

# THE CHINA AND EURASIA FORUM QUARTERLY

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*February 2008*



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Editor-in-Chief

**Niklas Swanström**

*Institute for Security and Development Policy, Sweden*



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## Editor's Note

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Dear Colleagues and Friends,

The Olympic Games in August is approaching and the Chinese have been preoccupied with stabilizing internal opposition and fending off international threats of boycotts. Notwithstanding the domestic and international protests and violence surrounding the situation in Tibet, Xinjiang and Central Asia have been relatively quiet. China has arrested a few persons allegedly planning terrorist attacks but most attention has been devoted to Tibet rather than Xinjiang. Many efforts are being put into monitoring and securing the border area between China and Central Asia in Xinjiang, however, to make sure that the situation does not get out of hand in the run-up to the Olympics and during the games.

It is interesting to note that Xinjiang is increasingly becoming a region of potential rather than a region of problems for Beijing. Much of China's attention now seems to be centered on the positive and integrative effects that the trade between Central Asia and China (Xinjiang) has. For example, China has begun to build a new pipeline between Xinjiang to Hong Kong and Shanghai which, in turn, is part of the Chinese US\$2.2 billion investment to build a gas pipeline from Turkmenistan to Xinjiang. Rather than showing any indications of retreating from the region, China has increased its investments and interest. To mention one example, it was recently announced that Datong Corporation will initiate the construction of several power stations in Kazakhstan to a value of US\$860 million.

There is not only a persistent Chinese interest in the region. India's first military outpost is nearing completion in Tajikistan; some 150 staff have already been stationed at the new Ayni airbase. This development may indeed be a nuisance for China but it most directly impacts the regional strategic considerations for Pakistan. Added to this is the incremental rapprochement that could be observed in the past few months between Uzbekistan and the US, after their relations unraveled three years ago. The Russian and Chinese roles in Central Asia are challenged, even if Russia still is the single most important actor. The small incursions into Central Asia seen from other actors have nevertheless made the "old" actors in the region concerned. The formation of a Persian-speaking union between Tajikistan, Afghanistan, and Iran together with Turkmenistan's recent tendencies toward a "multi-vector" foreign policy, including engagement with Azerbaijan and the West, are two recent examples of this.

One factor which consistently works in favor of China and Russia is nevertheless the political development (or non-development) in the region and the reactions from the West. Elections in both Uzbekistan and Kyrgyzstan have been held – and criticized by the West. Karimov was recently re-elected with 88 percent in Uzbekistan, and Igor Chudinov was elected as the new prime minister of Kyrgyzstan. Both elections have been subject to criticism, particularly the parliamentary elections in Kyrgyzstan which were beset by widespread irregularities and failed to meet international standards. Despite this, there seems to be comparatively little criticisms to both elections at this moment in time. Neither China nor Russia has any difficulty accepting a continuation of the status quo while both the EU and the US are displaying a more cautious approach after realizing the side-effects of unrestrained regime criticism. It is unlikely that the US, and particularly the EU, will radically alter their concerns for democracy in the region, but it is likely that they also are starting to realize the costs of non-influence. The trade-off between engaging with the authoritarian leaderships in the region and an uncompromising defense of democratic principles continues to be a difficult one for the West. Kazakhstan's positive development toward a viable market economy, gradual implementation of democratic reforms, and engagement with the West nonetheless points to the importance of having a nuanced and patient approach toward these countries.

The authors in this issue will focus on China's engagement with Kazakhstan, Russia, and Central Asia in general, with a particular focus on Kazakhstan's financial development. While it is clear that Kazakhstan is rapidly improving its investment climate and has set an example for the other Central Asian states to follow, it is also clear that the Kazakh financial system exhibits vulnerabilities. US-SCO relations will also be explored in-depth while the current fragility of NATO is also examined.

On behalf of the CEF team, we hope you will enjoy your read.

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# Durability in China's Strategy toward Central Asia – Reasons for Optimism

Robert Sutter\*

Debate continues among specialists of Chinese foreign relations as to whether or not Chinese foreign policy and behavior in the post-Cold War period reflect a coherent strategy that is likely to continue, or reflect sometimes contradictory goals and circumstances that could change and in turn change the direction of Chinese foreign policy and behavior. This assessment shows that contradictions and intruding circumstances that could change Chinese foreign policy and behavior seem less salient in China's approach to Central Asia than in other areas of Chinese foreign relations. As a result, it argues that continuity in China's strategy toward the region seems likely for some time to come.

## Debate over China's Strategy in Foreign Affairs

An outpouring of books, articles and other assessments and analyses by scholars and specialists document ever expanding Chinese interaction with the outside world through economic exchanges in an era of globalization, and broadening Chinese involvement with international organizations dealing with security, economic, political, cultural and other matters. They demonstrate a continuing trend toward greater transparency in Chinese foreign policy decision making and policy formation.<sup>1</sup>

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<sup>1</sup> David Michael Lampton, Ed., *The Making of Chinese Foreign and Security Policy in the Era of Reform* (Stanford: Stanford University Press, 2001); Bates Gill, *Rising Star: China's New Security Diplomacy* (Washington: Brookings Institution, 2007); Yong Deng and Fei-Ling Wang, Eds., *China Rising: Power and Motivation in Chinese Foreign Policy* (Lanham, Md.: Rowman and Littlefield, 2005); David Shambaugh, Ed., *Power Shift: China and Asia's New Dynamics* (Berkeley: University of California Press, 2005); Evan Medeiros and R. Taylor Fravel, "China's New Diplomacy," *Foreign Affairs* 82, 6 (November-December 2003), pp. 22-35; Alastair Iain Johnston and Robert S. Ross, Eds., *New Directions in the Study of China's Foreign Policy* (Stanford: Stanford University Press, 2006); Phillip C. Saunders, *China's Global Activism: Strategy, Drivers, and Tools* (Washington: National Defense University Institute for National Strategic Studies Occasional Paper 4, June 2006); Zheng Bijian, "China's 'Peaceful Rise' to Great-Power Status," *Foreign Affairs* 84, 5 (2005), pp. 18-24.

In general, Chinese leaders are seen to be focused on promoting China's economic development while maintaining political and social stability in China. These efforts undergird a fundamental determination of the Chinese Communist Party (CCP) administration to reinvigorate and sustain its one-party rule in China. Foreign policy is made to serve these objectives by sustaining an international environment that supports economic growth and stability in China. This is done partly through active and generally moderate Chinese diplomacy designed to reassure neighboring countries and other concerned powers, notably the United States, the dominant world power in Chinese foreign policy calculations. Chinese efforts try to demonstrate that rising Chinese economic, military and political power and influence should not be viewed as a threat, but should be seen as an opportunity for greater world development and harmony. In the process, Chinese diplomacy gives ever greater emphasis to engagement and conformity with the norms of regional and other multilateral organizations as a means to reassure those concerned with possible negative implications of China's increased power and influence.

Chinese foreign policy places great emphasis on seeking international economic exchange beneficial to Chinese development. China has become the center of a variety of intra-Asian and other international manufacturing and trading networks that have seen China emerge as the world's third largest trading nation and a large or the largest consumer of a variety of key world commodities and raw materials, notably oil. China today depends fundamentally on a healthy world economy in which Chinese entrepreneurs promote economic development as an essential foundation for continued rule of the CCP administration. At the same time, the world economy depends increasingly on China. China is a key manufacturing center for world markets and an increasingly prominent trading nation with a positive balance of trade and the largest foreign exchange reserves in the world.

Chinese nationalism and Chinese security priorities also are important determinants in contemporary Chinese foreign policy. The CCP administration has placed greater emphasis on promoting nationalism among Chinese people as communism has weakened as a source of ideological unity and legitimacy. Nationalism supports the CCP administration's high priority to prevent Taiwan independence and protect Chinese territorial claims.<sup>2</sup> Chinese leaders build advanced

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People's Republic of China State Council Information Office, "China's Peaceful Development Road," *People's Daily Online*, December 22 2005. Yan Xuetong, "The Rise of China and its Power Status," *Chinese Journal of International Politics* 1 (2006), pp. 5-33.

<sup>2</sup> Suisheng Zhao, *A Nation-State by Construction: Dynamics of Modern Chinese Nationalism* (Stanford: Stanford University Press, 2004); Peter Gries, *China's New Nationalism* (Berkeley: University of California Press, 2004).

military power and voice determination to take coercive measures to achieve nationalistic goals.<sup>3</sup> More broadly, Chinese leaders seek to build what they call “comprehensive national power”—particularly economic, military, and political power—as China seeks an as yet not clearly defined leading role as a great power in Asian and world affairs.

### **Issues in the Debate**

Despite considerable agreement among specialists about the course and many of the goals in Chinese foreign policy after the cold war, there also is considerable uncertainty and debate over the durability of China's recent approach. Some specialists judge that China's leaders are following a firm strategy that will last well into the 21<sup>st</sup> century. Others argue that China's approach is subject to change, particularly as major uncertainties and variables could push Chinese foreign policy in directions different than the recent course.

On one side, Chinese government officials and some Chinese and foreign scholars and specialists emphasize that the mix of Chinese government priorities and prevailing conditions in the post-cold war provide the basis of a Chinese strategy of peace and development that will last for decades.<sup>4</sup> The Chinese leadership is seen as determined to avoid confrontation in Chinese foreign policy as it pursues economic development at home and abroad in the interest of enhancing the legitimacy and standing of the CCP administration. China's cooperative diplomacy and international activism will grow as China seeks the role of a responsible world power endeavoring to preserve and enhance China's international rights and privileges while it pulls its weight with greater international contributions, commitments, and obligations. Chinese leadership priorities regarding economic development and domestic stability also favor a foreign policy that is inclined to accept the world situation as it is and avoid the often disruptive and assertive Chinese initiatives in world affairs during the Maoist period. Thus, China's strategy is said to accept the prevailing international and regional balance of power and influence that is often dominated by the United States. It pursues China's advantage by working with existing regional and other international economic organizations, and by cooperating more closely with international groupings dealing with security, politics, culture, the environment, and other matters.

On the other hand, arguments against a durable strategy in post-Cold War Chinese foreign relations focus on several factors:

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<sup>3</sup> David Shambaugh, *Modernizing China's Military* (Berkeley: University of California Press, 2002); Dennis Blasko, *The Chinese Army Today* (London: Routledge, 2006).

<sup>4</sup> These assessments are reviewed in Robert Sutter, *Chinese Foreign Relations: Power and Policy Since the Cold War* (Lanham, Md.: Rowman and Littlefield, 2007), pp. 3-7.

- Chinese goals of peace and development in foreign affairs seem contradicted by strong Chinese goals emphasizing nationalistic interests and claims and the determination of the Chinese administration to protect Chinese security and other interests at home and abroad by using military force if necessary. In the area of Chinese national security, Thomas Christensen argued that while the priorities of the Chinese leadership seemed clear, “many of the means to reach the regime’s domestic and international security goals are so fraught with complexity, and sometimes contradiction, that a single, integrated grand plan is almost certainly lacking, even in the innermost circles of the Chinese leadership compound.”<sup>5</sup>
- Chinese foreign policies and behavior remain heavily influenced by the policies and behavior of external forces that the Chinese administration does not control. Notable examples are the United States, Japan, and the Taiwan leadership. Susan Shirk demonstrated that significant shifts in the policies and behavior of these actors could prompt shifts in China’s overall foreign policy approach.<sup>6</sup>
- The ability of the Chinese leadership to forge and sustain a coherent strategy in foreign affairs is weakened by the leadership’s continuing lack of confidence and uncertainty about the legitimacy of the Communist Party administration at home and its relative power and influence abroad. While some observers in China and abroad highlight growing Chinese confidence and assurance in world affairs, a wide range of Chinese and foreign specialists underline continued leadership uncertainties caused by concerns over the leadership’s domestic legitimacy and its weak international standing relative to the United States in particular.<sup>7</sup>

### Why Chinese Strategy in Central Asia is Durable

The end of the Cold War, the collapse of the USSR, and improvement in Russia-China relations defined Chinese policy and behavior toward Central Asia. Post-Cold War developments on the one hand resulted in the creation of new states, reduced Moscow’s influence, and opened avenues for spreading Chinese interests. On the other hand, the collapse

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<sup>5</sup> Thomas Christensen, “China,” in *Strategic Asia, 2001-2002*, Eds. Richard Ellings and Aaron Friedberg (Seattle: National Bureau of Asian Research, 2001), p. 27.

<sup>6</sup> Susan Shirk, *China: Fragile Superpower* (New York: Oxford University Press, 2007) pp. 140-254.

