform in Central Asia

The socialist banking system was quite different from the capitalist system. Even central banks of the countries were fully controlled by the state government. Insurance sector was not included into this system. Therefore, the transition to the capitalist banking system was very difficult for the post-communist countries. One of the most important reasons for the entrance of the IFIs into the region was their support in the financial system development.

After the collapse of the Soviet Union the New Independent Countries have undergone the significant economic transformation that was accompanied by the simultaneous political restructuring. Changes and reforms in these countries have led to the deep recession from 1989 until 2000s. Kornai mentioned several reasons of this recession, which are:

the shift from a sellers' to a buyers' market, the transformation of the real structure of the economy, the disturbances in the coordination mechanisms, the macroeconomic consequences of the hardening of financial discipline, and the backwardness of the financial system³⁷.

It can be seen that there are several reasons of financial restructuring and the market changes, in which the EBRD has specialized and was able to help to overcome the recession. Yet, the extensive intervention of state and various interested groups did not bring innovation, but rather decrease in productivity, inflation and unemployment.

Kornai emphasized that the big scale and depth of the recession was caused by poor coordination and mistakes from the government³⁸. Central Asia had especially poor socio-economic conditions because its economy was raw materials export based. Therefore, the

³⁷ Janos Kornai, "Transformational recession: the main causes," *Journal of Comparative Economics* 19, no. 1 (March 1994): 8-39.

³⁸ Janos Kornai, "Transformational recession: the main causes," *Journal of Comparative Economics* 19, no. 1 (March 1994): 37-63.

process needed professionals and experts in the sphere to accomplish this transformation. The EBRD as a part of IFIs in Central Asia was helping post-socialistic countries to adjust their institutional structures. Also, through its transparent system and exact feasible projects the Bank has contributed to the overcoming of the uncertainty in the banking system and private market.

The main tool of the EBRD, that is the work with the private sector, is considered to be effective in stimulating economic growth. Privatization stimulates modernization of the organizations, new management apparatus leads to innovation, and, moreover, creation of new sectors, companies leads to more employment opportunities. Yet, with the restructuring of the organizations in the beginning it causes dismissal of employees and decrease in productivity that constitutes GDP. Therefore, the EBRD carefully comes to this problem, supporting the process of privatization by big organizations, reforms that lead to larger privatization and helping to prepare mass privatization programs³⁹.

However, there are many similarities of economic development of the five Central Asian countries, choices of the policies and reforms make the country to move along its own path. Thus, the objective of the EBRD is to have an individual approach to each country, working to overcome present barriers for further transition, yet, taking into the account experience the accomplished projects in different countries.

1.2. Advantages of foreign bank entry

The development of the financial sector is essential for the building of the solid market economy of a country. Many researchers see the presence of the foreign banks as a sign of advancements in the financial sphere. For instance, László Csaba in his article “Financial institutions in transition: the long view” argues that financial institutions are

³⁹ The EBRD, *Privatization*, May 19, 2010, <http://www.ebrd.com/pages/about/what/evaluation/privatisation.shtml> (accessed April 20, 2011).

important for the sustainable growth of the economy⁴⁰. He emphasized that failure in the creation of the stable financial system is one of the reasons of slow development of the transition countries.

The advantages of foreign banks in comparison to the local ones are in “capital adequacy”, “goodwill of the parent corporation”, “solid banking practices” and “solid behaviour”⁴¹. Therefore, for the faster transition of the Central Asian countries stable financial institutions are required. Thus, the EBRD, as a IFIs presented in Central Asia, with its advantages and activities as investments in the financial sphere have the positive ‘transition impact’ towards sustainable development of the market economy in the region.

To support the previous argument Tigran and Arsen Poghosyan’s research shows the better functioning of the banking sector in the Central and Eastern European countries after entrance of the foreign banks in the region⁴². They claim that the presence of the foreign banks in the country can lead to the better functioning of the whole banking sector due to the higher quality of working standards and increased competition pressure on the existing banks. A parallel line can be drawn to the Central Asian countries because both these regions have the same path. There should be less fear of foreign entry to Central Asia because these institutions already carry into the country with themselves years of reputation, experience and projects/clients that shows their past activities. Therefore, the local clients can be sure whom they are working with, the advantages and disadvantages of the organization.

Jürgen von Hagen and Valeriya Dinger show more specific measurements of the financial system. They analyze that level of financial mediation is a better reflection of

⁴⁰ László Csaba, "Financial institutions in transition: the long view," *Post-communist economies* (Routledge: Taylor & Francis Group) 23, no. 1 (March 2011): 1-13.

⁴¹ Ibid, 5.

⁴² Tigran Poghosyan and Arsen Poghosyan, "Foreign bank entry, bank efficiency and market power in central and eastern Europe," *Economics of Transition* 18, no. 3 (2010): 571-598.

financial wealth in the country than GDP⁴³. The research emphasizes the importance of the bank's financial mediation and calls for more precise evaluations in the transition economies, rather than only general index GDP. The article adds to other papers' the argument that the banking system is one of the most important links in the market economy chain and foreign banks play in it an essential role of promoting sustainable growth. It is important to take into account that initial low development of banking sectors can reflect the further low level of banking intermediation⁴⁴. Thus, in the research a long term period of banking reforms in Central Asia analyzed.

In order to show the situation in the banking sector in Central Asia in the next chapter activities of the IFIs in Central Asia will be described and compared to the functions performed by the EBRD, as the bank with the purpose of stimulating transition in the region. Afterwards, the particular cases of banking sector development in Kazakhstan and Turkmenistan will be examined with the EBRD approach to the 'transition impact' of the banking sector in these countries.

1.3. The EBRD differs from other IFIs in the Central Asia

There are four International Financial Institutions (IFIs) working in Central Asia: the IMF, the World Bank, the EBRD and the ADB (European External Action Service 2002). All of them provide financial assistance for the economic development of the region. While being established more than a half of the century ago (with the exception of the EBRD), other institutions have developed their own goals, strategies, found their niches, and received reputation. Back in the beginning of 1990s the perception of newly opened the EBRD was skeptical. Haggard and Moravcsik stated that its establishment was "an act of symbolism and

⁴³ Jürgen von Hagen and Valeriya Dinger, "Banking sector (under?)development in Central and Eastern Europe," *Zentrum für Europäische Integrationsforschung*, February 2005, http://www.zei.de/download/zei_wp/B05-06.pdf (accessed May 26, 2011).

⁴⁴ Ibid.

its contribution is redundant”⁴⁵. In other words, it was a political gesture because the EBRD performs the same activities as the other international institutions in the region. To see if this is true the comparative analysis method of the EBRD activities and activities of the IMF, the World Bank and the ADB was used (see official websites the EBRD⁴⁶, International Monetary Fund⁴⁷, The World Bank⁴⁸, the ADB 2011⁴⁹).

After a comprehensive analysis of the comparison of activities provided by the IFIs that work in Central Asia and the services provided by the EBRD, it can be stated that the EBRD is not just a copy of other development banks. However, its niche is fragile. Specifically, the IMF and the World Bank work only with the public sector. IMF even works on the country level and not on a project basis and the World Bank is focused on long-term investments. The EBRD has chosen specialization based on the development of the private sector projects (mostly micro, small and medium businesses) that is the unique in the region. The EBRD uses its funds to reconstruct not only public sectors, as development banks do, but also it invests in the private sector. Moreover, the IMF provides consultations for the countries that need state restructuring in their institutional organization. This takes forms of advice, workshops, trainings that are included into the technical assistance services of the IMF. The EBRD does not provide such services, rather assistance in accomplishing a precise project.

Both the ADB and the EBRD work with the private sector. However, after the comparison it was identified that the EBRD and the ADB have different strategies and several operational areas do not correlate. For instance, the EBRD focuses on the market economy

⁴⁵ Stephan Haggard and Andrew Moravcsik, *After the Cold War: international institutions and state strategies in Europe, 1989-1991*, ed. Robert Owen Keohane, Joseph S. Nye and Stanley Hoffmann (Harvard University Press, 1993): 265.

⁴⁶ The EBRD, *Our services*, April 6, 2010, <http://www.ebrd.com/pages/about/what/services.shtml> (accessed January 20, 2011).

⁴⁷ International Monetary Fund, *Our work*, <http://www.imf.org/external/about/ourwork.htm> (accessed March 26, 2011).

⁴⁸ The World Bank, *Operations*, <http://go.worldbank.org/1YXPMBNDO0> (accessed March 26, 2011).

