As Global Markets Cool, Investors Find Warmth In Central Asia's Infrastructure

By Ariel Cohen
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Freight station on the *Silk Road Express* in Eastern Kazakhstan linking Almaty and the Chinese city of Ürümqi.DIMOTRANS KAZAKHSTAN

The long-anticipated global market correction may now be upon us. Worldwide stocks extend their losses over the weekend, leaving little room for optimism of a macroeconomic rebound. Chinese goods-exports growth slowed to 5.4% year-over-year in November, down from 15.6% in October. S&P futures are now down 10% on the year and the Dow Jones is still 2,400 points below its October high.

China and the United States – the world's two largest economies – continue what Beijing – and many Americans -- agree is a destructive trade war. Despite a brief truce achieved at the G-20 summit in Buenos Aires last week, the curiously-timed arrest of Huawei's global chief financial officer Meng Wanzhou has re-escalated tensions.

Anemic economic growth in much of the OECD and developing world, rising U.S. interest rates, and UK Prime Minister Theresa May's pullout of the Brexit vote are swirling together into a perfect storm of market uncertainties.

Yet despite this, bright spots are still shining in this increasingly bleak economic landscape. Chinese investors, mostly state companies, but also public and private investors from the OECD have found shelter from the storm in Central Asia's emerging and frontier markets. China's ambitious $1 trillion-plus Belt and Road Initiative (BRI) is a major contributor to the region's economic growth.

This is the topic of the International Tax and Investment Center's (ITIC) new report, entitled Future Calling: Infrastructure Development in Central Asia Unlocking Growth in The Heart of Eurasia. Authored by me and my colleague James Grant, the report was presented at the Astana Club conference last month in Kazakhstan and at the Atlantic Council and Georgetown University this December. Energy – from fossil fuel pipelines to hydropower dams and solar and wind farms – feature prominently in the region's growth. Here's what we found:

Infrastructure: The Engine of Economic Development

The Central Asian Republics (CARs) – Kazakhstan, The Kyrgyz Republic, Uzbekistan, Tajikistan, and Turkmenistan – are in the midst of a quiet yet remarkable economic transition on a scale not seen since the period immediately following the collapse of the Soviet Union. Leveraging their critical geography between the world's largest markets, Central Asian governments are embarking on development strategies to increase regional/global connectivity, diversify and modernize their economies, and improve the welfare of their citizens. Behind these varying strategies for growth lies a common thread: infrastructure development.

CENTRAL ASIA-CHINA ENERGY INFRASTRUCTURE

Central Asia pipeline infrastructure highlighting oil (green) and gas (red).STRATFOR

As we demonstrate in our Report, Infrastructure (and its value chain) is the bedrock of economic opportunity – it facilitates trade, increases productivity, promotes knowledge sharing, and creates an environment for economic and even social innovation. For this reason, quality infrastructure development is both a top responsibility and top priority of the state.

Eager to unlock the potential of their respective economies, the CAR's are – to varying degrees – pursuing their own infrastructure build-out programs. Increasing urbanization, population growth, and rising energy demand are fueling this demand for energy, transport, and digital connectivity expansion. However, budgetary, technical, and bureaucratic constraints across the region mean that states on their own have been unable to meet domestic demand for infrastructure needs. Subsequently, the CARs have turned to external partners – nation-states, international financial institutions, and private companies -- to attempt to bridge the infrastructure gap.

Energy Focus

Central Asia is a region endowed with tremendous natural resources. Chief among its wealth of commodities are hydrocarbons – oil and gas, as well as coal – which form cornerstones of the economies of Kazakhstan, Turkmenistan, and Uzbekistan. Kyrgyzstan and Tajikistan, lacking the fossil fuel resources of their neighbors, hold impressive hydropower potential. Universal among the CARs, however, is aging energy infrastructure and a difficulty in matching domestic capacity with rapidly growing electricity demand.

While the West has historically been an active investor in Central Asia’s fossil fuel sector, the mantle of largest oil and gas financier now goes to China. In recent years, the region has received tremendous Chinese investments. Beijing’s drive to import more energy from Central Asia is a sensible pillar of its energy security policy, as the PRC is dependent on foreign producers to meet 60% of its energy needs. Beijing understands that a successful energy security strategy requires a diversification of supply.

The Kazakhstan-China Crude Oil Pipeline is one of the major energy projects of BRI. This 2,800 km (1,740 miles) pipeline links Kazakhstan’s huge oil resources in the Caspian Sea with China’s oil market by transporting crude oil from oil fields in Western Kazakhstan to Alashankou terminal station in China and then to the Dushanzi refinery in the Xinjiang Province of China. The total cost of building the pipeline is estimated at $3 billion. It is divided into 4 segments. One of them is the Kenkiyak-Kumkol pipeline with a maximum capacity of 10 million tons per year or 200,000 b/d.