<sup>7</sup> Shirk, *China: Fragile Superpower*, pp. 6-9; See review in Sutter, *Chinese Foreign Relations*, pp. 8-10.

of the USSR also created a power vacuum that posed problems for Chinese security.<sup>8</sup>

Generally preoccupied with affairs at home and seeking to stabilize China's periphery, Chinese officials worked to secure boundaries and advance relations with newly independent Central Asian states, as much for defensive reasons as for reasons of expanding Chinese influence and interests. For over a decade, China's more active interaction with the former Soviet republics in Central Asia, notably through regional groups such as the Shanghai Five, and its successor, the Shanghai Cooperation Organization (SCO) begun in 2001, avoided serious challenge to Russian interests in the region and endeavored to strengthen cooperation among China, Russia and Central Asian states in ways that tried to exclude the United States and curb Western influence.<sup>9</sup>

The U.S.-led global war on terrorism and the toppling of the Taliban regime in Afghanistan in 2001 had a major effect on China's relative influence in Central Asia. The stronger U.S. military presence and strategic influence in Central Asia meant that China's relative influence would remain secondary to the United States and Russia. Chinese leaders adjusted pragmatically to the new situation. They continued to pursue previous incremental efforts to improve relations with the Central Asian governments. Effective China's diplomacy in bilateral relations and multilateral forums like the SCO, growing trade relations, and increasing Chinese interest in Central Asian oil and gas laid the foundations for growing Chinese prominence in Central Asia.<sup>10</sup>

While Chinese leaders have had several important interests and goals in pursuing relations with Central Asia, they have managed them without significant conflict, reinforcing the likelihood of continuity and durability in China's approach to the region. Notably in contrast to Chinese approaches in eastern and southern Asia, there has been less tension between China's national development emphasis on promoting peace and development abroad and Chinese national security, territorial, and national unification objectives that emphasize China's use of force against foreign threats in ways that alienated and alarmed some of China's neighbors and other concerned powers.

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<sup>8</sup> Matthew Oresman, "Repaving the Silk Road: China's Emergence in Central Asia," in *China and the Developing World* Eds. Joshua Eisenman, Eric Heginbotham, and Derek Mitchell (Armonk NY: M.E. Sharpe 2007), pp. 60-83.

<sup>9</sup> Gill, *Rising Star: China's New Security Diplomacy*, pp. 37-52.

<sup>10</sup> Niklas Swanstrom, "China and Central Asia: A New Great Game or Traditional Vassal," *Journal of Contemporary China* 14, 45 (November 2005), pp. 569-584; Kevin Sheives, "China Turns West: Beijing's Contemporary Strategy Toward Central Asia," *Pacific Affairs* 79, 2 (Summer, 2006), pp. 205-224.

The varied Chinese interests and goals<sup>11</sup> have involved:

- **Borders and Security:** China's sought to demarcate, demilitarize and stabilize borders with Russia, Kazakhstan, Kyrgyzstan, and Tajikistan. Border stability has been central to Chinese development plans and foreign policy priorities. China also has sought to curb outside support to separatists in Xinjiang province. It sees common ground with regional governments in working against terrorist and criminal elements.
- **Economic:** China's main economic interest in the region is energy—China has sought growing amounts of oil and gas abroad and Central Asia—especially Kazakhstan--appeared as a promising partner.
- **Regional Position:** China's engagement with Central Asia, and specifically the SCO, is part of China's overall effort to foster a stable and productive international environment around China's periphery while fostering a more widely accepted Chinese leadership role. Beijing's relations with Central Asia also aim to legitimate Chinese positions on major international issues, strengthen relations with Russia, and serve as a counter to U.S. power and influence. China's diplomacy in Central Asia aims to prevent the region from becoming a distraction from China's internal development and more important foreign policy goals.

One of the reasons China's administration has been able to develop and sustain a coherent approach in post-Cold War Central Asia despite potentially conflicting goals is that external forces that the Chinese administration does not control and that strongly influence Chinese foreign policy in other areas do not play much of role in China-Central Asian relations. For example, Taiwan is insignificant in Central Asia. Chinese threats to use force against Taiwan separatism have much less disruptive impact on China's Central Asian neighbors than they do elsewhere around China's periphery. Japan's role in Central Asia also is relatively small. China's sometimes strident reactions to disputes with Japan have less disruptive impact on China's relations with Central Asia neighbors than on Chinese relations with neighbors in other parts of China's periphery.

The upswing in U.S. military presence and influence in Central Asia after the terrorist attack on America was an important change in China's strategic calculus in Central Asia. However, its overall impact has been off-set by the fact that the foundation of U.S. power in Central Asia is much weaker than in other parts of China's periphery.<sup>12</sup> Also, the record

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<sup>11</sup> Oresman, *Repaving the Silk Road*, pp. 62-72.

<sup>12</sup> Michael Mihalka, "Not Much of a Game: Security Dynamics in Central Asia," *China and Eurasia Quarterly* 5, 2 (2007), pp. 21-39.

of relatively low levels of follow-on U.S. aid and official involvement in the region, and Russia's continued leading importance among the Central Asian republics also has diminished Chinese concerns about the U.S. military presence and influence in Central Asia.<sup>13</sup>

Meanwhile, changes in Chinese foreign policy and behavior influenced by Chinese leaders' lack of confidence and uncertainty in their legitimacy at home and abroad are less in the case of Central Asia than in other parts of China's periphery.<sup>14</sup> Notably, the need for Chinese leaders to adopt tough policies on territorial or other nationalistic issues with Central Asian neighbors is less than in the case of Chinese relations with some neighbors to China's east and south. Part of the reason is that the Chinese administration has been successful in keeping Chinese media and other public attention focused away from territorial and nationalistic issues with Central Asian neighbors. Also, Chinese territorial and nationalistic issues with Central Asian neighbors seem less salient to core Chinese interests in development and national power than Chinese territorial and nationalistic issues with some other neighbors. And, the generally authoritarian Central Asian governments have endeavored to deal constructively and pragmatically with China over territorial and other disputes, a contrast with the nationalistic posturing of some of China's eastern and southern neighbors.

### **Sources of Uncertainty**

Though the course of China's strategy toward Central Asia seems more stable than in other areas of Chinese foreign relations, there remain significant uncertainties clouding the longer term outlook. For one thing, specialists are divided on China's long term goals in the region and how these goals could lead to a major change in China's approach to the region. Some emphasize strongly that the prevailing Chinese interest in regional stability and energy trade will remain core determinants of Chinese policy and will reinforce continuity in the Chinese policy and behavior we see today.<sup>15</sup> However, others argue that recent accommodating and moderate Chinese policies and behavior presage the creation of an emerging Central Asian order dominated by China that will be reminiscent of the Sino-Central Asian relationship during the strong dynasties in Chinese history.<sup>16</sup>

Meanwhile, China's influence in Central Asia and developments in the region depend heavily on the power and policies of Russia. Russian

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<sup>13</sup> Dan Burghart, "The New Nomads? The American Military Presence in Central Asia," *China and Eurasia Forum Quarterly* 5, 2 (2007), pp. 5-19.

<sup>14</sup> Compare Shirk, *China: Fragile Superpower*, pp. 140-254 with Oresman, *Repairing the Silk Road*, pp. 75-80.

<sup>15</sup> Sheives, "China Turns West."

<sup>16</sup> Swanstrom, "China and Central Asia."

weakness in the 1990s provided the opportunity for expanding Chinese influence in Central Asia and the foundation of Russian inclination to cooperate closely with rising China on trade, including arms trade, and a variety of international issues. Under the leadership of Vladimir Putin, Russia has endeavored to rebuild elements of national strength and to use them to reassert Russian interests against those perceived as encroaching on Russian interests. Thus far, the Russian relationship with China generally has remained cordial and cooperative, though Russia-China competition for influence in Central Asia and over other issues continues.<sup>17</sup> If China were to be seen to seek regional dominance in Central Asia, Russia might adopt more competitive and perhaps confrontational policies that would have a major impact on China's existing approach to the region. At the same time, if Russia successfully pursues a more assertive leadership role in the region, China's leaders presumably would be forced to choose between accommodating rising Russian power and possibly losing Chinese equities and influence, or resisting the Russian advances.

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<sup>17</sup> Celeste Wallander, "Russia: The Domestic Sources of a Less-than-Grand Strategy," in *Strategic Asia 2007-2008* Eds. Ashley Tellis and Michael Wills (Seattle: National Bureau of Asian Research 2007), pp. 138-175.

# How Financial Alchemy Engineered a Central Asian Credit Crunch

Maria Kielmas\*

## Introduction

Kazakhstan became the darling of the international markets over the decade that followed the Russian and Asian financial crises of 1997-98. Energy companies continued to invest in the country's oil and gas industries despite the Kazakh government's tightening control on the sector, and the formidable technical problems associated with the production of oil and gas in this region. Kazakh banks acquired an appetite for foreign borrowing, mostly to finance the domestic construction industry, itself booming as the population at last grasped the new opportunities of mortgages and home ownership. International hedge funds, dubbed variously over this decade as the guerrillas of the investment world, the saviors of pension funds, and the financial markets' very own philosopher's stone, targeted Kazakhstan and its banking sector as the "emerging market" *par excellence*.

It all began to unravel in mid-2007 as the effects of the U.S. sub prime mortgage crisis began to reverberate around the world. However, it was only in February 2008 when three announcements brought home the truth.

- On February 1, the credit rating agency Standard & Poor's announced that it had changed its ratings on 44 emerging market asset-backed securities (ABS) future flow securitizations two of which, JSC Bank TuranAlem and Kazkommerts DPR, were issued by Kazakh banks. The reason for the S&P downgrade was that the agency had placed the ratings of two of the financial guarantors of these issues, New York-based MBIA Insurance Corp (MBIA) and Bermuda-based XL Capital, on negative watch.
- On February 19 the London-based European Bank for Reconstruction and Development (EBRD) announced that it plans to earmark up to half a billion dollars in much-needed funding for Kazakh banks as they struggle to borrow

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\* Maria Kielmas is a London based journalist and energy consultant.

internationally. Kazakh banks have borrowed more than US\$45 billion overseas. This is equivalent to 95 percent of the country's GDP, is larger than Russia's foreign debt of US\$44 billion, and of Kazakhstan's total foreign reserves, including its oil fund, of US\$40 billion.

- On February 27, the government of Kazakhstan announced that it would impose export tariffs on wheat and triggered a 25 percent overnight rise in international wheat prices in the process. The immediate cause of the tariff imposition was the rise in wheat and bread prices domestically; a consequence of extreme weather conditions and low stocks, which already had fuelled public protests.

So it must have come as a measure of relief, albeit to a specialist audience, when the following day a London-based financial publisher awarded Bank TuranAlem an award for "Best Deal 2007" for its innovative financing of a cement plant in Akmola Oblast. In the context of today's worldwide credit crunch, cynics may view such awards as the triumph of hope over experience. The financial sector always seems to innovate its way out of a credit crisis.

### **We have been here before**

It is as if the collapse of Long Term Capital Management (LTCM) and Enron never happened. Ten years after the demise of a hedge fund – run by no less than three winners of the Nobel Prize in Economics – which gave rise to the term "financial engineering", and seven years after the fall of its energy industry analogue, Enron, governments, regulators, financiers and sundry analysts are struggling to explain why we are in the midst of yet another financial crisis. How does the inability of "Joe Six-pack" in a U.S. Midwest small town to pay his mortgage have such an impact in Central Asia? In late January, an apt explanation came forward in the credit downgrading, possible collapse, and probable rescue of bond insurers.

Until recently the names Ambac Assurance Corp., MBIA Insurance Corp., ACA Capital Holdings, Financial Guarantee and Insurance Corporation (FGIC), and XL Capital were unknown outside of a much-specialized financial market. These companies insure the bonds issued by private companies, state-owned enterprises and municipalities. Known as "monolines" these insurers (except for XL Capital which is a Bermuda-based reinsurer) started in business by covering bonds issued by (mostly) U.S. municipalities where the default rate was less than 1 percent. For a modest fee, the financial guarantee provided by the insurers upgrades a bond's credit rating to investment grade. This depends on the insurers

themselves being graded “AAA” (or Triple “A”) by agencies such as Fitch, Moody’s and Standard & Poor’s. It was a low margin, low credit risk business which did not require a massive amount of capital. Matters changed in the 1990s when structured financial instruments became widespread and the bond insurers extended their services to, among others, the energy industries and developing economies known as “emerging markets”. By comparison, the Lloyds of London insurance market has been forbidden by law since the 1930s to issue financial guarantees.

Structured finance in the form of bonds backed by mortgages has been around since the 19<sup>th</sup> century. However, it took the liberalization and deregulation of the financial markets in the 1990s and the repeal of the 1933 Glass-Steagall Act by the Clinton administration in 1999 to trigger a boom. Under the Act, U.S. banks were not allowed to use depositors’ money in anything other than loans. After its repeal, banks, insurance companies and other financial institutions could compete against each other as they pleased. Regulatory control was kept to a minimum, due largely to strong lobbying by Wall Street and its supporters in Congress, especially for complex derivative instruments such as today’s ill fated collateralized debt obligations (CDOs). In Europe, there never was an equivalent of the Glass-Steagall Act. As a result, financial institutions in France and Scandinavia bankrupted themselves in ill-advised mergers and shopping sprees in the 1980s and early 1990s.