⁴⁹ Asian Development Bank, *Operations*, January 14, 2010, <http://www.adb.org/About/operations.asp> (accessed March 26, 2011).

development in the region, whereas the ADB on poverty reduction and regional cooperation projects. The EBRD does not focus on education and region integration, whereas, the ADB does not work in the manufacturing and leaves agribusiness projects. What is also specific about the EBRD is its legal reforms support for the friendly policies towards the market economy. Overall, the position of the EBRD as a new IFI is quite stable. It has found its own specialization, different from other IFIs in the region and its own operational areas, where it develops its expertise. Nevertheless, some of the EBRD activities, for example investments in public projects, in the financial sector may overlap with other organizations. Thus, the Bank should try to avoid repetitiveness in its activities to other IFIs.

1.4. The EBRD differs from the domestic investment banks of Central Asia

There are some similarities and differences between the EBRD, as a representative of a foreign investment bank, and domestic investment banks of the Central Asian region. Domestic investment banks and the EBRD provide financial advice and financial assistance to investors, issue securities for companies and act as intermediaries in contracts. However, as Wooldridge, Domanski and Cobau emphasize, foreign investment banks bring more capital to the country and usually have bigger capital opportunities and, also, they bring more knowledge and expertise to the country⁵⁰. For a better look on the specific activities the comparison of the EBRD and Halyk Finance bank was made (see the websites of the EBRD⁵¹ and Halyk Finance⁵²). During the analysis following distinctions were pointed out. First of all, the assets of the EBRD are EUR 21 billion, while Halyk Finance is a subsidiary company of Halyk Bank of Kazakhstan, whose assets consist of only \$ 14 billion. Second, the

⁵⁰ Philip D Wooldridge, Dietrich Domanski and Anna Cobau, "Changing links between mature and emerging financial markets," *BIS Quarterly Review*, September 2003: 45-54.

⁵¹ The EBRD, *Our services*, April 6, 2010, <http://www.ebrd.com/pages/about/what/services.shtml> (accessed January 20, 2011).

⁵² Halyk Finance, *About Halyk Finance*, 2010, <http://eng.halykfin.kz/ABOUT-HALYK-FINANCE> (accessed April 12, 2011).

activities of two banks are quite different. For instance, the EBRD's main activities are funding projects by issuing loans, guarantees, or through equity investment. Halyk Finance's activities are based on sales and trading, mergers and acquisitions and corporate debt restructuring and investment portfolio management. The only similar activity is provision of technical assistance and consulting for clients, which, on the other hand, maybe diverse considering different structure and strategies of the banks. Therefore, the EBRD position towards other domestic investment banks is stable as they provide different kinds of services following different set of goals.

Overall, positive tendency of the EBRD appearance on the Central Asian market can be traced. The emergence in the Central Asian market of a big variety of banks tells that the financial market in the region grows. It allows more competition between institutions that lead to bigger variety of services and better deals in terms of pricing, risk taking, and information support for customers.

Chapter 2: 'Transition impact' of the EBRD on the banking sectors in Kazakhstan and Turkmenistan

2.1. The impact of the EBRD on banking reform in Kazakhstan

Viewing as a whole picture, there is a progress in the economic growth of Kazakhstan. If take a general indicator as real GDP of the country, it can be seen that from 1989 it was going down until 1998, declining by 40%, then it has started to grow encountering in 2010 50% bigger real GDP comparing to 1989⁵³. The growth after 1998 was devoted to the creation of essential initial reforms for market growth, such as privatization, price liberalization and institution building, overcoming the currency crisis 1998 and benefiting from rising prices of oil and gas.

Talking about the first years of banking reforms, Kazakhstan has achieved some progress. Yet, it is very slow and there is no sufficient rate of banking reforms in the country. The positive movements are the increase in the quantity of the banks from 30 in 1990 till 76 by 1998⁵⁴. The transition of the banking sector in 1998 was in progress through privatization of the banks and becoming a majority in the country and increase of the foreign capital of the banks. Yet, the negatives are that even after a decade of transition in 1998 everywhere in Central Asia (with the slight improvements of Kyrgyzstan) there were still no "capital adequacy, related party lending and transactions, and bank insolvency", problems with the

⁵³ The EBRD, "Transition report 2010: recovery and reform," *European Bank of Reconstruction and Development*, 2010:121, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

⁵⁴ The EBRD, "Transition report 1998: financial sector in transition," *European Bank for Reconstruction and Development*, May 1998, <http://www.ebrd.com/downloads/research/transition/TR98.pdf> (accessed April 27, 2011).

usage of “internationally acceptable accounting standards” with the range of other problems⁵⁵.

The financial sector is a core sector of the EBRD activities. The Bank performs several functions to help transformation of the banking sector in Kazakhstan. It evaluates banking reforms in the country with a set measurement that helps to compare different years of development within one country and with other countries. It also supports the transition in the sector mostly by short-term lending, advising and buying stakes in the banks. All these activities constitute the ‘transition impact’ of the EBRD in Kazakhstan.

The “banking reform” indicator measured every year by EBRD shows the progress in banking sphere from the independence of Kazakhstan until these days. This indicator, as well as other eight indicators, is a transition indicator that helps the Bank to measure the transition of the country in different sectors separately and in the country as a whole. Since 1991 the “banking reform” indicator in Kazakhstan has moved from 1 to 2.7 level. This means that, in general, the country moved from the range of 1 implying “little progress beyond establishment of a two-tier system” to the range of 2 score, which means “significant liberalization of interest rates and credit allocation; limited use of directed credit or interest rate ceilings”⁵⁶. The EBRD considers its own ‘transition impact’ in the financial sector of Kazakhstan from minimal to moderate impact⁵⁷.

Table 1: Comparison of the EBRD “banking reform” indicator with the banking reforms in Kazakhstan

Year	“Banking reform” indicator	Description of the major banking reforms in Kazakhstan
1991	1.0	
1992	1.0	

⁵⁵ The EBRD, "Transition report 1998: financial sector in transition," *European Bank for Reconstruction and Development*, May 1998:117, <http://www.ebrd.com/downloads/research/transition/TR98.pdf> (accessed April 27, 2011).

⁵⁶ The EBRD, *Transition indicators methodology*, April 29, 2010, http://www.ebrd.com/russian/pages/research/analysis/surveys/ti_methodology.shtml (accessed February 19, 2011).

⁵⁷ The EBRD, "Strategy for Kazakhstan," *European Bank for Reconstruction and Development*, January 26, 2010, <http://www.ebrd.com/pages/country/kazakhstan/strategy.shtml> (accessed April 6, 2011).

1993	1.0	April: law on banking enacted November: tenge currency adopted
1994	1.0	January: prudential regulations introduced April: mass privatization began November: massive price liberalization December: Foreign Investment law
1995	2.0	April: law on central bank April: bank and enterprise agency introduced July: prohibition of barter trade August: foreign exchange surrender prohibited December: privatization law introduced
1996	2.0	June: last voucher auction July: Full current account convertibility is available November: new accounting standards December: first sovereign Eurobond issued
1997	2.3	January: Bankruptcy law introduced
1998	2.3	
1999	2.3	
2000	2.3	August: National Fund establishment
2001	2.7	May: establishment of National Development Bank July: capital amnesty decreed
2002	2.7	January: transfer pricing law enacted January: revision of foreign investment law January: Minimum banking capital requirements increased to €10 million May: new National Bank program
2003	3.0	Development of lending practices
2004	3.0	
2005	3.0	December: foreign ownership of banks raised to 50%
2006	3.0	
2007	3.0	March: transparent market index "KazPrime" started August: reduced access to international funding
2008	3.0	
2009	3.0	September: Anti-Money Laundering Law enacted
2010	2.7	Restrictions on foreign borrowing by banks and increase of state stakes percentage in the local banks

Sources: the EBRD transition report 2002⁵⁸, the EBRD transition report 2004⁵⁹, the EBRD transition report 2009⁶⁰, the EBRD transition report 2010⁶¹.

⁵⁸ The EBRD, "Transition report 2002: agriculture and rural transition," *European Bank for Reconstruction and Development*, November 2002: 169, <http://www.ebrd.com/downloads/research/transition/TR02.pdf> (accessed April 25, 2011).

⁵⁹ The EBRD, "Transition report 2004: infrastructure," *European Bank for Reconstruction and Development*, November 2004: 150, <http://www.ebrd.com/downloads/research/transition/TR04.pdf> (accessed April 25, 2011).