Wind turbines spin in the Zhambyl region of Kazakhstan.KAZAKH-TV.KZ

Green energy is an as of yet underdeveloped sector in central Asia. Excluding hydropower capacity, renewables range from 1% of Kazakhstan's energy profile up to 3% in Uzbekistan and Tajikistan. One explanation is that high fossil fuel subsidies and low electricity prices significantly reduce the competitiveness of renewables projects. The limited presence of technology vendors and lack of technological and institutional knowledge (know-how) are also significant obstacles. That being said, there has been some positive movement. For instance, under the auspices of International Renewable Energy Agency (IRENA), the energy ministries of Kazakhstan, Turkmenistan, Uzbekistan, Kyrgyzstan, and Tajikistan have all pledged to pursue an accelerated build-out of renewable energy.

The vast Central Asian Steppe, for example, is an ideal location for wind power capacity additions. Kazakhstan is the regional leader in wind energy and has ambitious plans to accelerate the technology under its new "2050 strategy." The proposal hopes to achieve 50% of its electricity from renewable and alternative energy sources. Currently, only 50 alternative energy facilities are operating in the country while in three years that number is expected to grow to 100, of which 23 are wind energy plants (also includes 7 solar power stations, and 13 hydroelectric power stations, as well as plants capable of producing biogas).

Challenges of Financing

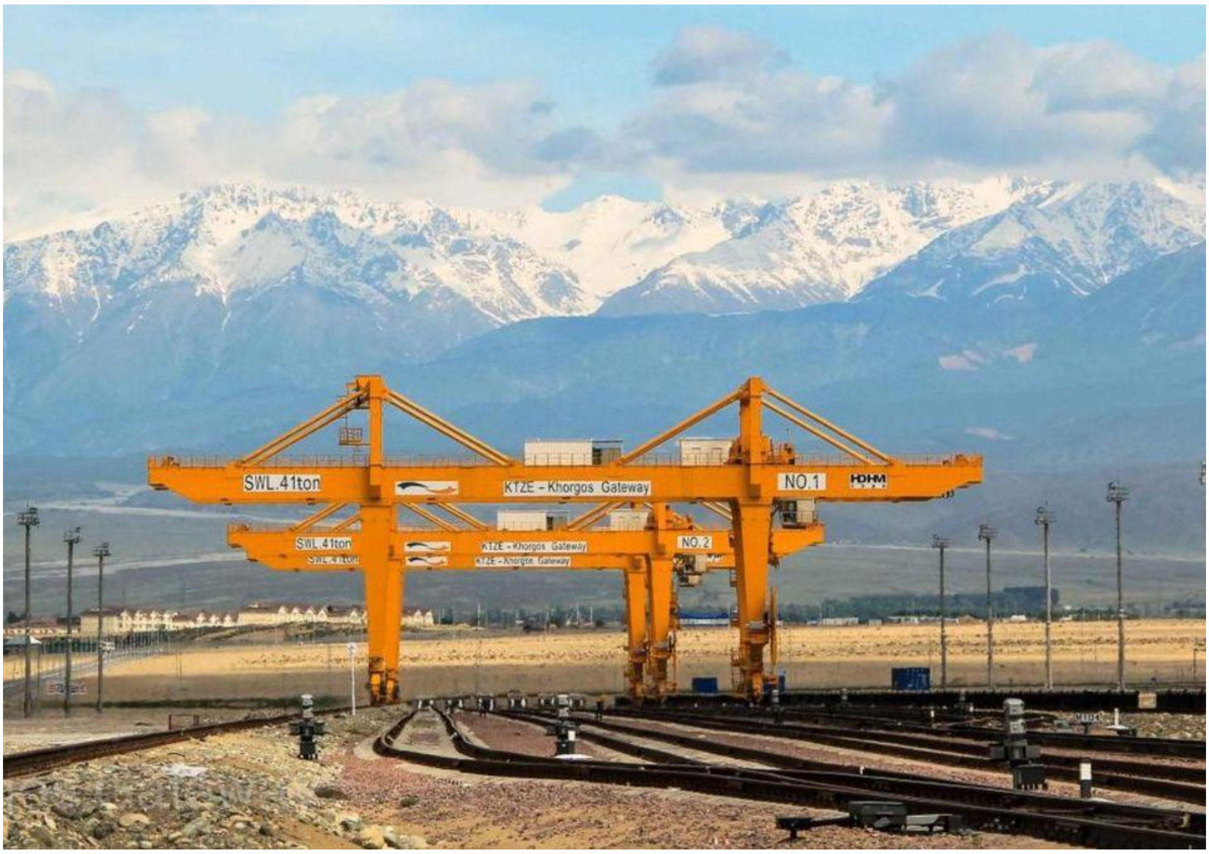
The Asian Development Bank (ADB) projects that USD 33 billion per year will be needed between 2016 and 2030 to tackle the massive infrastructure requirements of Central Asia. The CARs inherited a decrepit Soviet-era infrastructure network oriented for north-south trade. Today, however, international trade flows are no longer dominated by Moscow.