In the new deregulated climate, banks were able to offload their loans to insurance companies, pension funds and the like rather than as in the past, keeping them on their books and holding adequate reserves. The loans were repackaged with a variety of swaps and credit-linked notes into the complex financial instrument known as the CDOs, insured by the monocline insurers, and sold as a top-notch investment security to the rest of the financial world. The entire process is called collectively “securitization”. Even the mathematics doctorates who invented these instruments had no idea of how to track the real exposure in CDOs. That is, they had and still have little real idea of how much capital is at risk. So to cover this, they invented approximate models that, like many of the mathematical models that claim to depict climate change, fall apart at the first hint of reality. Frank Partnoy, Professor of Law at San Diego University observed that the sellers could pass off these complex derivatives to buyers who did not understand them.<sup>1</sup> The buyers, for their part, could use the CDOs to minimize their own capital requirements or

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<sup>1</sup> Frank Partnoy writing in the "Conglomerate Blog: Business Law, Economics & Society," *Conglomerate*, November 12 2007.  
<[www.theconglomerate.org/2007/11/conglomerate--4.html](http://www.theconglomerate.org/2007/11/conglomerate--4.html)> (March 1 2008)

boost their yields. Credit rating agencies are paid fees by the monoline insurers and the CDO issuers to monitor the securities and, in effect, act not as purveyors of accurate information, but of “regulatory licenses that unlock financial doors for regulated investors”, Partnoy says.<sup>2</sup> William Ackman, head of New York-based hedge fund Pershing Square Capital Management, noted that there was a huge conflict of interest all along the line. MBIA and Ambac reinsure, i.e. offload their insurance, to each other as well as their Bermuda-based captive reinsurers. The credit ratings of these reinsurers are not updated regularly and so offer the potential for abuse, said Ackman in a letter to the three main agencies.<sup>3</sup> The credit rating agencies were similarly admonished in 2001 for their lack of reporting on Enron’s shortcomings.

### **Expansion into Eurasia**

Up until autumn 2007 when the credit crisis caught up with the bond insurers these were making great strides into emerging markets in particular in major oil-producing countries such as Kazakhstan and Mexico. Kazakhstan’s first ever mortgage-backed securitization was managed by Dutch Bank ABN AMRO and offloaded US\$150 million of mortgages held by BTA Ipoteka, the mortgage subsidiary of Bank TuranAlem. Subsequent mortgage securitizations by BTA Ipoteka were guaranteed in part by agencies such as the World Bank’s Multilateral Investment Guarantee Agency (MIGA). Without the financial guarantees provided by such insurers, state oil enterprises and numerous national banks would have been unable to obtain investment grade credit for their paper. So the costs of credit, used for example for capital investment by state-owned oil companies, would have been substantially higher and an excessive financial burden on government budgets. One of the most spectacular inventions of financial engineering over the past five years has been the securitization of diversified payments rights (DPRs). These enable banks in non-investment grade countries to harness financial flows such as commodity export revenues for their own funding. This arises from the banks’ positions as intermediaries between the commodity seller and buyer. In April 2007, Kazakhstan was planning to issue up to US\$500 million in such bonds. The securities were to be guaranteed by multilaterals such as the Asian Development Bank as well as two bond insurers MBIA and FGIC and reinsurer XL Capital. Kazakhstan became the poster child for such deals, one of which was downgraded less than a year later.

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<sup>2</sup> *Ibid.*

<sup>3</sup> Letter sent by William Ackman to rating agencies Standard & Poor's, Moody's and Fitch, January 18 2008.

Every financial crisis needs its saviors and this one is no different. A variety of banks and private investors such as Warren Buffett, CEO of U.S. financial conglomerate Berkshire Hathaway and popularly known as the “Sage of Omaha”, have been suggested. Buffett has even offered a bail out package to two of the bond insurers. Now sovereign wealth funds (SWF) have been suggested as potential saviors. The first SWF was established in 1953 by Kuwait. Several years of high oil and commodity prices have led to the creation of 12 such funds in the last three years. Kazakhstan’s oil fund holds an estimated US\$22 billion. The World Bank and International Monetary Fund (IMF) have been active in persuading commodity-producing countries especially to create funds that could be used to stabilize domestic economies during periods of price volatility, as well as providing a long-term national pension fund. These government investment vehicles are generally regarded as having a high risk tolerance. According to Robert Kimmett, Deputy Secretary at the U.S. Treasury Dept., the SWF assets total about US\$2.9 trillion. This compares with an estimated US\$190 trillion in global financial assets. Hedge funds by comparison manage US\$1.5 trillion while pension funds total US\$53 trillion. Mostly opaque in their operations, the most transparent fund is Norway’s. But even this fund does not provide any information about its holdings in derivatives (see Table 1 below).

**Table 1.** Largest Sovereign Wealth Funds (Assets under Management)

Country	Fund name	Assets US\$bn	Inception year	Source of funds
UAE	Abu Dhabi Investment Authority	250 to 875	1976	Oil
Norway	Government Pension Fund	300	1996	Oil
Saudi Arabia	Saudi Arabian funds (various)	250+	n/a	Oil
Kuwait	Kuwait Investment Authority	160 to 250	1953	Oil
China	China Investment Corp.	200	2007	Non-commodity
Russia	Stabilization Fund of Russian Federation	120	2004	Oil
Singapore	Government Investment Corp.	100+	1981	Non-commodity
Singapore	Temasek Holdings	100+	1974	Non-commodity
Australia	Australia Future Fund	54	2006	Non-commodity
Qatar	Qatar Investment Authority	50	2005	Oil
Algeria	Revenue Regulation Fund	40	2000	Oil
US (Alaska)	Permanent Fund Corporation	35	1976	Oil

Brunei	Brunei General Reserve Fund	30	1983	Oil
South Korea	Korea Investment Corporation	20	2005	Non-commodity
Malaysia	Khazanah Nasional	18	1993	Non-commodity
Kazakhstan	Kazakhstan National Fund	18	2000	Oil
Canada	Alberta Heritage Fund	15	1976	Oil
Venezuela	National Development Fund	15	2005	Oil
Iran	Oil Stabilization Fund	13	1999	Oil
New Zealand	Superannuation Fund	11	2001	Non-commodity

Source: IMF GFSR (September 2007), *The Economist*, [futurefund.gov.au](http://futurefund.gov.au), [nzsuperfund.co.nz](http://nzsuperfund.co.nz).

### Limits of Sovereign Wealth Funds

But SWFs have their own limits. The creation of such funds is premised on the notion that the years of plenty come first. Unless the fund can borrow against future income, it cannot exercise a stabilizing influence on government budgets. So the fund has an additional political burden of first acting as a drag on the economy before it can be a stimulus. In addition, a series of IMF studies has found that these funds have not always acted as a restraint on government expenditure. The operational objective has been to smooth government revenue while the government's policy objective has been to smooth government expenditure. Combined with the fact that oil prices do not fluctuate around a constant average, the result is that the funds do not have an automatic savings mechanism. So the fund's balance is determined entirely by the national budget.

The most high profile investments by SWFs in recent months have been in troubled American banks such as Citigroup, Morgan Stanley and Merrill Lynch. Britain's Barclay's Bank invited Singapore's Investment Corporation and China's Development Bank to become shareholders. But governments have drawn the line on foreign sovereigns taking controlling stakes in major companies. In the 1980s UK Prime Minister Margaret Thatcher instructed the Kuwait Investment Office's (KIO) to dispose of its 24 percent stake in BP which had been acquired in the wake of an earlier financial crisis. Similarly, the U.S. Congress halted the China National Oil Corporation's attempt to buy Unocal in 2005. Troubled bond insurers may hope to follow U.S. banks to receive a capital injection from the SWFs, but these insurers are still expected to lose many billions of dollars over coming years as much of their questionable business unravels. In the meantime, the SWFs themselves may be obliged by their own governments to bail out national financial

sectors. This has already been the case in Russia as well as Kazakhstan. In the latter case, the oil fund may be expected also to bail out the construction sector and even agriculture if the current bread price crisis continues. Currently Kazakhstan's oil fund is believed to hold 25 percent of its assets in equities and the remainder in cash deposits and fixed income securities.

## Conclusion

“Why should I invest in something I can't even spell?” This was the Southern sensibility of David Bronner, head of the Alabama state pension fund in 1992 when Wall Street traders tried to sell him some complex derivative deals. Officials from California's Orange County called Bronner “antiquated” and bragged about their investment returns. Those boy geniuses at Orange County, who eventually gambled away US\$1.7 billion of public funds on the new-fangled financial instruments invented by Wall Street's rocket scientists, were led by the county's treasurer, 70-year old Robert Citron, who did not have a college degree and had visited New York just four times in his life. Citron used structured derivatives to bet on low interest rates but lost out when the Federal Reserve raised its rates on 4 February 1994. Asked the previous year how he knew that interest rates would not rise, Citron replied, “I am one of the largest investors in America. I know these things.” But when the scale of his losses became known Citron was humble. “I am an inexperienced investor,” he pleaded to a California State Senate Committee.

Frank Partnoy recounts this anecdote in his 2003 book “Infectious Greed” which explained, among other things, how the U.S. energy giant Enron collapsed amidst massive fraud that led to the conviction and imprisonment of various of its business executives and the eventual death of its founder, Ken Lay.<sup>4</sup> Enron traders used to boast that the more complex, inexplicable and even fictitious their mathematical models of energy markets were, the easier it was to fool naïve clients, most of whom were too scared to admit they did not understand the product they were buying. Prior to its collapse, U.S. economist and Nobel Prize winner Myron Scholes claimed that Enron's clever trading model would eventually replace organized securities exchanges. Scholes at the time was working at hedge fund Long term Capital Management (LTCM) that collapsed in 1998 losing an estimated US\$4.8 billion. For anyone who remembers the details of these crises, today's worldwide credit crunch comes as little surprise. The difference is that today it has gathered up “emerging market” stars such as Kazakhstan in its wake. The last decade

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<sup>4</sup> Frank Partnoy, *Infectious Greed - How Deceit and Risk Corrupted the Financial Markets* (London: Profile Books Ltd., 2003).

of high commodity prices, though coupled with low inflation and as well as economic growth, has boosted a false confidence in oil and commodity producing countries. Domestic companies borrowed highly on the international markets using financial engineering instruments that were poorly understood but in reality were part of a vast vortex of the same money rotating around the world. It was only a matter of time when this vortex would collapse in on itself.

Over the same period, commodity producing countries have followed advice from the World Bank and IMF and created sovereign wealth funds. These were supposed to be a form of national “rainy day” or pension fund. Industrialized country governments have worried that SWFs would adopt a “political” approach to investment and overturn western dominance over the world economy. But the reality is quite the opposite. SWFs not only have been used to bail out western financial institutions on the verge of a bankruptcy due to their own arrogance and ignorance, but also now probably will have to do the same in their own domestic economies. The result is that if SWFs are not already embroiled in today’s financial chaos, they soon will be. Financial engineers all over the world may find more innovative ways of papering over the chaos, but such alchemy is unlikely to affect the high price of bread in Kazakhstan.

# The Shanghai Cooperation Organization: A Threat to American Interests in Central Asia?

*Gene Germanovich\**

## ABSTRACT

With the apparently rising, Chinese-led, and Russian-supported Shanghai Cooperation Organization (SCO) attracting increased attention in Washington, a question arises as to the level of danger the bloc poses to U.S. objectives for Central Asia. Is it a threat to U.S. interests in the region or largely irrelevant to those interests? To what extent does the nascent SCO currently pose a challenge, and secondly, what developments should the policy community track to assess the SCO as it relates to U.S. objectives for the region? This article explores contending views regarding this rising organization.

*Keywords* • Shanghai Cooperation Organization • Central Asia • Peace Mission 2007 • U.S.-Central Asia interests

## Introduction

In the mid-1990s China, Russia, and several Central Asian countries resolved a series of border disputes, which ultimately led to the formation of a new multilateral security organization known as the “Shanghai Five.” At the time, it appeared as if the China-led initiative was merely another addition to the alphabet soup of newly emerging multilateral groupings around the world.

A little more than a decade later, this group – now dubbed the Shanghai Cooperation Organization (SCO) – conducted a large-scale military exercise. The SCO’s “Peace Mission 2007” involved a reported 6,500 troops, 80 aircraft, a war game at the general staff level, troop movements across 10,000 kilometers, and a “spectacular air and ground assault.”<sup>1</sup> Open source literature does not, at least as of yet, identify

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\* The author is a defense consultant at a Washington, D.C.-based firm. The author thanks Jennifer Sims for numerous reviews and discussions. Several anonymous reviewers also provided meaningful guidance. The views in this article do not necessarily reflect anyone’s other than those of the author.

<sup>1</sup> As quoted in Jane’s Information Group, “Sino-Russian differences over Central Asia persist,” *Foreign Report*, August 30 2007. For the most comprehensive analysis of the Peace

specifics regarding the military objectives of the exercise, but the predominant view describes the event as contingency planning for a scenario in which SCO member states would militarily intervene to assist a Central Asian government in either defeating a terrorist organization or reversing a Color Revolution-style mass uprising. With the United States notably absent from the list of observer nations and Vladimir Putin, Hu Jintao, and their authoritarian colleagues from Central Asia viewing the exercise through a set of binoculars, this message could not be clearer: American influence in the region will diminish as Russia and China regain their rightful status as the dominant powers in Central Asia.

Peace Mission 2007 raises a pressing yet relatively unexamined question: does the SCO present a challenge to U.S. national interests in Central Asia?<sup>2</sup> Apprehension consumes American scholars, journalists, and government officials who point to the SCO as a short-term competitor and long-term threat.<sup>3</sup> American interests in Afghanistan appear at stake, with the SCO in 2005 taking an unambiguous stance against a U.S. military presence on the territory of its member states. In the longer-term, Russia has hinted that it may attempt to form what would essentially amount to a natural gas cartel with an anti-American economic agenda. The possibility that Iran, which currently enjoys observer status, may attain full membership presents a disturbing thought to American strategists seeking to limit Tehran's influence in Asia. Even the idea of the SCO as a counterbalance to NATO attracts attention. As Deputy Assistant Secretary of State for South and Central Asia Evan Feigenbaum recently summarized, the SCO is "a subject that seems to make a lot of Americans blood just boil."<sup>4</sup> But do SCO actions and intentions merit the anxiety? Both Beijing and Moscow privately value the U.S.-led mission to cultivate a stable, Taliban-free Afghanistan: the Taliban's connections to terrorist and separatist groups in the region posed a serious threat to China's West, Russia's South, and the entirety of Central Asia. Divergent interests and mutual suspicions amongst the

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Mission 2007 exercises, see Marcel de Haas, "The 'Peace Mission 2007' Exercises: The Shanghai Cooperation Organization Advances," *Central Asian Series*, Advanced Research and Assessment Group at the Defense Academy of the United Kingdom, September 2007.