⁶⁰ The EBRD, "Transition report 2009: Transition in crisis?," *European Bank for Reconstruction and Development*, November 2009:178, <http://www.ebrd.com/downloads/research/transition/TR09.pdf> (accessed April 25, 2011).

⁶¹ The EBRD, "Transition report 2010: recovery and reform," *European Bank for Reconstruction and Development*, November 2010: 128, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

In Table 1 “the banking reform” indicator for years 1991- 2010 is shown with the significant reforms in banking sphere in Kazakhstan in order to evaluate the consistence of the EBRD measurement. The score of 1.0, which is the lowest score in the range, fully describes the poor initial banking conditions of Kazakhstan in 1991 when the country was just established with no previous market system banking experience. The transition from 1.0 to 2.0 score happened in 1995 when number of essential reforms have been initiated, that are massive privatization and liberalization accompanied by prudential regulations and central bank regulations establishment. Progress to 2.3 score in 1997 is devoted to successful completion of the mass privatization followed by adoption of international accounting standards and beginning of foreign bank lending by issuing Eurobonds. 2001 jump to 2.7 score is devoted to capital amnesty, which allowed to return more capital into the banking sector. In addition, high liquidity due to the foreign lending to Kazakh banks has led to the expansion of the banking sector. The EBRD points out that the growth of assets in the sector increased by 60 per cent during the first half of 2001 and loans of the banks grew by 88 per cent⁶². This credit expansion that booms the economy helped to rise the indicator’s score in 2001.

Another rise of the score to the 3.0 was made in 2003 indicating the successful transition of the banking sector in the country. Several significant reforms in 2002 as National Bank law helped to provide adequate supervision over the commercial banks and credit provision while increasing quality requirement for the banks. This progress was followed by changes in classifications and rules of loan provisioning in 2003. In general, from the end of the 1990s the growth of financial sector was based on the Kazakh bank short-term borrowings from the western countries to supply with credits their local customers on the higher interest rates. The state supports its transformation by buying stakes of the Kazakh banks and

⁶² The EBRD, "Transition report 2001: energy in transition," *European Bank for Reconstruction and Development*, November 2001, <http://www.ebrd.com/downloads/research/transition/TR01.pdf> (accessed April 15, 2011).

encouraging state-owned companies to put deposits in these banks. By 2010 Kazakh banks still face significant problems with asset quality⁶³. It means that banks still cannot recover from the foreign debts and regulate their balance sheets. World bank reports that in the beginning of 2010 bad consequences after the crisis still exists, they are growth of non-performing loans, depreciation of national currency in February 2009⁶⁴. The decline in index score of banking reform in 2010 is devoted to the difficulties in restructuring of the banking system from one, which relies on foreign borrowing, to the system, which relies on the domestic capital sources for growth. Yet, in the long-term these changes are expected to lead to the stability of the banks. By this indicator, comparing to other Central Asian countries Kazakhstan remain on its position of possessing the strongest banking sector in Central Asia, even after the sever hit by the crisis.

The EBRD does not only passively measures changes in the country, it also tries with the investment tools to speed up the transition process. By 2011 there were 140 projects conducted with the total value of EUR 10 345,7 million⁶⁵. Its total net business volume from 1991 to 2010 into Kazakhstan consisted of EUR 3 942 million, which is one of the highest among all the countries, where the Bank performs⁶⁶. The most concentration of the work in Kazakhstan was concerned with financial institutions, corporate sector, energy and infrastructure⁶⁷. The latest projects were in the sphere of energy resources and infrastructure. For instance, there were investments in Zhanros Drilling LLP, oil company, renovation of two heating districts, RauanNalco, chemicals company for oil business, and investments in

⁶³ Clare Nutall, "ANALYSIS: Bank lending lags Kazakh recovery," *Silk Road Intelligencer*, July 26, 2010, <http://silkroadintelligencer.com/2010/07/26/bank-lending-lags-kazakh-recovery/> (accessed May 12, 2011).

⁶⁴ The World Bank, "Country Brief 2010: Economy," *The World Bank*, April 2010, <http://go.worldbank.org/9UH84B3B70> (accessed May 12, 2011).

⁶⁵ The EBRD, "Kazakhstan," *European Bank for Reconstruction and Development*, January 2011, <http://www.ebrd.com/downloads/research/factsheets/kazakhstan.pdf> (accessed March 10, 2011).

⁶⁶ The EBRD, "Annual Report 2010: Securing the recovery," *European Bank for Reconstruction and Development*, May 19, 2011, <http://www.ebrd.com/downloads/research/annual/ar10e.pdf> (accessed May 19, 2011).

⁶⁷ The EBRD, "Strategy for Kazakhstan," *European Bank for Reconstruction and Development*, January 26, 2010, <http://www.ebrd.com/pages/country/kazakhstan/strategy.shtml> (accessed April 6, 2011).

Almatyelectrotrans, public transportation company, water resources in Aktau city and railway transportation⁶⁸.

One of the first projects of the EBRD in Kazakhstan in 1993 was the lending an ‘apex’ credit line to the National Bank of Kazakhstan (Central Bank in Kazakhstan) that started the chain of funding commercial banks and they in their turn supported with credits small and medium enterprises in Kazakhstan⁶⁹. This type of projects provided on the early stages financial immediate push towards development of market system.

Lending activities to the banks with specific orientation on the transition of other sectors of the economy were practiced by the Bank for a decade in the country. For instance, first syndicated loan structure in Kazakhstan was organized by the Bank in 2002 with the lending of USD 50 million to the largest Kazakh Bank, Kazkommertsbank, for support of private sector development⁷⁰. In 2008 in order to support lending ability of the Kazakh banks, the EBRD invested USD 75 million for the purpose of lending to the project of improving energy efficiency⁷¹. In addition, this project was scored by the EBRD’s Evaluation Department as an “excellent” project that is committed to the ‘transition impact’⁷².

The Bank also invests in the banks for a longer support with capital and technical advice. For instance, in 2003 the EBRD bought 15% in equity share of Kazkommertsbank

⁶⁸ The EBRD, *News articles: Kazakhstan*, <http://www.ebrd.com/saf/search.html?page=1> (accessed April 10, 2011).

⁶⁹ Axel Reiserer, "EBRD gives boost to the small/medium sized business in Kazakhstan," *European Bank for Reconstruction and Development*, December 22, 2003, <http://www.ebrd.com/english/pages/news/press/1993/96dec22.shtml> (accessed May 2, 2011).

⁷⁰ Axel Reiserer, "EBRD lends \$50 million to Kazkommertsbank," *European Bank for Reconstruction and Development*, September 23, 2002, <http://www.ebrd.com/english/pages/news/press/2002/02sep23x.shtml> (accessed April 20, 2011).

⁷¹ Alex Reiserer, "EBRD promotes energy efficiency," *European Bank for Reconstruction and Development*, December 10, 2008, <http://www.ebrd.com/english/pages/news/press/2008/081210.shtml> (accessed April 28, 2011).

⁷² The EBRD, "Annual report 2008," *European Bank for Reconstruction and Development*, May 2009, <http://www.ebrd.com/downloads/research/annual/ar08e.pdf> (accessed May 5, 2011).

and is considered as the EBRD's first pure equity share in the country⁷³. Since then the EBRD possess equity shares in several banks of Kazakhstan.

Kazakhstan was severely hit by the financial crisis of 2007. It brought up all of the weakness of the Kazakh financial system. The EBRD is actively involved in solving the banking sector problems. It is important fact that the involvement of the government into the economy grows since the financial crisis of 2007⁷⁴. There is a concern of the increasing influence on the economy from the state, since it may lead to distortions in the market structure. On the other hand, improvements can be seen, which are fiscal restructuring, greater banking reforms and improvement of trading through the common Customs Union with Russia and Belorussia. To support the country's banking system during the crisis, the EBRD increased investments in the banks, where it has had equity stakes⁷⁵.

Currently, The main problem in the economy of Kazakhstan is the banking sector that is significantly dependent on the external financing, dependence on the hydrocarbon exports. In addition, there is a need for agricultural restructuring, in particular, better transportation, quality standards, and innovation in agricultural infrastructure⁷⁶. The present issues of the further banking sector development is overcoming the damages from the crisis of 2007 by restructuring debts, improving efficiency of the providing loans and further work with development of prudential regulation in financial sector⁷⁷. For instance, in order to promote trade bank transactions in the country, The EBRD launched Trade Facilitation Programme, where in 2009 Kazakhstan scored the fourth on the quantity of the transactions, being the first

⁷³ Axel Reiserer, "EBRD buys 15% of largest Kazakh bank," *European Bank for Reconstruction and Development*, June 6, 2003, <http://www.ebrd.com/english/pages/news/press/2003/74june06.shtml> (accessed April 20, 2011).