East-West trade, which now includes Western Europe and China, is emerging as the future of Central Asia's economic destiny. Furthermore, despite geopolitical difficulties, North-South trade towards the Indian ocean is also developing. New partnerships, new technologies, and new ideas will be needed for Central Asia to reach its economic potential. Renewable Energy Resources (RES) and Information Communication Technology (ICT) are among the most promising sectors for realizing this potential.

Financing is and will remain a challenge for a while. Borrowing for these projects, however, is constrained due to rising budget deficits and debt sustainability concerns across Central Asia. Relatively low commodity prices – the backbone of Central Asia's economic growth – are straining state budgets, while population growth and increasing urbanization necessitate increased infrastructure spending. As national debt levels rise, responsible governments have put stricter fiscal policies into effect. Together these factors limit the ability of governments to address infrastructure needs through the state budget.

Given these constraints, China's estimated $1 trillion Belt and Road Initiative, fueled by Beijing's economic and geopolitical ambitions, is a tremendous resource for Central Asian economies. Indeed, infrastructure development across Central Asia's transport, energy, and telecommunication sectors is dominated by Chinese funding. China's perfect storm of excess capital, manufacturing overcapacity, increasing demand for natural resources, and a desire to be respected as a major player in international affairs have combined to create this massive initiative.

But while the BRI can be a great facilitator for connectivity and development in the region, Central Asian countries must be active in the management of the belt and road projects passing through their territory if they hope to maximize local input -- and impact. In addition, participants of China's BRI – particularly those which are overly dependent on China as a trade partner and creditor – run the risk of debt spirals and dangerous exposure to market shocks.



The container transfer area at Khorgos Gateway - the largest dry port in the world (China-Kazakhstan border).KTZE-KHORGOS GATEWAY

The Kyrgyz Republic and Tajikistan, for example, respectively owe 40% and 50% of their public debt to China. BRI commercial loan repayment will exacerbate the hazards of debt distress among the CARs, and therefore they must exercise caution in their approach to investment relations with Beijing. This is to say nothing of the potential geopolitical ramifications of BRI, which could place traditionally strong relationships with the West in jeopardy if not marshalled properly by CAR governments.

With BRI investment posing both risk and reward, Central Asian countries should seek balance and continue to identify private investment through whatever means and mechanisms available. Multilateral Development Banks (MDBs), which ushered Central Asia into global free-market economy into the 1990s, are a historically promising source of investment. Public-Private Partnerships (PPPs), which come with fewer constraints but require more sound business environments, are an increasingly attractive instrument for infrastructure development in Central Asia. To paraphrase from the 1990's oil and gas pipeline development boom, "happiness is multiple investors."

Infrastructure Gap

As the Republics of Central Asia continue on their trajectory of economic development, there will be an ongoing increase in demand for connective infrastructure in the forms of energy, transport, telecommunications, and beyond. Macroeconomic realities dictate that CAR governments will not be able to meet these needs on their own, leading to the emergence of an infrastructure gap. To bridge this gap, Central Asia will need to work with investment mechanisms of all different varieties, including commercial banks, capital markets, such as AIFC, Belt and Road funding from China, International Financial Institutions, nation-states' loans, and private partnerships. Each comes with its own advantages and disadvantages, and it will be up to the leadership of CAR governments to strike the appropriate balance to maximize efficient and successful execution of investment capital.

Central Asia's Promise in the 21st Century

Granted, it is not easy for the Central Asian Republics – led by Kazakhstan and Uzbekistan to buck the trends of slowing global growth. But as we outline in our report, if the high-potential region can demonstrate a level playing field for investors (guaranteed by strong institutions), reliable funding sources will follow. China too, with its BRI megaproject, will look to the CARs as an economic lifeboat amidst the market storms ahead. The region is finally arriving into the 21st century, despite the high capex costs and serious – but surmountable – geopolitical and geo-economic challenges.

James C. Grant, Program Manager at International Market Analysis Ltd., contributed to this article