<sup>2</sup> For the purposes of this article, I define Central Asia broadly and include the five Central Asian states and their periphery (Afghanistan, Iran as it relates to non Mid-East issues, China's western province of Xinjiang, and Russia's southern regions). The SCO has a limited impact on issues falling outside of this geographic limit (e.g. Taiwan), but most of the scholarly and policy debate surrounds Central Asia.

<sup>3</sup> The six SCO members (China, Russia, Kazakhstan, Uzbekistan, Kyrgyzstan, and Tajikistan) and four observers (Pakistan, India, Iran, and Mongolia) together account for approximately one-fourth of the world's land mass and population. The club also includes the world's second and third highest military spenders.

<sup>4</sup> Evan A. Feigenbaum, "The Shanghai Cooperation Organization and the Future of Central Asia," speech at the Nixon Center, September 6 2007.

SCO states mitigate any energy-related concerns, with China seeking diversification from suppliers, Russia monopoly on production and transport, and the Central Asian states independence. While Iran's entry into the grouping would provide Tehran an added measure of influence, the SCO has thus far shied away from conducting any serious discussions about promoting observer states to full membership. Most importantly, SCO nations may have exhibited similar behavior even in the absence of the formal multilateral forum; to validate western anxiety, the SCO's organizational mechanisms must provide value-add for challenging American interests.

With the apparently rising, Chinese-led, and Russian-supported organization attracting increased attention in Washington, the question becomes, which view of the SCO is correct? Is it a threat to U.S. interests in the region or largely irrelevant to those interests? To what extent does the nascent SCO currently pose a challenge, and secondly, what developments should the policy community track to assess the SCO as it relates to U.S. objectives for the region?

In this article, I answer the above questions and in doing so develop recommendations for effective monitoring of SCO activity in Central Asia. Following a brief literature review, I identify three primary U.S. interests in Central Asia and assess the level of threat the SCO poses to each of them. I highlight which types of activities could occur just as easily outside the auspices of the SCO and which require such a multilateral arrangement. The concluding section includes an overall assessment and a note on several implications for U.S. policy towards the SCO and the region more broadly.

## **Literature Review and Contemporary Thought**

Current western thinking on the Shanghai Cooperation Organization consists of three schools of thought.

The first portrays a pessimistic outlook regarding the SCO's future and its implications on U.S. interests in Central Asia. A leading advocate of this line of thinking is Stephen Blank of the U.S. Army War College in Carlisle, Pennsylvania. He believes that the SCO's utility to Russia and China goes far beyond military exercises, stating in the Russian journal *Demokratizatsiya*: "Moscow and Beijing have clearly envisioned it since its inception as a forum for unifying the Central Asian governments in an anti-American regional security organization."<sup>5</sup> Although authors belonging to this school of thought do not usually mention concrete initiatives that the SCO undertakes (aside from rhetoric and declarations) against U.S. interests in the region, they

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<sup>5</sup> Stephen Blank, "U.S. Interest in Central Asia and Their Challenges," *Demokratizatsiya*, (April 2007), p 318.

speculate that Russia and China use summitry and other multilateral venues as a mechanism to pressure the smaller states into anti-American positions. Julia Nanay of the PFC Energy consultancy, writing online for *The National Interest*, goes as far as to say that Russia and China could “develop a Eurasian military grouping through the auspices of the SCO as a counterweight to NATO.”<sup>6</sup>

The second school of thought states that the SCO does not pose a threat at all. Some observers point to a long-term divergence of interests on the part of Russia and China, while others emphasize that a secretariat in Beijing and an annual meeting of heads of state is far from something to be concerned about. Martha Brill Olcott summarized this view in 2006 testimony to Congress, stating: “Today, I don’t believe that the Shanghai Cooperation Organization poses any direct threat to U.S. interests in Central Asia or in the region more generally...” and “I don’t have concern about the SCO.”<sup>7</sup> Donald Rumsfeld even stated that the SCO’s Peace Mission 2005 exercise, which involved 10,000 troops conducting an amphibious landing operation, posed no reason for alarm: “I mean, countries do that...We are obviously observing what takes place, but I didn’t see anything in it that was threatening...”<sup>8</sup>

The third line of thinking proposes that more time needs to pass before interested observers can determine what the SCO will become. No leading proponent of this argument stands out, but analysts at the Advanced Research and Assessment Group of the Defense Academy of the United Kingdom – the only entity that has released detailed observations and analysis on the Peace Mission 2007 exercise – conclude, “Although the West at present does not have anything to fear from the SCO, its current endeavors in the security dimension might encourage the West at least to closely observe further activities of the SCO but possibly also to seek cooperation with this organization.”<sup>9</sup> State Department officials agree on a wait-and-see approach and acknowledge, “We don’t fully understand what the Shanghai Cooperation Organization does.”<sup>10</sup>

Observers from each of the three camps follow one of several approaches: briefly mention the SCO in a broader discussion on Central

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<sup>6</sup> Julia Nanay, “Inside Track: SCO Gaining Importance,” *The National Interest* online, August 8 2007.

<sup>7</sup> U.S. Congress, United States Commission on Security and Cooperation in Europe (Helsinki Commission), Hearing: “The Shanghai Cooperation Organization: Is it Undermining U.S. Interests in Central Asia?,” September 26 2006.

<sup>8</sup> “Rumsfeld: China-Russia drill no threat,” *China Daily*, November 25 2005, <[www.chinadaily.com.cn/english/doc/2005-08/25/content\\_472093.htm](http://www.chinadaily.com.cn/english/doc/2005-08/25/content_472093.htm)> (November 18 2007).

<sup>9</sup> de Haas, “The ‘Peace Mission 2007’ Exercises”, p. 11.

<sup>10</sup> Evan A. Feigenbaum, “The Shanghai Cooperation Organization and the Future of Central Asia,” speech at the Nixon Center.

Asia; describe the SCO but largely not in the context of the range of U.S. interests; or discuss the SCO in the context of U.S. interests but do so with a broad brush. This article fills a void in the current debate by focusing on the SCO specifically as it relates to U.S. interests in Central Asia.

The concept of interests is, of course, illusive. Even if experts and decision makers manage to agree on defining American interests in a given region, the interests shift as time progresses. Proliferation concerns dominated the U.S. Central Asia agenda in the early 1990s, energy issues rose in importance during the mid- to-late 1990s, while counterterrorism topped the list of concerns after the turn of the century. Interests can also compete with each other. The foremost example of conflicting American interests in Central Asia revolves around the issue of maintaining government-to-government cooperation now while encouraging authoritarian governments to reform for the sake of stability later. Regions that present neither vast opportunities (like Eastern Europe after the fall of the Soviet Union) nor concrete threats (like Iran or North Korea today) add to this definitional dilemma.<sup>11</sup> Central Asia fails to fall into a clear category, requiring a constant reexamination of the national interest. With the above caveat in mind, it remains possible to group American interests in Central Asia into three broad categories: energy, Afghanistan, and stability.

### **Energy: SCO the Cartel?**

#### *The U.S. Interests*

American energy interests in Central Asia are relatively clear cut: moderating global prices via continued extraction of oil and gas in the region, ensuring pipeline security, promoting U.S. and European energy security through diversified suppliers and export routes, and supporting U.S. private investment.<sup>12</sup> Although dreams of the Caspian Sea becoming another Middle East have faded since a premature euphoria in the 1990s, the region does represent a significant source of hydrocarbon reserves (See Table 1). Any disruptions to installations or pipelines would cause prices to rise, while continued exploration and extraction acts as a tempering force. Multiple export routes with substantial transport capacity (not a reality today) would provide a measure of energy security for western states, alleviating the consequences of events such as Russia's

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<sup>11</sup> Eugene Rumer, Dmitri Trenin, and Huasheng Zhao, *Central Asia: Views from Washington, Moscow, and Beijing* (New York: M.E. Sharpe Inc, 2007), p. 23.

<sup>12</sup> Jim Nichol, "Central Asia: Regional Developments and Implications for U.S. Interests," *CRS Issue Brief for Congress*, Updated December 14 2007, p 27.

January 2006 temporary cutoff of gas to Ukraine.<sup>13</sup> Lastly, profits by American energy companies conducting business in Central Asia provide economic benefits to U.S. citizens and greater control over the region's resources.

**Table 1.** Hydrocarbons in Central Asian SCO States and Turkmenistan

Hydrocarbon	Oil			Natural Gas		
	Proven Reserves (billions of barrels)*	Production (1000 barrels/day)^	Exports (1000 barrels/day)*	Proven Reserves (trillion cubic feet)^	Production (billion cubic feet/day)^	Exports (billion cubic feet)*
Kazakhstan	9-40	1426	1114	105	2.3	268
Uzbekistan	0.3-0.59	125	None	66	5.4	406
Turkmenistan	0.55-1.7	163	None	100	6.0	1596

Sources: \* U.S. Department of Energy, Energy Information Administration; ^ BP Statistical Review of World Energy, Jun. 2007

#### *Potential Challenges to U.S. Interests*

Although some talk of energy security and exploration existed prior to the 2006 SCO summit in Shanghai, it was at that time that Vladimir Putin proposed the creation of an SCO Energy Club and thus moved energy issues beyond occasional discussions at working group levels and into the political limelight.<sup>14</sup> At the 2007 summit in Bishkek, energy security and energy cooperation reportedly served as a major focus of the gathering.<sup>15</sup> But no substantive developments have yet come to fruition, with SCO gatherings essentially serving as a meeting place for limited bilateral discussions. Those commentators concerned with an aggressive SCO in the energy arena hence point to possible future developments.

In a 2006 background paper published by the Central Asia-Caucasus Institute at Johns Hopkins University, Stephen Blank contends, "The formation of a genuine energy club in the SCO might not be that far away" and that "certainly any such organization would constitute a rival to any American-organized plans..."<sup>16</sup> Blank's argument focuses on Russia's ambition to further monopolize its hold on Central Asia's natural gas industry and become "an OPEC for natural gas." He bolsters

<sup>13</sup> *Ibid.*, p 28. The more oil and gas that flows via transport routes that bypass Russia, the less damage there is from any cut-offs directed by Moscow.

<sup>14</sup> Artyom Matusov, "Energy Cooperation in the SCO: Club or Gathering?," *China and Eurasia Forum Quarterly*, 5, 3 (2007), p. 84.

<sup>15</sup> Niklas Swanström and Nicklas Norling, "Editors Note - the SCO and the Bishkek Summit," *China and Eurasia Forum Quarterly*, 5, 3 (2007), prelude.

<sup>16</sup> Stephen Blank, "The Shanghai Cooperation Organization as an Energy Club, Portents for the Future," *Central Asia-Caucasus Institute Analyst*, October 4 2006, pp. 1-3. For a similar argument, see also Mathew Brummer, "The Shanghai Cooperation Organization and Iran: A Power-Full Union," *Journal of International Affairs*, 60, 2 (Spring/Summer 2007), pp. 185-198.

the case by introducing the possibility that Iran's joining of such a club would lead to a cartel with the world's first and second leading producers of natural gas. An alternate view, also expressed in a Johns Hopkins publication, brings up a key actor not addressed in Blank's analysis: China. As an energy-starved nation, why would China allow the SCO to form a gas cartel only to see it set higher prices?<sup>17</sup> This narrative asserts that the real product of SCO activity on the energy front is management of China's increasing access to Central Asia and the prevention of tensions with Russia. The question here, therefore, is whether the SCO is a cartel-in-waiting or a facilitator of Chinese integration into the region. Even more pertinent to Washington is whether either of these trajectories would clash with U.S. energy interests in the region.

#### *Assessment*

If a cartel formed and successfully raised global gas rates, the American objectives of keeping prices down and diversifying gas routes would indeed suffer. But numerous obstacles make the idea of a Russian-led, Iranian-supported, and Chinese-tolerated cartel both far-fetched and not altogether relevant to U.S. interests.

Russia could use Gazprom's influence (it controls much of Central Asia's natural gas and the pipelines that carry it) to coerce its smaller energy-exporting Central Asian neighbors into joining such a cartel. But China, the SCO's largest net-importer of hydrocarbons, constitutes a significant barrier to any Russian plans for a natural gas cartel, as Beijing has shown and will continue to show serious reservations about participating in such an arrangement. Energy relations between the two SCO giants already exhibit stress. The basic issue at hand revolves around the Chinese desire to tap into the Central Asian energy market and do so with pipelines avoiding Russian territory. Over the last year, for instance, tensions rose as a result of competition over Turkmenistan's resources: each seeks to build a new pipeline to transfer gas through its own territory.<sup>18</sup> The Defense Academy of the United Kingdom, a group that closely monitors the SCO, concluded, "There is quite likely to be a clash of energy interests between Russia and China in Central Asia, and this could cause problems for international cooperation both in and around the region."<sup>19</sup> Given current and historical friction between

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<sup>17</sup> Matusov, "Energy Cooperation in the SCO," p. 97. For a similar argument, see also Henry Plater-Zyberk, "Who's Afraid of the SCO?" *Central Asian Series*, Advanced Research and Assessment Group at the Defence Academy of the United Kingdom, March 2007, p. 10.