⁷⁴ The EBRD, "Transition report 2010: recovery and reform," *European Bank for Reconstruction and Development*, November 2010, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

⁷⁵ The EBRD, "Annual Report 2009," *European Bank for Reconstruction and Development*, May 2010: 48, <http://www.ebrd.com/downloads/research/annual/ar09e.pdf> (accessed May 5, 2011).

⁷⁶ The EBRD, "Strategy for Kazakhstan," *European Bank for Reconstruction and Development*, January 26, 2010, <http://www.ebrd.com/pages/country/kazakhstan/strategy.shtml> (accessed April 6, 2011).

⁷⁷ The EBRD, "Transition report 2010: recovery and reform," 2010.

in Central Asia⁷⁸. The Bank also supports rural financial development of the country. An example of it would be its loan to BankCenterCredit for lending to the private companies outside two major Kazakh cities⁷⁹.

According to the average (enterprise, competition, financial institutions, infrastructure transition) and the above average (privatization, price liberalization, trade and forex system) transition indicators results, there is a progress in the country towards market economy development⁸⁰. Yet, comparing to the results of Central Europe, there are important reforms and progress needs to be done. This development was achieved through the state's constant and active support of the country's transition. The EBRD also had an opportunity to put into the economy of Kazakhstan a lot of resources thorough its targeted projects.

The future plans of the Bank are to continue prioritizing its work in the financial sector, providing sufficient amount of lending to that sector for its further growth⁸¹. The Bank also takes further steps in changing its strategy. New attempts have been taken in Kazakhstan. According to the EBRD, the changes have been seen in the increase of cooperation with the government agencies in Kazakhstan and more active cooperation with the other IFIs to improve invest climate in the country⁸². For example, in the beginning of 2010 the Bank signed memorandum with the Kazakh Ministry of Industry and Trade and the Kazakh

⁷⁸ Ina Coretchi, "EBRD trade finance facility for Sberbank Kazakhstan," *European Bank for Reconstruction and Development*, September 22, 2010, <http://www.ebrd.com/english/pages/news/press/2010/100922.shtml> (accessed April 20, 2011).

⁷⁹ Axel Reiserer, "Bank Centercredit," *European Bank for Reconstruction and Development*, July 3, 2008, <http://www.ebrd.com/english/pages/news/press/2008/080703b.shtml> (accessed April 20, 2011).

⁸⁰ The EBRD, "Transition report 2010: recovery and reform," *European Bank for Reconstruction and Development*, November 2010, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

⁸¹ The EBRD, "Strategy for Kazakhstan," *European Bank for Reconstruction and Development*, January 26, 2010, <http://www.ebrd.com/pages/country/kazakhstan/strategy.shtml> (accessed April 6, 2011).

⁸² The EBRD, "Annual Report 2010: Securing the recovery," *European Bank for Reconstruction and Development*, May 19, 2011, <http://www.ebrd.com/downloads/research/annual/ar10e.pdf> (accessed May 19, 2011).

National Wealth Fund “Samruk-Kazyna” for further mutual development of the market economy in the country⁸³.

2.2. The impact of the EBRD on banking reform in Turkmenistan

The economy of Turkmenistan grows every year. If to evaluate the progress by its real GDP, then in 2010 it grew by 165 per cent compared to the year 1989 (taken as 100 per cent)⁸⁴. However, real GDP of the country was decreasing from 1989 to 1997, when it hit its bottom, scoring a half of what it had in 1989⁸⁵. Until 1998 the country was severely hit by the privatization and liberalization lagging. In 1998 the inflation was able to reduce with tightening of monetary policy and sales of foreign exchange⁸⁶. For example, the number of banks was reduced from 67 in 1997 to 13 in 1998⁸⁷. Also, since the end of the 1990s the country benefitted from the increase in gas prices and expansion of the export, which was fulfilling the GDP of the country⁸⁸. In spite of the increase in GDP from year to year it does not reflect the progress in transition of the country.

The transition indicators of the EBRD show that privatization, financial institutions, infrastructure, competition policy and enterprise restructuring are on the beginning stage of transition⁸⁹. If taking the core sphere of activities by the EBRD, financial sector, the progress in Turkmenistan is also very low. The main reason is lack of independence of bank

⁸³ Ina Coretchi, "EBRD and Kazakhstan sign memorandum of understanding to foster economic diversification," *European Bank for Reconstruction and Development*, February 18, 2010, <http://www.ebrd.com/english/pages/news/press/2010/100218a.shtml> (accessed April 20, 2011).

⁸⁴ The EBRD, "Transition report 2010: recovery and reform," *European Bank for Reconstruction and Development*, November 2010: 151, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

⁸⁵ Ibid.

⁸⁶ The EBRD, "Transition report 1999: ten years of transition," *European Bank for Reconstruction and Development*, May 1999, <http://www.ebrd.com/downloads/research/transition/TR99.pdf> (accessed March 23, 2011).

⁸⁷ Ibid, 276.

⁸⁸ The EBRD, "Transition report 2007: people in transition," *European Bank for Reconstruction and Development*, November 2007, <http://www.ebrd.com/downloads/research/transition/TR07.pdf> (accessed March 23, 2011).

⁸⁹ The EBRD, "Transition report 2010: recovery and reform," 2010.

functioning. The financial funds are mostly under the control of the state government. The funds are not transparent and are heavily regulated⁹⁰. The banking sector does not grow and remains very small with the small competition among banks⁹¹. The asset share of state owned banks in 2008 constituted 96.3 per cent⁹².

Table 2: Comparison of the EBRD “banking reform” indicator
with the banking reforms in Turkmenistan

Year	“Banking reform” indicator	Description of the major banking reforms in Turkmenistan
1991	1.0	
1992	1.0	June: Bankruptcy law introduced
1993	1.0	November: new currency started to function November: Foreign exchange law passed November: two-tier banking system launched
1994	1.0	May: beginning of small-scale privatization September: national privatization program introduced
1995	1.0	December: inter-bank market established
1996	1.0	January: most prices liberalized August: first Treasury Bill issued
1997	1.0	April: large-scale privatization law enacted
1998	1.0	April: unification of exchange rate December: merger of private and state bank enacted December: direct credits were banned
1999	1.0	December: president Bank established
2000	1.0	June: direct credits were allowed June: holding foreign bank accounts by citizens abolished
2001	1.0	
2002	1.0	
2003	1.0	August: National Program “The Strategy of Economic, Political and Cultural. Development of Turkmenistan for the Period until 2020”
2004	1.0	
2005	1.0	
2006	1.0	
2007	1.0	
2008	1.0	March: investment legislation passed May: reunification and redenomination of the dual exchange rate June: foreign exchange regulations introduced

⁹⁰ The EBRD, "Transition report 2006: finance in transition," *European Bank for Reconstruction and Development*, November 2006, <http://www.ebrd.com/downloads/research/transition/TR06.pdf> (accessed March 23, 2011).

⁹¹ The EBRD, "Strategy for Turkmenistan," *European Bank for Reconstruction and Development*, March 23, 2010, <http://www.ebrd.com/pages/country/turkmenistan/strategy.shtml> (accessed April 10, 2011).

⁹² The EBRD, "Transition report 2009: Transition in crisis?," *European Bank for Reconstruction and Development*, November 2009: 238 <http://www.ebrd.com/downloads/research/transition/TR09.pdf> (accessed May 6, 2011).

		October: ban on SWIFT accounts and correspondent accounts lifted
2009	1.0	January: redenomination of the currency Transition to International Financial Reporting Standards began
2010	1.0	

Sources: the EBRD transition report 2002⁹³, the EBRD transition report 2004⁹⁴, the EBRD transition report 2009⁹⁵, the EBRD transition report 2010⁹⁶.

The “banking sector” indicator, which shows the transition in financial field, did not move from the initial level of 1.0 for two decades (see Table 2). This means that in Turkmenistan there is a “little progress beyond establishment of a two-tier system”⁹⁷. If to examine Table 2 closer it can be seen that the lack of progress in the banking sector is due to the few reforms conducted for the banking development. Some of the laws were even reversing transition process, like, forbiddance to use foreign accounts by physical persons that passed on June 2000. Prices have been liberalized only by 1996 still with some exceptions. Eventhough, the privatization program was adopted in 1994 it was limited and slow. Units in energy, telecommunications and transport are not allowed to be liberalized until 2020⁹⁸. It is a significant failure in transition, especially because energy sector is the biggest sector constituting economy of Turkmenistan.