<sup>18</sup> Matusov, "Energy Cooperation in the SCO," pp. 92-93.

<sup>19</sup> Vladimir Paramonov and Aleksey Stokov, "Structural Interdependence of Russia & Central Asia in the Oil and Gas Sectors," *Central Asian Series*, Advanced Research and Assessment Group of the Defence Academy of the United Kingdom, September 2007, p. 1.

Beijing and Moscow, it seems implausible that they can cooperate on a formidable effort to create an organization the size and scope of OPEC.<sup>20</sup> In addition to the tension lies a fundamental, diverging interest. Beijing's strategy consists of lowering the price of hydrocarbons to satisfy its energy-thirsty economy; Russia's revolves around keeping prices high to facilitate export revenues. Seeing that Iran, like Russia, has a vested interest in high energy prices, Beijing will resist the idea of an expansive Energy Club operating as a gas cartel. From the American standpoint, furthermore, Caspian oil plays a more critical role than natural gas.

American energy interests in Central Asia relate to both natural gas and oil, but mostly the latter. Although in theory the U.S. government and American firms would like to invest in Caspian natural gas, several problems persist that make this investment both less likely and less attractive than the petroleum option. Difficulties with natural gas pertain to the aforementioned Gazprom influence and limited transport capacity. Almost all gas exports from the region pass through Russia.<sup>21</sup> Prospects for natural gas pipelines that flow westward (or to India or China) exist, but remain in exploratory stages. Oil pipelines, on the other hand, already transport a limited amount of Kazakh petroleum eastward to China, with plans to do so westward to Azerbaijan and Turkey. American strategy from the 1990s to the present has rested on constructing the Baku-Tbilisi-Ceyhan (BTC) oil pipeline.

BTC currently pumps Azeri oil from Baku to Ceyhan and onto European markets, but the West has staked the success of the pipeline on ensuring that it also transports Kazakh oil. The last factor making oil more attractive than natural gas, and more central to American interests, revolves around the relative business-friendly environment of Kazakhstan (oil and gas) as compared to the instability of Uzbekistan (gas only) and potential member Turkmenistan (gas only).<sup>22</sup> Although increased stability in Uzbekistan and Turkmenistan could propel American firms to display more interest in these nations, recent events

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<sup>20</sup> Although Blank eschews discussion about China, he suggests that India and Pakistan would seek full SCO membership to attain more favorable rates for their natural gas imports. Stephen Blank, "The Shanghai Cooperation Organization as an Energy Club, Portents for the Future," p. 2. If Russia and China settle their current differences, Beijing could potentially follow the same course and agree to a cartel as long as Moscow arranged lower fees for natural gas imports. But that would mean Moscow would have to provide a discount to a large portion of its Eurasian customers.

<sup>21</sup> Turkmenistan transports 12 percent of its extracted gas to Iran. Paramonov and Stokov, "Structural Interdependence of Russia & Central Asia in the Oil and Gas Sectors," p. 2.

<sup>22</sup> According to World Bank's "Doing Business in 2008" reports, Kazakhstan ranks as the 71st most favorable nation for doing business and 28th in terms of contract enforcement. Uzbekistan is 136th overall and 46th in contract enforcement. The report does not rate Turkmenistan and other highly closed or unstable nations. See <[www.doingbusiness.org](http://www.doingbusiness.org)> (February 1 2008).

such as the Andijon crisis and the death of Turkmenistan's ruler indicate the trend remains unfavorable.<sup>23</sup> Kazakhstan and its oil, therefore, constitute the most critical element of U.S. energy interests in the region. Indeed, an often-overlooked point in addressing regional energy issues, and one particularly important in assessing the SCO, is the disproportionate importance of Kazakhstan. In addition to having the most favorable business conditions in the region, this country is by far the most critical oil producer and exporter in the region, with 2006 production and proven oil reserves accounting for 1.7 percent and 3.3 percent of the world's total, respectively.<sup>24</sup> No other Central Asian nation possesses even one-tenth of one percent of proven global oil reserves. Hence, any SCO-engendered (or other) challenges to U.S. energy interests in nations other than Kazakhstan merit only secondary consideration.

Can Russia and China persuade Kazakhstan to sign agreements that, in whatever form, go against American interests? This brings the discussion back to what the SCO could possibly do to complicate U.S. policy. Other than the improbable cartel arrangement, observers have pointed to a management role for Chinese integration into the region, or perhaps the establishment of some form of common market. Kazakhstan has followed an omni-directional foreign policy, keeping relations stable with all three of its major partners: Russia, China, and the West. Ariel Cohen of the Heritage Foundation, an analyst deeply worried about the SCO's impact on U.S. interests, admits, "There is good news regarding the SCO. The U.S. is expanding ties with Kazakhstan, [the] major oil producer with the region's most liberal economic policy. It is also the nation most open to the West in the region."<sup>25</sup>

For the foreseeable future, the SCO does not merit anxiety as it relates to U.S. energy interests in Central Asia. The prospects of an energy gas cartel are slim and, regardless, U.S. interests relate more to oil than natural gas. Kazakhstan's linchpin role and consistent record of business-savvy relations with all of its major partners point to an SCO that could potentially manage China's integration into the region, but not at a significant expense to the United States. One caveat to this analysis is the potential role of the SCO in the event of severe instability in the region.

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<sup>23</sup> For more on the Uzbek government's widely criticized crackdown on a group of alleged terrorists and the death of Turkmenistan's leader, see Jim Nichol, "Central Asia: Regional Developments and Implications for U.S. Interests", pp. 11, 16.

<sup>24</sup> *BP Statistical Review of World Energy*, June 2007; and U.S. Department of Energy, Energy Information Administration, Kazakhstan Brief, updated October 2006.

<sup>25</sup> Ariel Cohen, "U.S. Challenge at the Shanghai Summit," Web Memo published by The Heritage Foundation, June 13 2006.

## Afghanistan: SCO the Sheriff?

### *The U.S. Interests*

Support for Operation Enduring Freedom represents the most immediate (yet at least semi-permanent) U.S. interest in Central Asia. Manas Air Base in Kyrgyzstan provides a staging area for U.S. and Coalition military activity in Afghanistan, a key element in the fight against the Taliban insurgency. The base serves as home to the 376th Expeditionary Air Wing, the lead refueling wing and premier mobility hub supporting operations in Afghanistan.<sup>26</sup> Following the expulsion of U.S. troops from Uzbekistan's Karshi-Khanabad Airbase (commonly referred to as "K2") in 2005, Manas took on an added importance as the only major facility in Central Asia home to U.S. troops. Thus in 2006, the U.S. tolerated a substantial increase in the annual price for access.<sup>27</sup> Constant visits by high-level U.S. officials further point to the base's significance.<sup>28</sup>

In addition to Manas, the other SCO Central Asian states also provide a range of assistance. Kazakhstan has in the past offered basing rights in an emergency situation. Tajikistan hosts a small contingent of U.S. and Coalition forces, and provides a refueling facility nearby Dushanbe. All of the Central Asian states provide over-flight rights for humanitarian missions, and some for search and rescue and combat operations. Together, these smaller elements contribute to the U.S. interest of military access in support of Operation Enduring Freedom. The Taliban's strength and Afghan government's inability to control its own territory, combined with a consensus in American politics about the need to attain stability, point to at least a medium-term presence of American troops in Afghanistan. Given the broad agreement that defeating the Taliban and limiting al-Qaeda's capabilities remain a core national security interest, military access to Central Asia serves as the most pressing U.S. priority in the region.

### *Potential Challenges to U.S. Interests*

As Eugene Rumor articulates, from 2001 to 2005 U.S. influence in Central Asia rose while that of the SCO's was in decline: "In the near term, the most prominent victim of the post-9/11 security order in Central Asia

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<sup>26</sup> 376th Expeditionary Wing website: <[www.manas.afnews.af.mil](http://www.manas.afnews.af.mil)> (November 11 2007). The wing's around-the-clock mission includes strategic airlift operations, aerial refueling, combat airlift and airdrop, as well as aero-medical evacuation support when needed.

<sup>27</sup> Jim Nichol, "Central Asia: Regional Developments and Implications for U.S. Interests", p. 23.

<sup>28</sup> Head of Central Command Admiral William Fallon visited in November of 2007, Secretary of State Condoleezza Rice in October 2007, and Secretary of Defense Robert Gates in June of 2007.

was the Shanghai Cooperation Organization (SCO), and, by extension, China.”<sup>29</sup>

Although a few cautious observers raised the issue of an aspiring and potentially threatening SCO, it was not until a July 5, 2005 declaration at a summit in Astana, Kazakhstan that western interest in the organization started to peak. The lengthy statement, signed by each of the SCO’s heads of states, included a subsection implicitly calling for the United States to set a timeline from withdrawing its military forces from the bases of SCO member states. Several weeks later, Uzbekistan formally requested all U.S. forces to leave the K2 facility. Kyrgyzstan shortly thereafter reportedly felt pressure from its fellow SCO states to shut down the U.S. operation at Manas.<sup>30</sup> At this juncture, a debate ensued as to the extent of SCO involvement in limiting the American military presence in Central Asia.

Did the SCO’s public statement at Astana and purported private pressure on Uzbekistan serve as the primary factor leading to the forced departure of U.S. troops at K2? Can SCO pressure on Kyrgyzstan engender a similar situation with Manas? Some experts, while acknowledging additional variables, point precisely to the SCO as the main vehicle used to uproot the American military presence in the region. Others disagree, noting that a deterioration of U.S.-Uzbek relations served as the impetus for K2 and that Kyrgyzstan’s continued acceptance of American forces at Manas demonstrates the relative weakness of the SCO in seeking to eliminate U.S. forces from Central Asia.<sup>31</sup> In other words, does the SCO play the role of an aspiring sheriff or a boisterous, but ultimately marginal, observer?

#### *Assessment*

Three explanations point to the SCO as only a marginal limitation on America’s regional military presence. The first two – the scope of SCO statements and actions on the issue and the stake that SCO member states themselves have in Afghanistan – indicate that the SCO will continue to lack the capability and collective will power to present U.S. Afghanistan planners with a serious problem. The third explanation – Russian and Chinese geostrategic priorities – currently supports a similar conclusion, but depends on trends and thus has potential to gain in

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<sup>29</sup> Rumer, *Central Asia: Views from Washington, Moscow, and Beijing*, p. 57.

<sup>30</sup> Blank, “U.S. Interests in Central Asia and Their Challenges,” p. 317. The author does not state, and it is generally not clear from the literature and news accounts, whether this pressure has come in the form of bilateralism, SCO multilateralism, or a combination of both.

<sup>31</sup> Lionel Beehner, “The Rise of the Shanghai Cooperation Organization,” *CFR Backgrounder*, June 12 2006.

importance and pose a threat to Manas and other regional military arrangements.

Since the 2005 Astana Declaration sparked much of the debate about the SCO and Afghanistan, it is instructive to look closer into the text of the statement (emphasis added by author):

We are supporting and shall continue to support the efforts by the international coalition, conducting anti-terrorist operation in Afghanistan. *Today we are noticing the positive dynamics of stabilizing internal political situation in Afghanistan.* A number of the SCO member states provided their ground infrastructure for temporary stationing of military contingents of some states, members of the coalition, as well as their territory and air space for military transit in the interest of the anti-terrorist operation. Considering the completion of the active military stage of anti-terrorist operation in Afghanistan, the member states of the Shanghai Cooperation Organization consider it necessary, that respective members of the anti-terrorist coalition set a final timeline for their temporary use of the above-mentioned objects of infrastructure and stay of their military contingents on the territories of the SCO member states.<sup>32</sup>

To date, this has been the most direct SCO statement or action regarding U.S. military facilities in Central Asia. The statement indirectly affirmed that NATO needed to set a timeline, not that it needed to leave by an SCO-prescribed date. The drafters of the declaration based it on the then “positive dynamics” occurring in Afghanistan; the situation turned for the worst over the last two years, with the Taliban insurgency looking stronger and the Afghan government weaker. Notably, the SCO has avoided similar statements at the 2006 Shanghai and 2007 Bishkek summits. Other SCO activities related to Afghanistan bear a more positive, or at least neutral, tone. For instance, the SCO established an SCO-Afghanistan Contact Group, which for now is limited to occasional meetings between high-level officials and rhetoric regarding the establishment of an anti-narcotics belt around Afghanistan. Aside from the Astana summitry, the SCO has not conducted any activities, at least not in public, to disrupt NATO operations in Afghanistan. One possibility is that SCO leaders use rhetorical statements to demonstrate to their publics that they are taking an anti-American position, but in the background quietly allow the U.S. to pursue stabilization and reconstruction efforts.

The second explanation pointing to a relatively unthreatening SCO in the Afghan sphere relates to SCO interests in Afghanistan. As evidenced by the Astana Declaration’s support for anti-terrorism

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<sup>32</sup> Declaration by the Heads of Member-States of the Shanghai Cooperation Organization, July 5 2005, Astana, Kazakhstan.

operations in Afghanistan, SCO member states themselves possess an interest in a stable Afghanistan. All SCO states have faced terrorism over the last decade: China from the Uigurs in Xinjiang, Russia from Chechnyans and other extremists in its southern region, and Uzbekistan and Kyrgyzstan from the IMU terrorist group. All of these groups had active links with the Taliban and al-Qaeda in the pre-September 11 period. China, Russia, and the Central Asian states seek to minimize any contacts or inspiration for these groups caused by the resurgent Taliban. Realizing that it cannot do what NATO does in Afghanistan<sup>33</sup>, the SCO quietly accepts the American-led mission as a necessity.<sup>34</sup> SCO military exercises may one day lead to the development of capabilities that mirror NATO, but these are quite limited for the foreseeable future.

Given the limited actions taken by the SCO to counter the U.S. military presence in the region, and the SCO's own interest in the stability of Afghanistan, what then drives the SCO to take what many consider as anti-American positions? China, Russia, and its fellow SCO Central Asian states have unique reasons for seeking to limit U.S. military presence in the region. Chinese thinkers have consistently feared a U.S. effort to encircle their nation through a carefully designed architecture of naval assets and land bases, from the Pacific Rim to Central Asia. In the event of a Sino-American confrontation over Taiwan, Beijing fears U.S. access to Central Asian bases will lead to exposure in its strategic rear. For Russia, NATO expansion in Eastern Europe was painful enough; Moscow's southern "near abroad" represents the vestiges of empire and a potentially explosive area in need of Russian control. Central Asian leaders, meanwhile, view Color Revolution uprisings in Ukraine, Georgia, and Kyrgyzstan as an alarming example of what could happen to them. They interpret these developments as an American-led democratization campaign aimed at overthrowing the region's authoritarian regimes. In this context, it is easy to see why Uzbekistan quickly engaged Russia and China in the aftermath of the Andijon crisis, and would have done so even without the SCO's rhetorical umbrella. U.S. pressure for an international investigation into the incident, coming on top of a consistent push for democratization, pushed the Islam Karimov regime away from Washington.<sup>35</sup>

Were Beijing, Moscow, and the Central Asian states to perceive their non-Afghanistan interests as more important than stability in that nation, they could use the SCO as an additional leverage point in pressing the United States military out of the region. This deserves

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<sup>33</sup> Eugene Rumer, "The U.S. Interests and Role in Central Asia after K2," *The Washington Quarterly*, 29, 3 (Summer 2006), p 150.

<sup>34</sup> For more on Central Asia's stake in Afghanistan, see Rollie Lal, *Central Asia and Its Asian Neighbors* (Santa Monica, CA: RAND, 2006), pp. 19-22.

<sup>35</sup> *Ibid.*, p. 141.

continued monitoring. For now, relative instability in Afghanistan threatens these regimes to a greater extent.

### **Stability: SCO the Instigator?**

#### *The U.S. Interests*

One lesson of September 11, 2001 was that weak states combined with fundamentalism pose a threat to U.S. national security interests. Eugene Rumer sums up this aspect of Central Asia:

Beyond access, the United States has a strong interest in Central Asia not becoming a collection of even weaker states – with shaky sovereignty and uncertain control over their lands. In that event, these territories could become a large ungoverned space, much like Afghanistan became after years of foreign occupation and factional infighting. If Central Asia were to slide to such a condition, that would be a major setback to the U.S. war on terror.<sup>36</sup>

Therefore, the U.S. has a deep interest in seeing increased border control, counter-narcotics work, counter proliferation, and counterterrorism. Two of the four Central Asian SCO states recently experienced episodes in which wide-scale instability became a plausible near-term risk: Kyrgyzstan's 2005 coup and subsequent protests of the new regime and Uzbekistan's Andijon crisis. Tajikistan fares no better and borders on being a narcostate, while Kazakhstan appears the most stable. As to the question of how to bring about an environment in which episodes such as the ones referenced above do not occur, this article does not include a detailed discussion of potential answers. One strategy is to promote civil society and democratization, another to stress the need to work with the current government in pursuing shorter-term objectives, and a third to mix and match the first two. But ultimately the U.S. interest remains stability and the prevention of failed states, regardless the strategy chosen to achieve such a result.

Inter-state conflict also runs against the U.S. interest in stability. Conflict between two or more Central Asian states would place in danger the first two interests mentioned in this article, energy and Afghanistan. War, or even mid-level conflict, can lead to the disruption of oil and gas supply. Afghanistan's northern regions have thus far been the most stable ones in that nation's stabilization and reconstruction efforts, but conflict on its borders would put at risk the gains made there. A host of additional problems not related to energy or Afghanistan could result from intra- or inter-state conflict: the need for non-combatant evacuations of American citizens, disputes with Russia and China over how to settle a conflict, the

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<sup>36</sup> Rumer, *Central Asia: Views from Washington, Moscow, and Beijing*, p. 62.

possibility of an additional front in the struggle with Iran, and, most of all, succession battles in the inevitable instances when Central Asian authoritarians die or are overthrown. In short, the U.S. needs no distractions from its pursuit of energy resources, stability in Afghanistan, and global interests beyond Central Asia.

*Potential Challenges to U.S. Interests*

SCO critics such as Stephen Blank point to China and Russia as “stalwart champions of the status quo, which includes massive corruption, repression, and the promise of sweetheart deals, if not complete support for Central Asian rulers and their chosen heirs.”<sup>37</sup> In other words, the Chinese and Russian approach is bound to lead to instability – the more they push the U.S. out of the region, the more control the SCO attains, and the more instability will occur. The most publicized mechanism for pushing the U.S. out of the region has been military exercises, most recently Peace Mission 2007.

Since the creation of the organization, member-states have conducted six exercises under the bloc’s auspices.<sup>38</sup> The “Peace Mission 2005” exercise presented a unique dynamic: China and Russia participated in practicing modern conventional warfare with a special focus on large-scale amphibious operations. Although the SCO- blessed the effort and its formal objectives cited anti-terrorism, in reality this was purely a bilateral exercise on the part of China and Russia. A prominent theory regarding the true objective of the 10,000 troop exercise is that the scenario may have served as a practice run for an amphibious invasion of Taiwan.<sup>39</sup>

With the exception of Peace Mission 2005, all exercises had a twofold military focus. First, militaries and other security structures concentrated on creating or enhancing interoperability and multinational command and control (C<sub>2</sub>) capabilities. The C<sub>2</sub> effort supported the second objective of conducting some kind of anti-terrorism training, ranging from a mock operation to free passengers from a hijacked commercial airliner to the retaking of territory held by a notional terrorist group.<sup>40</sup> Over the years, the exercises have grown in sophistication and utility: they are more multilateral, include both military and security organs, and involve an increasing number of senior participants. Peace Mission 2007

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<sup>37</sup> Blank, “U.S. Interests in Central Asia and Their Challenges,” p. 314.

<sup>38</sup> de Haas, “The ‘Peace Mission 2007’ Exercises”, p. 12.

<sup>39</sup> “China and Russia Conduct Peace Mission 2005: An ‘Exercise of Power’,” *Backgrounder*, (GlobalSecurity.org), August 23 2005.

<sup>40</sup> The “Cooperation 2003” maneuvers represented a typical SCO military exercise with the twofold focus mentioned above. See, Roger N. McDermott, “Shanghai Cooperation Organization Takes Significant Step toward Viability,” *Eurasia Insight* (Eurasianet), September 5 2003.

had an additional element of considerable logistical challenges, with 1,700 Chinese troops and their equipment moving from Xinjiang to Central Russia – “this was the first time that the PLA had sent so many soldiers and armaments to such a faraway place.”<sup>41</sup>

In addition to military objectives, most exercises contain a political flavor: China proves that it is capable of leading a multilateral security mechanism, Russia portrays a strengthening of control over its “near abroad,” and Central Asian leaders demonstrate that great powers take them seriously. All send an unambiguous warning to their respective internal separatist movements and hint that SCO military assistance to a troubled Central Asian state constitutes a real possibility. Another key political objective involves demonstrating that the region can handle its own internal affairs and needs no outside security arbitrator such as the United States. The simultaneity of the 2007 SCO heads of state summit in Bishkek with the military exercise pointed to the maturation of SCO security policy.<sup>42</sup>

Despite growing technical complexity and some benefits on the political side, several problems persist. Peace Mission 2007, the SCO’s most complex war game and exercise to date, involved difficulties in both preparation and execution. Although the movement of Chinese troops over vast territory proved impressive, it was not planned. The original plan called for the Chinese troops to pass through Kazakhstan, greatly reducing the distance of the voyage. But Kazakhstan in the end did not allow the Chinese to cross its territory. Just as in energy affairs, Astana is reluctant to side too closely to any of the major powers. Other rifts included disputes between Russia and China over the level of participation of the Collective Security Treaty Organization (CSTO), the presence of Chinese tanks and other heavy equipment, and the level of Chinese use of Russian ammunition, arms, and equipment.<sup>43</sup> On the whole, however, Peace Mission 2007 demonstrated a cautious development towards a more full-blown security organization.

Do these exercises present a challenge to U.S. Central Asia interests? Can the SCO truly balance NATO? Will Blank’s vision of Chinese and Russian intransigence, or at least vigorous pursuit of their interests, lead to SCO-provoked instability in the region?

Another potential challenge to the U.S. interest in maintaining stability is the possible expansion of SCO membership to Iran. Observers that presume such an outcome point to President Mahmoud

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<sup>41</sup> Quote from Qui Yanhan, deputy commander of the Chinese contingent to Chinese Xinhua news agency, found in de Haas, “The ‘Peace Mission 2007’ Exercises,” p. 4.

<sup>42</sup> *Ibid.*, p. 11.

<sup>43</sup> *Ibid.*, p. 6. The CSTO is a Russian-led security organization in Central Asia. When Russia needs Chinese support on security matters, it generally turns to the SCO. On instances when Moscow needs to exclude Beijing, it uses the CSTO.

Ahmadinejad's high-profile presence at the 2006 Shanghai summit. The contrary view states that the organization has not taken any concrete steps in this direction, member-states have divisions on the issue, and that expansion would dilute the SCO's impact. Will the SCO choose to be an instigator, or lie low on the issue of Iran?

#### *Assessment*

In military terms, none of the anti-terrorism- and anti-separatism-focused actions in the exercises were even remotely directed towards the United States (with the possible exception of Peace Mission 2005, which was an SCO event only in name). Despite increasing inter-operability, Russia and China remain far behind the NATO political-military standard. The SCO as a whole lacks an integrated military-political structure, permanent operational headquarters, a rapid reaction force, and continuous political deliberations. For the foreseeable future, the "SCO still lacks a considerable number of essential elements which a mature military security organization should have."<sup>44</sup>

As for the prospect of military assistance to prop up an authoritarian regime in Central Asia, two potential scenarios come to mind. The first is a situation similar to a Color Revolution, in which a democratic movement threatens to topple a government and its leader. Putting aside the likelihood that Russia or China would sanction use of SCO military force, losing the opportunity to produce a pro-western, semi-democratic government in Central Asia could run counter to the long-term American interest of stability. Although evidence from Ukraine, Georgia, and Kyrgyzstan demonstrates that Color Revolution transitions have at best paid mixed short-term dividends.<sup>45</sup>

The second type of scenario would involve a challenge from an insurgent group that occupies territory or holds hostages. In this type of situation, a successful restoration of stability could contribute to everyone's interests, including those of the United States. A possible drawback would be that the SCO could take credit and perhaps blame the U.S. for the existence of the insurgents in the first place. Such a development in theory could encourage the Central Asian states to rely more exclusively on the SCO, negating U.S. efforts at professionalizing the region's militaries. But behavior up-to-date would suggest that the Central Asian states would continue to balance between Russia and China on the one hand and the West on the other.

The SCO Charter includes a mechanism for adding new members, though exact criteria and procedures remain vague.<sup>46</sup> What is clear is that

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<sup>44</sup> *Ibid.*, prelude.

<sup>45</sup> The best case was Georgia, but in November 2007 even it saw a democratically elected president impose emergency rule to suppress peaceful demonstrations.

<sup>46</sup> Plater-Zyberk, "Who's Afraid of the SCO?," p. 7.

accepting Iran as a full member would be problematic and potentially damaging to the SCO's international credibility. How could the SCO justify bringing in a state that sponsors terrorism into its anti-terrorist coalition? One concrete example where this contradiction would pose a dilemma is that Iran has reportedly tried to fuel a measure of instability in eastern Afghanistan. Perhaps the greatest impediment to Iran joining the organization stems from Beijing: one of its chief foreign policy priorities is stable relations with the United States. Even Russia, despite its recent rhetoric, values a somewhat stable relationship with the world's only global power.<sup>47</sup>

### **Conclusion: Wait-and-See**

The SCO has risen in importance, mission breadth, and potential membership. The grouping constitutes an important player in Central Asia. But this does not necessarily dictate that the SCO poses a threat to the United States and its interests in the region. Although interests shift over time and Central Asia fails to fit into any clear categories, the U.S. has shown a consistent priority towards energy, Afghanistan, and stability in the post-September 11 era. Of the three western approaches to viewing the SCO (current threat, non-threat, or wait-and-see), this analysis has thus far suggested the first is largely wrong. An SCO-led natural gas cartel is unlikely, and in any case U.S. interests lie more with petroleum. In Afghanistan, the persistence of instability has led the SCO, despite its rhetoric, to accept quietly that the U.S.-led mission in Afghanistan is the only way to ensure that the Taliban does not once again threaten to reignite regional terrorist and separatist movements. In terms of long-term stability, the SCO may be contributing to some unhealthy authoritarian practices, but the alternative of democratization has not proved stable either. Finally, military exercises and potential membership expansion has not led to an organization that comes close to resembling a challenge to the NATO alliance.