⁹³ The EBRD, "Transition report 2002: agriculture and rural transition," *European Bank for Reconstruction and Development*, November 2002: 208, <http://www.ebrd.com/downloads/research/transition/TR02.pdf> (accessed April 25, 2011).

⁹⁴ The EBRD, "Transition report 2004: infrastructure," *European Bank for Reconstruction and Development*, November 2004: 188, <http://www.ebrd.com/downloads/research/transition/TR04.pdf> (accessed April 25, 2011).

⁹⁵ The EBRD, "Transition report 2009: Transition in crisis?," *European Bank for Reconstruction and Development*, November 2009: 238, <http://www.ebrd.com/downloads/research/transition/TR09.pdf> (accessed May 6, 2011).

⁹⁶ The EBRD, "Transition report 2010: recovery and reform," *European Bank for Reconstruction and Development*, November, 2010: 150, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

⁹⁷ The EBRD, *Transition indicators methodology*, April 29, 2010, http://www.ebrd.com/russian/pages/research/analysis/surveys/ti_methodology.shtml (accessed February 19, 2011).

⁹⁸ The EBRD, "Transition report 2006: finance in transition," *European Bank for Reconstruction and Development*, November 2006, <http://www.ebrd.com/downloads/research/transition/TR06.pdf> (accessed March 23, 2011).

In 2003 the long-term program of national development was adopted⁹⁹. This program left less hope for the soon transition of the country because the program consisted of the use of the planned state-controlled economy system. This kind of system contradicts to the market economy principles with which the EBRD operates.

The country began to show some improvements only with the presidency of Berdymukhamedov¹⁰⁰. Important steps in the monetary policy have shown progress in the economy. Exchange rate was reunified and limited transactions with foreign currency became possible, allowing commercial banks to start financial trading, though it stayed highly regulated¹⁰¹. Also, lending for the private sector expanded. The next step was taken in 2009 in the form of redenomination of the currency “manat”. Now, 1 denominated manat equals 5000 of old manats.

Another important event for the EBRD activities in Turkmenistan was the new constitution taken in October 2008. According to it, “the concept of a market economy with private property and independent enterprises” is going to be used in the country¹⁰². The willingness to abandon the Soviet-style economy provides the EBRD with opportunity to support the country in its attempts.

With these improvements in the financial sector there should have been increase in the “Banking sector” indicator. Yet, it had stayed on the same level. There are several reasons that can explain the same score of the indicator in 2008 and 2009. First of all, to remain the exchange rate fixed central bank of Turkmenistan regularly intervenes for stabilizing

⁹⁹ The EBRD, "Transition report 2005: business in transition," *European Bank for Reconstruction and Development*, November 2005, <http://www.ebrd.com/downloads/research/transition/TR05.pdf> (accessed March 23, 2011).

¹⁰⁰ The EBRD, "Transition report 2009: Transition in crisis?," *European Bank for Reconstruction and Development*, November 2009, <http://www.ebrd.com/downloads/research/transition/TR09.pdf> (accessed May 6, 2011).

¹⁰¹ The EBRD, "Transition report 2008: growth in transition," *European Bank for Reconstruction and Development*, November 2008, <http://www.ebrd.com/downloads/research/transition/TR08.pdf> (accessed March 23, 2011).

¹⁰² The EBRD, "Transition report 2009: Transition in crisis?," 2009: 236.

operations and regulating inflation pressures¹⁰³. Second, price controls and free or cheap utilities remained in the economy, distorting the market system¹⁰⁴. Third, privatization remains very slow. It touches mainly small and medium- sized business, while avoiding large corporations¹⁰⁵. Eventhough, there were few steps taken by the new government, the role of the banks in the economy remains constrained.

Taking into the account the resistance for the fast transition in Turkmenistan, the EBRD is the least active in this country among all its member-countries. By 2011 there were 28 projects conducted with the net business in 1991-2010 of EUR 135 million¹⁰⁶. Turkmenistan is the least invested country from the EBRD. The main obstacle that the EBRD faces is a state dominance and regulation in all of the economic spheres of the country by the state, including state directed lending. This concerns with the EBRD strategy for privatization, spread of the small-medium enterprises and state-dominance in the banking sector – the sectors of the Bank’s specialization. The Banks points out that Turkmenistan is the lowest on the transition scale not only in the Central Asia, but also in the whole region of the EBRD operation.

The main focus the work of the EBRD in Turkmenistan is on financial institutions and private sector/ corporate sector investments, few projects were conducted in transportation sector and energy¹⁰⁷. In July 2010 the EBRD spend EUR 4 million for small and medium

¹⁰³ The EBRD, “Transition report 2010: recovery and reform,” *The European Bank for Reconstruction and Development*, November 2010, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

¹⁰⁴ The EBRD, "Transition report 2007: people in transition," *European Bank for Reconstruction and Development*, November 2007, <http://www.ebrd.com/downloads/research/transition/TR07.pdf> (accessed March 23, 2011).

¹⁰⁵ The EBRD, "Transition report 2008: growth in transition," *European Bank for Reconstruction and Development*, November 2008, <http://www.ebrd.com/downloads/research/transition/TR08.pdf> (accessed March 23, 2011).

¹⁰⁶ The EBRD, "Annual Report 2010: Securing the recovery," *European Bank for Reconstruction and Development*, May 19, 2011: 2, <http://www.ebrd.com/downloads/research/annual/ar10e.pdf> (accessed May 19, 2011).

¹⁰⁷ The EBRD, “Strategy for Turkmenistan,” *European Bank for Reconstruction and Development*, March 23, 2010, <http://www.ebrd.com/pages/country/turkmenistan/strategy.shtml> (accessed April 10, 2011).

enterprises development¹⁰⁸. This came in line with the government reforms favoring private sector development. Other recent projects were in the sphere of agribusiness, which included investments in the first Turkmenistan's retail chain store, brewery factories and ice-cream production company¹⁰⁹. These activities bring out the strategy of the Bank in diversification of private sector from the energy sector economy reliance.

The first project of the EBRD in Turkmenistan was initiated in 1994. It was UDS 35 million credit line for the Central Bank of Turkmenistan that will lend money to the three participating commercial banks for the support of export-oriented local companies¹¹⁰. By the project it was aimed to provide more liquidity for banks and stimulate trade in the private sector of the country.

Among successful projects of the EBRD in Turkmenistan are Turkmenbashi Port Development Project and Gap Turkmen¹¹¹. Gap Turkmen is a joint-stock textile producing company. The EBRD have seen the future potential of Turkmenistan in expansion of textile industry. In 1996 it invested in equity share of Gap Turkmen USD 13.8 million, which equals to 20 per cent of the company share and lent US 17.5 million¹¹². Turkmenbashi Port Development Project is the first project of the EBRD in the public sector in Turkmenistan. The Bank gave US 30 million in loan to support international trade by improving the Caspian

¹⁰⁸ Ina Coretchi, "EBRD launches small and medium enterprise financing facility in Turkmenistan," *European Bank for Reconstruction and Development*, July 23, 2010, <http://www.ebrd.com/english/pages/news/press/2010/100723b.shtml> (accessed April 10, 2011).

¹⁰⁹ The EBRD, *News articles: Turkmenistan*, <http://www.ebrd.com/saf/search.html;jsessionid=2146E42FE9D4049D584AC1FA4FFC556E?type=article&country=Turkmenistan> (accessed April 10, 2011).

¹¹⁰ Axel Reiserer, "EBRD signs first project in Turkmenistan; US 35 million credit line to Central Bank," *European Bank for Reconstruction and Development*, November 25, 1994, <http://www.ebrd.com/english/pages/news/press/1994/95nov25.shtml> (accessed April 10, 2011).

¹¹¹ The EBRD, "Strategy for Turkmenistan," *European Bank for Reconstruction and Development*, March 23, 2010, <http://www.ebrd.com/pages/country/turkmenistan/strategy.shtml> (accessed April 10, 2011).

¹¹² Axel Reiserer, "Turkmen cotton industry boosted by EBRD loan and equity," *European Bank for Reconstruction and Development*, January 5, 1996, <http://www.ebrd.com/english/pages/news/press/1996/02jan05.shtml> (accessed April 10, 2011).