Given that the SCO is probably not a current threat to U.S. interests in Central Asia, which of the other two remaining approaches best deals with this emerging organization: should U.S. policymakers treat the SCO as largely irrelevant or embrace a wait-and-see approach? Three potentialities that are largely beyond U.S. control lead to the latter, more cautious approach.

First, natural gas firms could discover previously unidentified fields. If a great deal more natural gas becomes available for extraction and

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<sup>47</sup> Two observers claim that Russia and China go to great lengths to limit Iran's participation as a result of U.S. pressure. See, Nicklas Norling and Niklas Swanström, "The Shanghai Cooperation Organization, trade, and the roles of Iran, India and Pakistan," *Central Asian Survey* 26, 3 (September 2007), p. 438.

export, two mutually reinforcing, positive developments could occur: there may be enough gas to encourage Central Asian suppliers to diversify transport routes away from Russia and U.S. firms may tolerate higher prices (including the price of dealing with unstable nations) for access. But if by that time the SCO establishes an Energy Club that locks in Gazprom and Russia as the dominant players in the energy game, it may be too late for U.S. firms to enter the competition, especially in a state such as Uzbekistan that has reoriented away from Washington.

Second, China and Russia's non-Central Asian issues may prevail over its interests in the region. The most obvious example of such a scenario involves Taiwan. If a Sino-American confrontation over Taiwan's status erupts, Beijing will use every lever possible to attain the maximum amount of international support. This will include leveraging the SCO in an effort to marginalize any advantage the U.S. might attain from its presence in Central Asia. Beijing would quickly sacrifice any Afghanistan-related interests in a quest to secure a favorable Taiwan arrangement. If the situation was dire, Beijing could pressure the Central Asian states to expel immediately any U.S. forces. The SCO could provide a perfect political cover for Central Asia's leaders, who would otherwise hesitate to take such drastic measures.

The third and final potentiality does not rest solely on future scenarios. This article, like most others on the topic, uses literature available in the public domain to speculate into the inner-workings of the SCO. There exists a possibility that more anti-American activity, either current or as preparation for the future, occurs in private SCO sessions. The Defence Academy of the United Kingdom has noted that military exercises and political meetings occur in large part on a secret basis, with some sort of official document serving as the public rendition of what occurred.<sup>48</sup> More could be happening in private.

Despite these potential developments, the SCO does not currently present a significant threat to U.S. interests in Central Asia. Although the above assessment argues for a cautious wait-and-see approach, policymakers should not interpret such a strategy as one of inaction. Encouraging a select few allies to maintain mid-level contacts with the organization, for instance, could bring about several benefits. Allies that engage with the SCO could aid the U.S. government's monitoring effort by providing information about the bloc's working groups, summits, and military exercises. SCO interaction with U.S. allies would also offer the organization an incentive to appreciate, if not move toward, western positions. Which nations could play the role of an informal U.S.-SCO conduit? Afghanistan and Turkey stand out as two prime candidates.

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<sup>48</sup> de Haas, "The 'Peace Mission 2007' Exercises: The Shanghai Cooperation Organization Advances," p. 6.

Instead of preventing Afghan engagement with the SCO, the U.S.-led International Security Assistance Force (ISAF) should support Afghanistan in utilizing the SCO-Afghanistan Contact Group. Since NATO forces are the glue that keeps the Afghan government together, it is highly unlikely that the Contact Group would somehow move Afghan leadership away from its near-total dependence on western governments. On the other hand, SCO nations have a stake in Afghan stability and could potentially contribute to the reconstruction effort through financial assistance and counter-narcotics cooperation.<sup>49</sup> Given Turkey's deep historical, cultural, and trade relations with Central Asia and an anti-separatist agenda in its struggle against the PKK terrorist organization, the SCO may be willing to grant Ankara observer status – or at least access to its working groups.<sup>50</sup> Such a development would link a NATO country with the SCO, foster dialogue between the two blocs, and thus make it less likely that the SCO develops into an anti-NATO alliance.

For the foreseeable future, a cautious wait-and-see strategy based on a low profile and some encouragement of ally-SCO cooperation presents the best policy option.

SCO-inspired anxiety in Washington has been overblown. In this there is a practical lesson for U.S. strategists. As they assess multilateral organizations and their impact on U.S. interests around the world, policymakers need to keep in mind that the absence of the U.S. from an organization's membership list does not automatically mean that the grouping is adverse to U.S. interests. What it could mean, and does in the case of the SCO, is that observers and policymakers need to keep an eye on the organization: certain potentialities could come to fruition, and the SCO could pose more of a challenge in the future.

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<sup>49</sup> Norling and Swanström, "The Shanghai Cooperation Organization, trade, and the roles of Iran, India and Pakistan," p. 441.

<sup>50</sup> Though Turkey may have a few financial and political reservations about such a role, Ankara will probably judge that the benefits of a loose relationship with the SCO outweigh the costs, given support from its key ally Washington.

# China's Investments in Russia: Where do they go and how Important are they?

*Libor Krkoska and Yevgenia Korniyenko\**

## ABSTRACT

This article outlines the extent of Chinese direct investments in Russia, comparing the investment strategy of Chinese companies in Russia with their strategy in other countries. The experience to date suggests that Russia is an important target market for Chinese investors. The key determinants of Chinese investments in Russia are proximity of the investment location, market size, and ability to use Russia's natural resources. Investments by Chinese companies are concentrated in Siberia, Far East, Moscow and St. Petersburg, with a prominent role in the natural resources related sectors, including not only oil and gas, but even more so, in forestry.

*Keywords* • Foreign Direct Investments (FDI) • China • Russia

## Introduction

China is not only a dominant player in global trade flows but increasingly also an important investor. This article looks at the scale and distribution of China's investments in Russia, analyzing which sectors and regions are key targets for Chinese investors.<sup>2</sup> We also assess to what extent Chinese investors in Russia follow the same strategy as Chinese

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<sup>2</sup> The data come from the three databases: Zephyr (Bureau Van Dijk) was used for the information on recorded 30 projects with Chinese investments in Russia. Factiva has around 10000 news about privatizations, takeover deals, investments, joint ventures and other activities of Chinese investors in the Russian Federation, starting from January 1<sup>st</sup>, 1998. Ruslana database has information on about 276 enterprises in Russia with Chinese investments, although the last year of database update is 2005.

investors in other countries. According to Buckley et al. (2007)<sup>3</sup> foreign direct investments by Chinese companies are driven by three key factors: (1) proximity to target countries (including not only geographic but also cultural proximity), (2) market size and (3) natural resources endowment. This article looks into enterprise level evidence, by collating available data on announced investment projects to date, to see whether Chinese foreign direct investments (FDI) in Russia follows the same pattern. Given the general lack of sectoral and regional data on Chinese investments in Russia, this article makes a unique contribution to the rapidly expanding literature on trends in the development of China's FDI (e.g., Taylor 2002<sup>4</sup>; Deng 2003<sup>5</sup>, 2004<sup>6</sup>; Wong and Chan 2003<sup>7</sup>; Buckley et al. 2006<sup>8</sup>) as well as in-depth case studies on a small number of high-profile Chinese MNEs (e.g., Liu and Li 2002<sup>9</sup>; Warner et al. 2004<sup>10</sup>).

### How Important are China's Investments in Russia?

Figures on trade between China and Russia give a useful benchmark to assess the importance of China's investments in Russia. Trade volumes between China and Russia reached approximately US\$50 billion in 2007,<sup>11</sup> growing at double digits every year since the Russian financial crisis in 1998. China is now Russia's third largest trade partner, importing mostly energy and timber,<sup>12</sup> while Russia is currently China's eighth largest trade partner, importing a wide range of mostly finished industrial goods. More than 20 percent of trade between China and Russia is accounted for

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<sup>3</sup> P. Buckley, L. Clegg, A. Cross, X. Liu, H. Voss and P. Zheng, "The determinants of Chinese outward foreign direct investment," *Journal of International Business Studies*, 38 (2007), pp. 499-518.

<sup>4</sup> R. Taylor, "Globalisation strategies of Chinese companies: current developments and future prospects," *Asian Business and Management* 1, 2 (2002), pp. 209-225.

<sup>5</sup> P. Deng, "Foreign direct investment by transnationals from emerging countries: the case of China," *Journal of Leadership and Organisational Studies* 10, 2, (2003), pp. 113-124.

<sup>6</sup> P. Deng, "Outward investment by Chinese MNCs; Motivations and implications," *Business Horizons* 47, 3, (May-June 2004), pp. 8-16.

<sup>7</sup> J. Wong and S. Chan, "China's outward direct investment: expanding worldwide," *China: An International Journal* 1, 2 (2003), pp. 273-301.

<sup>8</sup> P. Buckley, A. Cross, H. Tan, H. Voss, and X. Liu, "An investigation of recent trends in Chinese outward direct investment and some implications for theory," Centre for International Business University of Leeds, Working paper, (2006).

<sup>9</sup> H. Liu and K. Li, "Strategic implications of emerging Chinese multinationals: The Haier case study," *European Management Journal* 20, 6 (2002), pp. 699-706.

<sup>10</sup> M. Warner, N. Hong, and X. Xu, "Late development experience and the evolution of transnational firms in the People's Republic of China," *Asia Pacific Business Review*, 10, 3/4 (2004), pp. 324-345.

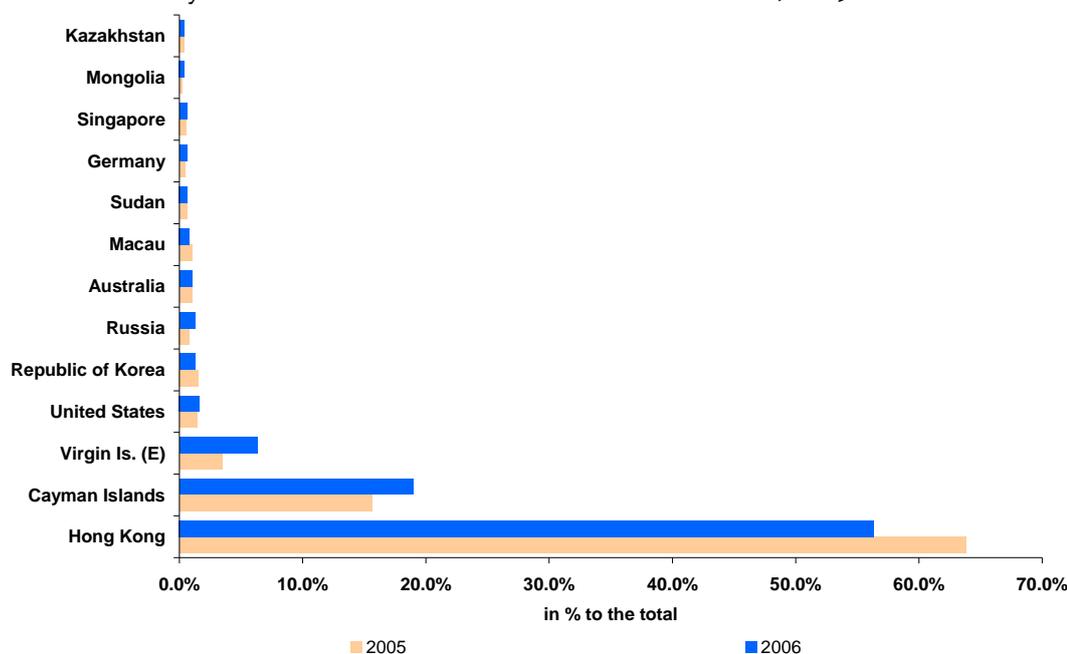
<sup>11</sup> Russia's Ministry of trade and economic Development figures.

<sup>12</sup> China also buys about US\$1 billion worth of Russian weapons every year, making it the Russian arms industry's biggest customer.

by the shuttle trade, with important implications for investments by Chinese small and medium-sized enterprises.

Compared to these sizeable trade flows, investment flows between the two countries remain low. The stock of Chinese FDI in Russia is estimated at up to US\$3 billion,<sup>13</sup> less than 5 percent of total FDI stock in Russia, with the focus on energy, natural resources, building materials, wood processing, manufacturing, the car industry, major appliances, and telecommunications. The limited size of Chinese investments in Russia is also evident when compared to the total amount of Chinese outward FDI in 2006 which reached US\$75 billion.<sup>14</sup> Nevertheless, Russia is one of the key markets targeted *directly* by Chinese investors, on par with the US, Republic of Korea, and Australia, once we exclude offshore centres (Virgin Islands, Cayman Islands) and Hong Kong (see Chart 1).

**Chart 1.** Country breakdown of outward Chinese FDI stock, 2005-2006



Source: 2006 Statistical Bulletin of China's Outward Foreign Direct Investment (2007).

The size of the Chinese investments in Russia is likely to be underestimated, mainly due to the use of off-shore vehicles based in Cayman Islands, Hong-Kong, and Virgin Islands. In addition, many

<sup>13</sup> Official data provided by Goskomstat of Russian Federation. According to the Ministry of Commerce of the People's Republic of China the stock of Chinese FDI by the end of 2006 in Russia adds up to only US\$1 billion.