Sea port¹¹³. In addition, the EBRD was involved in the technical assistance to improve legal and administrative environment of the Turkmen Sea Administration. Also, the project helped to initiate first tenders in Turkmenistan for construction in the port.

Except lending, equity shares and technical support, the EBRD also provides credit lines. An example of it is the credit line of USD 500 000 to National Bank of Pakistan in Turkmenistan in 2005¹¹⁴. This project was conducted within the Trade Facilitation Programme of the EBRD to provide guarantees for banks trading operations and to support private sector in Turkmenistan. However, In 2005 the EBRD had problems with the USD 7.5 million SME credit lines¹¹⁵. The problems were related to the poor investment climate and the facility. This program failed to achieve its goals and was closed.

Reforms leading to the market economy and the development of banking sector are essential for the EBRD functioning in the country. Thus, the Bank is actively involved in the policy dialogue with state authorities¹¹⁶. The Bank believes that there is a need for government to become more cooperative for political and economic development.

Overall, the work in Turkmenistan is still very challenging for the Bank as there is little space for the increase in its operations due to the prevailing state-owned share of the companies and the dominant state regulation. However, improvements of the last years give a hope the Bank to apply its knowledge, skills and other resources to move transition of the country in the complementing tandem with the state and other international financial institutions. For instance, in 2008 in Turkmenistan after the reform the EBRD was able to

¹¹³ Axel Reiserer, "Turkmenistan infrastructure strengthened by two-fold EBRD financing," *European Bank for Reconstruction and Development*, December 18, 1997, <http://www.ebrd.com/english/pages/news/press/1997/102dec18.shtml> (accessed April 10, 2011).

¹¹⁴ Axel Reiserer, "TFP line in Turkmenistan," *European Bank for Reconstruction and Development*, November 22, 2005, <http://www.ebrd.com/english/pages/news/press/2005/146nov22.shtml> (accessed April 10, 2011).

¹¹⁵ The EBRD, "Strategy for Turkmenistan," *European Bank for Reconstruction and Development*, March 23, 2010, <http://www.ebrd.com/pages/country/turkmenistan/strategy.shtml> (accessed April 10, 2011).

¹¹⁶ Ibid.

open its TAM (TurnAround Management) program, which helps with managerial and structural development of small and medium enterprises¹¹⁷.

The recent plans of the EBRD work in Turkmenistan relate to the establishment of the new bank for private sector development, expansion of the Trade Facilitation Programme of the EBRD to help in the growth of the trade and provision of credit lines to the banks for the support of micro, small and medium enterprises¹¹⁸. These plans became possible for the realization after the reforms in the last few years towards strengthening of financial sector. Yet, due to various barriers and conditions there is a long way for Turkmenistan towards the EBRD graduation.

¹¹⁷ The EBRD, "Annual report 2008," *European Bank for Reconstruction and Development*, May 2009, <http://www.ebrd.com/downloads/research/annual/ar08e.pdf> (accessed May 5, 2011).

¹¹⁸ The EBRD, "Strategy for Turkmenistan," *European Bank for Reconstruction and Development*, March 23, 2010, <http://www.ebrd.com/pages/country/turkmenistan/strategy.shtml> (accessed April 10, 2011).

Chapter 3: Transition of financial sector in Central Asia and the role of the EBRD in it

3.1. Impact of the global financial crisis 2007-2009 on the financial system in Central Asia

Several financial crises after collapse of the USSR preceded the crisis of 2007, they are Mexican crises of 1994 and Asian crisis of 1997. Even though they did not touch specifically Central Asian region, they showed several gaps in the capitalist banking system and the areas, in which IFIs should improve. The common conclusion from all these crises is that banking system should be regulated, yet, the level of regulation and actors are at the question. As the state governments, local banking systems and IFIs compose one big world financial system. Therefore, there is a strong necessity of coherent work of the whole system and effectiveness of all its actors.

The financial crisis was caused by the fall down of world stock markets and U.S. currency. In general, it caused decrease in the prices of commodities, difficulties with credits and loans, and capital inflows into the countries accompanied with difficulties of local stock markets and devaluation of local currencies. Crisis of 2007 has touched all developed and developing economies that are integrated into the global economic system.

However, the degree of vulnerability towards the crisis differed. Aslund even called his book “The last shall be the first: East European financial crisis” meaning that East European countries (also transition countries) prepared better policies for crisis reduction using “hard budget constraints and ... more responsible fiscal policies” and might become

policy-makers of the Europe¹¹⁹. Thus, the crisis may also show the economy transition of Central Asia.

The current crisis only slightly touched the Central Asian region¹²⁰. The crisis only severely hit the banking sector of Kazakhstan. The problem was that it relied a lot on the capital share of the foreign banks and natural resources export. Currently, the bank restructuring is in the process to bring more stability in their working, where the state started to play bigger role by taking various stakes in the local banks. In Central Asia Turkmenistan was affected the least by this global financial crisis. This happened due to the isolation of the majority of Turkmen economy from the world market. It does not rely on external financing and has limited trade of goods¹²¹.

The global financial crisis of 2007 has led to the various banking reconsiderations from the state governments and the EBRD. The EBRD was also hit by the crisis. It experienced losses in the income in 2008 and 2009, while currently the Bank has recovered from the crisis¹²². Yet, the Bank on contrary to support financial sectors in the member-countries increased its investments in this sector by 50 percent¹²³. The EBRD quickly responded to the crisis and lack of liquidity in the banks by following several objectives:

- “maintaining the flow of finance to the region in support of local banks and viable enterprises
- preventing the withdrawal of Western-owned parent banks from the region

¹¹⁹ Anders Aslund, *The Last Shall Be the First: The East European Financial Crisis* (Washington, DC: Peterson Institute for International Economics, 2010): 8.

¹²⁰ Richard Pomfret, "Central Asia and the global economic crisis," *EU-Central Asia monitoring*, June 2009, http://www.eucentralasia.eu/fileadmin/user_upload/PDF/Policy_Briefs/PB-7-reversion.pdf (accessed May 2, 2011).

¹²¹ Economist Intelligence Unit, "The IMF praises "prudent" policies," *Economist Intelligence Unit*, July 2, 2009, <http://country.eiu.com/article.aspx?articleid=1834650168> (accessed May 7, 2011).

¹²² The EBRD, "Annual Report 2010: Securing the recovery," *European Bank for Reconstruction and Development*, May 19, 2011, <http://www.ebrd.com/downloads/research/annual/ar10e.pdf> (accessed May 19, 2011).

¹²³ Anthony Williams, "EBRD supports Kazakh banks," *European Bank for Reconstruction and Development*, May 7, 2009, <http://www.ebrd.com/english/pages/news/press/2009/090507n.shtml> (accessed April 20, 2011).

- upholding critical infrastructure and sustainable energy projects”¹²⁴.

The Bank successfully met these objectives by helping the countries to maintain its transition scores with continuation and beginning of new projects. This findings correspond to the article of Dinger about support of foreign banks by increasing liquidity assets and smoothing risks¹²⁵.

Even though the global financial crisis of 2007 is seemed to be over, there are many unresolved problems in the financial system are left. Before the perfect single solution for building strong united financial system is not found, there are possibilities of the future crises. Development banks as a part of the system are able to speed up the process of building strong financial system. Therefore, there is an essential need in the EBRD in particular, as an active actor in the effective building of the financial system.

On the whole, crisis does not reflect the negative impact of international intermediation between banks. This supports case of Kazakhstan that is among all Central Asian countries has the most advanced economy and was hit the most by the financial crisis. Its fastest growth and development of financial system in Central Asia was mostly due to the reliance on foreign banks. Also, after the crisis it did not lose its positions. GDP per head in Kazakhstan in 2010 consisted of USD 11, 976, leaving all other Central Asian countries far behind¹²⁶. Therefore, it can be stated that closed countries with less international reliance are hit less during crisis periods, but, also, they benefit less from their reluctance from mutual work with foreign banks.

¹²⁴ The EBRD, "Annual Report 2009," *European Bank for Reconstruction and Development*, May 2010: 11 <http://www.ebrd.com/downloads/research/annual/ar09e.pdf> (accessed May 5, 2011).

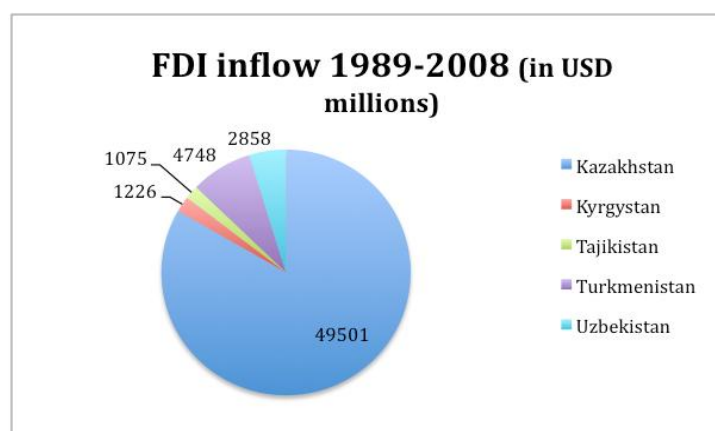
¹²⁵ Valeriya Dinger, "Do foreign-owned banks affect banking system liquidity risk?," *Journal of Comparative Economics* 37, no. 4 (December 2009): 647-657.

¹²⁶ Economist Intelligence Unit, "Comparative economic indicators," *Economist Intelligence Unit*, May 1, 2011, <http://country.eiu.com/article.aspx?articleid=1058054290&Country=Kazakhstan&topic=Economy&subtopic=Charts+and+tables&subsubtopic=Data+and+charts%3a+Comparative+economic+indicators> (accessed May 20, 2011).

3.2. Transition of the financial institutions in the Central Asia

In the beginning of independence Central Asia was lacked the support from outside comparing the substantial international support to Central European and Baltic countries¹²⁷. The Central Asian region was highly dependent on Russia, which suffered from the economic and political hardships itself. If we take the EBRD, in particular, Aslund points out that its concern in the beginning of the 1990s to support development of big private corporations with transparent financial system failed because most assistance was needed during the process of privatization and establishment of the financial system with market economy standards¹²⁸. Thus, the EBRD before restructuring its work to assist small and medium enterprises and provide assistance from the initial level was not able to meet its 'transition impact' role in Central Asia.

Figure 1



Source: based on the data from the EBRD Transition Report 2009¹²⁹

Through a more general analysis of the banking reforms in the Central Asia there are several conclusions that can be made. First, there is a low investment interest in the region.

¹²⁷ Anders Aslund, *How capitalism was built: The Transformation of Central and Eastern Europe, Russia, and Central Asia* (New York: Cambridge University Press, 2007).

¹²⁸ Ibid.

¹²⁹ The EBRD, "Transition report 2009: Transition in crisis?," *European Bank for Reconstruction and Development*, November 2009: 27, <http://www.ebrd.com/downloads/research/transition/TR09.pdf> (accessed May 6, 2011).

According to the IMF, central banks and EBRD statistics, the FDI to the Central Asian region is low. For instance, the FDI inflow from 1989- 2008 into the Central Asian countries is USD 59, 408 million compared to the FDI to Central Europe and Baltic states that is USD 320, 216 million¹³⁰. More FDI went to the oil and gas rich countries of the Central Asia, which are Turkmenistan and Kazakhstan (see Figure 1).

Second, banking development in this region is the lowest among all post-soviet transition countries, where the EBRD works. The “banking reform and interest rate liberalization” index ranges from the lowest 1 point in Turkmenistan till 3- in Kazakhstan in 2010, the average is around 2, which reflects the long way towards the end of transition in this sphere¹³¹. The problems range from no privatization of the banks in Turkmenistan until the vulnerability of Kazakh banks from the foreign capital.

One of the reasons of poor investments in the Central Asian region and the limited development of the banking sector is the low economic freedom degree. According to the scores of economic freedom and its components, calculated by the Heritage Foundation, there are the following results in Central Asian countries in 2011, whose assessment began in 1998: the highest economic freedom is in Kazakhstan (62,1 out of 100) showing a large progress from 41.7 points, then stands Kyrgyzstan on the descending scale having slower progress than in Kazakhstan with 61,1 points from 51.8 in 1998 and receiving lower results than two years before, then Tajikistan (53,5 starting from 41.1), Uzbekistan has 45,8 points with zero investment freedom, starting from 31, 5 and deteriorating since 2007, and Turkmenistan has 43,6 starting from 35 points in 1998 and currently having no investment freedom and very low

¹³⁰ The EBRD, "Transition report 2009: Transition in crisis?," *European Bank for Reconstruction and Development*, November 2009: 27, <http://www.ebrd.com/downloads/research/transition/TR09.pdf> (accessed May 6, 2011).

¹³¹ The EBRD, "Transition report 2010: recovery and reform," *European Bank of Reconstruction and Development*, November 2010: 4, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

financial freedom and property rights¹³². These results correspond with the degree of activities of the EBRD in those countries. Thus, the low economic freedom is a reason for IFIs to have low interest in the region.

Third, there is high influence on the economy from the government. Aslund characterizes Turkmenistan and Uzbekistan as “full-fledged authoritarian systems with Soviet-type economies”, Kazakhstan and Tajikistan as “mildly authoritarian states with rent seeking dominated by the rulers”, and Kyrgyzstan as “semidemocratic oligarchic states with market economies”¹³³. Therefore, Central Asia can be generalized as a region with limited democracy. In the example of Turkmenistan, government intervention into the economy is one of the highest. In the case of Uzbekistan it is also very high, compared to the other Central Asian countries. For instance, considering the political mandate of the EBRD, Kazakhstan’s government on paper and in words follows the principles of democracy. There are several political parties and regular presidential and parliament elections are going on¹³⁴.

However, as the EBRD states, there are still problems in political structure in the form of a powerful executive branch, corruption and fairness during election processes¹³⁵. For instance, the constant winning in elections of Nursultan Nazarbayev, who serves as president of Kazakhstan since 1991 and has won recently in April his next term. There are significant problems with the application of the political mandate of the Bank in Turkmenistan. Even though, Turkmenistan calls itself democratic, there is no pluralism or multiple parties in the country. There are still concerns about human rights violations and full

¹³² Heritage Foundation/Wall Street Journal, *Explore the data*, Heritage Foundation and Wall Street Journal, 2011, <http://www.heritage.org/index/explore?view=by-region-country-year> (accessed May 3, 2011).

¹³³ Anders Aslund, *How capitalism was built: The Transformation of Central and Eastern Europe, Russia, and Central Asia* (New York: Cambridge University Press, 2007), 214-215.

¹³⁴ Economist Intelligence Unit, *Kazakhstan: political structure*, April 1, 2011, <http://country.eiu.com/article.aspx?articleid=137914798&Country=Kazakhstan&topic=Summary&subtopic=Political+structure&subsubtopic=Political+structure> (accessed April 6, 2011).

¹³⁵ The EBRD, “Strategy for Turkmenistan,” *European Bank for Reconstruction and Development*, March 23, 2010, <http://www.ebrd.com/pages/country/turkmenistan/strategy.shtml> (accessed April 10, 2011).

media control¹³⁶. However, since 2008 Berdymukhamedov made several reforms in the sphere of telecommunications, finances and opened a wider market for foreign direct investment¹³⁷. Since this period the EBRD intensified its activity in the country, offering and accomplishing various projects.

This intervention slows down private sector development, leaving parts of the population without an opportunity for employment. According to the statistics of 2010, in Turkmenistan the share of the private sector of GDP consisted of 25 percent, whereas in Uzbekistan 45% compared to the Kazakhstan, which has 65%¹³⁸. These economies are characterized by the lack of liberal reforms in the countries that hinder the transition process in the region. Aslund emphasizes the necessity of the democratic political regime as the precondition for market economy development because it works in the interest of the majority compared to the authoritarian regimes that work in the interest of a limited group of people¹³⁹.

In Kyrgyzstan, with a weak government system, the private sector is well developed. Kyrgyzstan has the highest percent of the private sector share of the country's GDP in Central Asia that is 75¹. In addition, by the EBRD transition indicators of 2010 it has also high scores on price liberalization and trade and forex system¹⁴⁰. From first sight it can be concluded that liberal reforms should put Kyrgyzstan on the leading positions among Central Asian countries. Yet, the development of the country is at a relatively similar level to other countries of Central Asia. Havrylyshyn explains this by the necessity of the simultaneous development of the stabilizing, liberalizing and developing of institutional reforms¹⁴¹. The lack of one aspect would not lead to growth. So, in the case of Kyrgyzstan, it lacks institutional

¹³⁶ The EBRD, "Strategy for Turkmenistan," *European Bank for Reconstruction and Development*, March 23, 2010, <http://www.ebrd.com/pages/country/turkmenistan/strategy.shtml> (accessed April 10, 2011).

¹³⁷ Ibid.

¹³⁸ The EBRD, "Transition report 2010: recovery and reform", *the European Bank of REconstruction and Development*, 2010: 4, <http://www.ebrd.com/downloads/research/transition/tr10.pdf> (accessed March 15, 2011).

¹³⁹ Anders Aslund, *How capitalism was built: The Transformation of Central and Eastern Europe, Russia, and Central Asia* (New York: Cambridge University Press, 2007).

¹⁴⁰ The EBRD, "Transition report 2010: recovery and reform," 2010:122.

¹⁴¹ Oleh Havrylyshyn, "Growth recovery in CIS countries: the sufficient minimum threshold of reforms," *Comparative Economic Studies* 50, no. 1 (2008): 53-78.

development and, considering recent violent political changes, also stabilization. The lack of liberalization, stabilization and more institutional reforms are the main aspects of slow banking development in the region.

Fourth, corruption in all five countries of Central Asia is one of the biggest barriers towards liberal democracy and market economy. It disturbs the market system of institution building, as well as liberalization, stabilization and privatization processes. As was shown previously, the corruption problem in Central Asia stays strong. Mickiewicz emphasizes the importance of property rights, as the essential element for the formal institutional formation, in the elimination of corruption and in the formation of a favorable climate for investment¹⁴². Property rights is also an element that constitutes economic freedom. In the index of economic freedom, the same hierarchy of the property rights can be traced, with the highest in Kazakhstan, and the lowest in Turkmenistan¹⁴³. There are slight differences in the freedom from corruption element, however, the numbers are very close, and changes can be seen in the future, thus Kazakhstan received 27/100, Tajikistan 20, Kyrgyzstan 19, Turkmenistan 18 and Uzbekistan 17¹⁴⁴. This index has shown the significant corruption problem throughout the region. This problem is a large barrier for the process of transition.

Through the comparison of the economy in Central Asia and looking at concrete cases of the banking reforms in Kazakhstan and Turkmenistan it can be concluded that the financial system of Central Asia is still in the transition process. In the case of Turkmenistan, the banking system after two decades did not move from the initial level. In case of Kazakhstan, where the banking system is the strongest in Central Asia, there is a lot of space for improvement, growth and more stability for the financial system. There are gradual banking

¹⁴² Tomasz M Mickiewicz, "Hierarchy of governance institutions and the pecking order of privatization: central-eastern Europe and central Asia compared," *Post-Communist Economies* (Routledge) 21, no. 4 (December 2009): 399-423.

¹⁴³ Heritage Foundation/Wall Street Journal, *Explore the data*, Heritage Foundation and Wall Street Journal, 2011, <http://www.heritage.org/index/explore?view=by-region-country-year> (accessed May 3, 2011).

¹⁴⁴ Ibid.

reforms across the region. Although, there is a need for more reforms to ensure the building of a stable financial system that would in its turn bring more growth to the economy.

To summarize, the slow movement of the transition in the banking sector in Central Asia became a consequence of several conditions described in detail earlier, such as, initial poor level of the financial system, mistakes during privatization and liberalization with Uzbekistan and Turkmenistan still not enough privatized and liberalized. There is also lack of interest from the government in the fast transition coming along with corruption and autocratic principles and finishing with the lack of legislation for building an independent, strong financial sector.

3.3. The EBRD as an agent for transition in Central Asia

The EBRD is an important international financial institution in Central Asia. Through its political mandate towards democracy and transition strategy towards market economy it helps Central Asian countries to integrate into the global market system. Unlike the other financial institutions, the EBRD uses international knowledge and applies its through banking methods into its spheres of specialization, such as private sector development, small and medium enterprises support and financial sector improvement.

The work of the EBRD in Central Asian region is challenging. The economies of these countries are less developed compared to the Central and Eastern European countries. The transition process is at the initial to average level in Central Asia. Yet, the Bank, due to its experience of working in Europe, applied strong expertise to the region. The EBRD supports governments and enterprises of Central Asia in their attempts to build a market economy.

The EBRD operations through its years of experience became very transparent. It shows all the goals and their vision of achieving them through the set of standardized projects. Also, methodological calculations can be seen in the evaluation of projects and the

transition progress of the countries. In addition, the Bank issues various reports from country evaluations, such as transition report, to technical reports of the EBRD work, as annual reports. Furthermore, the Bank sets clear goals and objectives to every country and shows to the public precise strategies for every country. In all of these reports separate sections are devoted to the Central Asian region and its countries in detail.

The core sphere of the Bank's functioning is the financial sector. It supports it with projects in both private and public sectors. Also, large funding goes to the spheres that constitute most of the GDP of the countries, as in the cases of Kazakhstan and Turkmenistan by hydrocarbon exports. The EBRD tries through loans and technical assistance to support the emergence of the diverse private sector in the countries. Firms have a chance to find assistance even in the beginning of the business and in the micro level of the project, having the opportunity to develop and grow in the future. Therefore, it can be concluded that the EBRD has a positive impact in the transition of the financial sector in the Central Asian region.

Conclusion

The research has presented an analysis of the EBRD's role in the transition process of Central Asia. The focus was on the financial sector as it is an important foundation for the market economy and it is a core activity of the Bank. Cases of banking reforms in Kazakhstan and Turkmenistan analyzed the banking system in Central Asia and impact of the EBRD on the financial sector.

Referring to the 'international regime' of the country, finances constitute the linkages between different actors, such as the state, financial institutions and IFIs, represented by the EBRD, in Central Asia. The transition of the region is influenced by the 'international regime' as a whole and its particular actors. The functioning of the EBRD, as an actor in the 'international regime' towards building transition was a core of the research. Yet, it was also essential to see the work of other parts of the regime.

The state plays the most crucial role in the Central Asian 'international regime'. This regime is more positive and cooperative when the state is more committed to democratic principles. In the Central Asian region these regimes are not very cooperative and productive. As could be seen from the examples of Turkmenistan and Kazakhstan, excessive state interference into the economy does not help the EBRD to operate in the countries. However, with the reforms going on in the region, there is a tendency towards strengthening the 'international regimes' that would lead to the successful completion of the transition period in Central Asia.

Financial institutions in Central Asia are not fully developed. The EBRD transition indicator shows small or medium scores for banking reform in the region. There is a high dependence on other actors in the system, it maybe the state or foreign banks. In addition, banks still lack transparency in their activities and in some cases even do not follow

international standards of accounting. Transition in Central Asia can go faster with the strengthening of financial institutions with market economy principles.

In addition, it was traced through the cases that the EBRD is being an active agent in the financial system in Central Asia. It is not only a useful source for the increase in investments into the region. Through its activities in monitoring transition, lending to banks, buying equity shares, providing technical support and guarantees, working with other IFIs and communicating with the government in policy advancements, the EBRD tries to achieve its main goal to forward the transition process in Central Asia. The Bank's 'transition impact' to the region is high. It not only invested millions of euros in Central Asia, it acted as an intermediary guarantor for other investors to the region. In addition, the Bank constantly tries to diversify the reliance of the Central Asian economy on natural resources and tries to expand other economic sectors. The EBRD increased its activity and loans during the crisis that helped to prevent more recession in the countries. The EBRD understands the barriers and the difficulties of working in Central Asia and tries to overcome them. It is important for the accomplishment of its role in assisting the countries to achieve democracy with solid market economy and helping successful graduates from the Bank upon finishing their transition period.

The EBRD and other IFIs are not able fully substitute the lack of capital inflow into the region. There is a need of more investments that are difficult to attract due to the lack of proper functioning institutions in Central Asia. It is largely the consequence of restrictive politics of authoritarian governments in these countries and reliance of economy on the natural resources export. These barriers do not allow economy fully develop and differ the Central Asian countries from the Central and Eastern European post-socialist countries that possess better institutional structure and democratic principles.

On the whole, within the complex debate upon the necessity of the IFIs and their impacts, this study argues, on the example of the EBRD work in Central Asia, that they are an important source of the investment in the countries with unstable economic conditions, where the private FDI come in a small amount. However, the case studies have shown that the IFIs are only supporters to the countries that are on the way to the integration into the world economy. In Kazakhstan with more reforms the EBRD invests more. In Turkmenistan with the change of the government in 2007 and the following even slight reforms, the EBRD made an attempt to increase its activity in the country. Thus, there should be an incentive from policy-makers to change, taking for instance the countries that undergoing economic reforms to join the European Union, and the IFIs will help through their international experience and expertise.

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