<sup>14</sup> In 2006 China was ranked 13 in the world by amount of its outward FDI. In addition, China's investments are likely to be boosted by the newly created China Investment Corporation, the sovereign wealth fund, with US\$ 200 billion at its disposal, although China Investment Corporation's investments are more likely to be portfolio rather than direct investments.

Chinese investors prefer to establish fully owned companies with the minimum statutory capital of 10,000 rubles (around US\$400), which are likely to require significantly higher financing. Examples of such nominally small, and very likely undervalued, investments in Russia are sawmills and other wood processing plants.

Chinese companies have also been successful in winning outsourcing contracts, involving the use of Chinese labor, in construction sector, energy, forestry, agriculture, and textile industry. The newly signed contracts in 2006 exceeded US\$1 billion, bringing the total of China's contracted investments in Russia to almost US\$7 billion.<sup>15</sup> These contracts have been growing by over 40 percent per year and are concentrated mainly in the Far East and Siberia, which suffer from labor shortages.

Over 2004-2007, 54 investment projects have been signed between Russia and China totaling US\$5 billion. According to data from the Ministry of Economic Development and Trade of the Russian Federation this figure will more than double by the end of 2020. Given the overall FDI flows to Russia, estimated at US\$50 billion in 2007 only, China's share of FDI flows may seem rather low. This may be partly due to the strategy of China's companies to target so-called strategic sectors<sup>16</sup> in which the operations of foreign investors are limited as noted by Kari Liuhto.<sup>17</sup> The legislation, currently considered by the Russia's State Duma, defines "strategic sectors" and puts limits on investment from foreign companies into sectors such as mining, the aircraft industry, nuclear power and media.<sup>18</sup> This has an impact of investments by enterprises in the nuclear industry or involved in handling radioactive materials; enterprises involved in work on infectious diseases; arms, munitions and military equipment production, maintenance or repair; the aviation and space industries; data-transmission infrastructure; production and distribution of encryption technologies and equipment; and production and sales of goods and providing services under conditions of a "natural monopoly" (e.g., activities such as operating certain gas networks), among other sectors. The rules for foreign investor involvement in the oil and gas sector are not part of this legislation and are covered under amendments to the subsoil law.<sup>19</sup>

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<sup>15</sup> 2006 Statistical Bulletin of China's Outward Foreign Direct Investment (2007).

<sup>16</sup> Buckley, Clegg, Cross, Liu, Voss and Zheng, "The determinants of Chinese outward foreign direct investment," , pp. 499-518.

<sup>17</sup> K. Liuhto, "A future role of foreign firms in Russia's strategic industries", Electronic Publications of Pan-European Institute, 4 (2007), <http://www.tse.fi/pei/pub>.

<sup>18</sup> As the Vedomosti newspaper reported, publishing and typesetting companies, as well as internet providers have now joined the over 40 economic sectors considered critical to Russian security.

<sup>19</sup> For details see Transition Report 2007, EBRD.

## Which Sectors and Regions are Targeted<sup>20</sup>?

There were more than 1,000 joint ventures with Chinese capital in Russia at the end of 2007. Most of these are trading firms set up in border areas, although there are over 200 joint ventures in manufacturing. For the purpose of this note, we have collected the available data on 276 enterprises with majority Chinese capital in Russia. Half of the sample is in wholesale and retail trade, 25 percent of which is in trade in wood and construction materials and another 25 percent in food and clothing, and services (restaurants, letting and travelling agencies, repair services, and financial services). The sample contains only one project in the energy sector with majority Chinese ownership despite the energy sector's overwhelming importance for the trade between the two countries.

**Table 1.** Sectoral breakdown of Chinese-Russian joint ventures in 2005

Sector	Number of companies	Share of the sample
Wholesale and retail trade	101	36.6
Services	61	22.0
Agriculture and forestry	57	20.7
Manufacturing	30	10.8
Construction	19	6.9
Energy	1	0.4

Source: Bureau Van Dijk Ruslana database, EBRD estimate.

About 80 percent of the investments in our database is in the Far East and Siberia. The remaining 20 percent of enterprises are operating in Central Russia, out of which half, or about 10 percent of total Chinese investments in Russia, are established in Moscow, the Moscow region and St. Petersburg. China has also signed agreements to invest around US\$300 million in Chechnya, the first foreign investor to do so.<sup>21</sup>

### Energy

The Russian-Chinese oil trade and related investments have been very slow to develop. Up to 1995, China was not importing any crude oil from Russia. As a result of the development of railroad infrastructure in eastern Russia and northern China, Russia exported approximately 26,000 barrels per day to China in 2000. By 2005, following a number of major

<sup>20</sup> There are no official data available on the sectoral and regional breakdown of Chinese investments in Russia. As a result the following analysis is prepared on the basis of information available in public databases such as Zephyr, Ruslana and Factiva. The data on the size of available transactions is incomplete and therefore it is currently impossible to provide a meaningful econometric analysis of investment flows on the basis of enterprise data.

<sup>21</sup> An agreement has been signed by Chechen President Alu Alkhanov with Vneshekonombank and China's State Development Bank on March 21, 2006.

intergovernmental agreements, Russia exported over 250,000 barrels per day to China. In 2006, Russia was China's fourth-largest crude oil supplier, accounting for 11 percent of total imports, 25 percent more than in 2005. A further increase could be achieved once a planned 5,000 kilometer pipeline linking East Siberia and China is completed.

In line with the expansion of oil trade between Russia and China, Chinese investments in Russia in this sector have increased as well. The four biggest Chinese energy companies (China National Petroleum Corporation, China Petroleum & Chemical Corporation, China National Ocean Oil Corporation Ltd, China Oilfield Services Ltd) are now operating in Russia.

In July 2006, China National Petroleum Corporation (CNPC), bought a US\$500 million stake during Rosneft's IPO and China Petroleum & Chemical Corporation (Sinopec) acquired a 96.9 percent stake in Udmurtneft for US\$3.5 billion from TNK-BP International (British Virgin Islands). The Udmurtneft acquisition is a prime example of Chinese investments in Russia which do not appear in the FDI statistics due to the channelling of funds through off-shore vehicles.

The need to invest heavily in infrastructure currently restricts further expansion of oil and gas trade between China and Russia. One of the most important projects is the East Siberia-Pacific Ocean pipeline. The approximately US\$16 billion project to transport 1.6 million barrels per day is scheduled to be completed in 2015. In 2006, Gazprom and the China National Petroleum Corporation signed a memorandum of understanding to build two gas pipelines connecting Russia and China. The agreement envisages two gas pipelines delivering between 60 and 80 bcm per year of Russian gas to China<sup>22</sup>. The western pipeline, linking Russia's Altai region to north-western China, would carry western Siberian gas to China's internal west-east pipeline, while the eastern pipeline is geared to link eastern Siberian and possibly Sakhalin Island gas to eastern China. Although Chinese companies may provide some of the financing and, in particular, labor for the construction of these pipelines, it is unlikely that these would be opened to majority Chinese ownership, given the state control of export pipelines in Russia.

#### *Forestry*

The forestry sector is one of the key targets of Chinese investments, given that Russia's timber reserves account for a quarter of the world's total, most of them located in the Far East and Siberia, and trade in timber accounts for 10 percent of the total trade between the two countries. China has become the number one importer of timber products

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<sup>22</sup> According to official statistics of the Russian Federation there is no gas supply to China at the moment.

in the world over the past seven years, and Russia has become the number one supplier to China, accounting for approximately 50 percent of China's total timber imports. Ninety percent of Russian timber exports to date are unprocessed logs, with most of the processing capacity located at the Chinese side of the Russia-China borders.

Russia may lease one million hectares (3,800 square miles, or twice the size of Delaware) of Siberian forests to Chinese state timber companies, according to plans released by the two countries' forestry ministries in November 2006. The forests would be leased for 49 years, and may lead to significant investments into wood processing facilities, not least due to the increases in unprocessed timber tariffs which will soon make exports of unprocessed logs uneconomical.

There are a number of large projects by Chinese investors in the Russian forestry industry at different stages of implementation. The construction of a US\$250 million pulp and paper manufacturing facility in Habarovskiy Kray of Russia has started in late 2006. In mid-2007, the governments of Russia's Tomsk Region and China's Liaoning Province have signed an agreement to set up timber-processing facilities of up to US\$1 billion. Under the agreement, Chinese investors will finance the construction of several facilities in the Asinovsky district of the Tomsk Region, including a sawmill with a capacity of up to 2 million cubic meters of timber per year, an unbleached pulp plant with a capacity of 400,000 cubic meters per year, as well as fiberboard production facilities.

Despite these large scale investments, most of the activity by Chinese investors in the Russian forestry sector is on a small scale at the moment. In the Irkutsk region, 152 joint Russian-Chinese wood processing companies are registered, some of them fully owned by Chinese investors. There are also reportedly a large number of Chinese entrepreneurs involved in illegal logging. Estimates of the extent of illegal logging in Siberia and the Russian Far East published in the Russian press range from 15 to 70 percent of the total, depending on the definition and methodology used.

#### *Retail Trade*

As shown by the analysis of the public information on Chinese investments in Russia, the highest share of majority Chinese owned companies, exceeding one third of the total, is active in wholesale and retail trade, 75 percent of which is concentrated in Far East and Siberia. These are mostly micro and small enterprises active in open markets.

As a result of a recent crackdown on illegal immigration into Russia<sup>23</sup>, Chinese retail enterprises were greatly affected by strict limits on immigrant workers in certain areas, including retail trade. Some markets were greatly reduced in size while the Chinese entrepreneurs were struggling to comply with the new regulation, finding local partners or registering local companies. Marriages between Chinese entrepreneurs and Russian citizens have reportedly started to be used to obtain Russian citizenship to escape the impact of new legislation, with the price of such matrimonial services to market vendors reportedly around 300,000 rubles (approximately US\$12,000 dollars).<sup>24</sup>

#### *Automotive Sector*

The automotive sector is one of the key targets for large scale foreign direct investments from China into Russian manufacturing sector<sup>25</sup>. Unlike car manufacturing investments by major international producers (which focus on relatively expensive but also high quality cars), Chinese companies aim at the segment of the market currently served by local companies with cheaper models affordable to the majority of the population and thus pose the greatest competitive threat to local producers, particularly AvtoVAZ which is a dominant local producer of passenger cars and is now state controlled, following Rosoboron's recent acquisition. Russian standards of emissions and safety are lower than in Western Europe, allowing current Chinese models to be sold locally with minimum of modifications.

Several Chinese car producers have established joint ventures in Russia and a further number of investments are being considered. Chinese automotive producers have also expressed an interest in car components production facilities in Russia. However, Chinese car producers have yet to receive state approval to assemble cars in Russia. China's Chery is currently the only Chinese car company with a license to produce cars in Russia. Joint production of Chinese-designed Geely cars started in the Urals at the beginning of 2007, using production capacities of the Ural Automobiles and Engines plant (UralAZ). There are also plans by Russian Avtotor and Chinese Chery to start the construction of a US\$200 million car assembly plant in Russia's Kaliningrad Region. Other Chinese automobile companies are also eyeing

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<sup>23</sup> Foreign nationals were prohibited from selling alcoholic beverages and medical formulas as of January 1, 2007. The presence of foreign salespersons at wholesale and retail markets was lowered to 40 percent as of January 15; they were completely prohibited starting from April 1, 2007.

<sup>24</sup> Banned from bazaars, foreign vendors enter into sham marriages. *ITAR-TASS World Service*, April 2 2007.

<sup>25</sup> There are also some investments in the production of white goods and other manufacturing activities, but these have currently limited impact on the relevant markets.

the Russian market – Changfeng Motors is reportedly also discussing plans to build an assembly unit in Russia while Great Wall has been negotiating with the government of the Tatarstan region to set up a motor vehicle production joint venture. Beijing Automotive Industry Corp. chairman An Qingheng also disclosed that the company is in talks to launch production of commercial vehicles in Ulyanovsk.

Moscow-based automobile plant ZIL is expected to start producing buses and 3.5-ton trucks on the basis of models from major Chinese automobile manufacturer FAW although no big investments are expected at the moment. It is interesting to note that the Chinese FAW was built in 1953 with help from ZIL experts. The assembly charts acquired in Russia at the time have been preserved, and the FAW management still includes Russian-speakers.

Most of the newly created joint ventures in automobile industry benefit from special tax incentives, including the duty free import of most components or with minimal 5 percent duty. These incentives are in theory also available to Chinese producers. However, Chinese companies have been so far unsuccessful in their application for investment incentives in the car sector. Great Wall has been trying to obtain the preferential industrial assembly regime in Yelabuga for over two years. In July 2007, Russia's Economic Development and Trade Ministry and the Industry and Energy Ministry decided not to sign an agreement on the industrial assembly of Chinese cars in Russia. The proposal involved four car assembly projects - a Great Wall plant in Tatarstan; assembly of Geely and ZhongXing vehicles at the Automobiles and Engines of the Urals (AMUR) based in the Sverdlovsk region; Lifan assembly at the Derways plant in Cherkessk and the production of BAIC light trucks in the Ulyanovsk region. It is however still possible that some of these projects, with the total value of about US\$400 million, would be accepted by the authorities.

#### *Construction Sector*

The fast growing real estate sector has been the target of a number of large scale projects by Chinese investors, both in Central Russia and in the Asian part of the Russian Federation. Importantly, these projects involve not only Chinese investments but also Chinese construction workers.

Three large scale projects by Chinese investors are being implemented in Moscow: the construction of a Chinese trade and cultural center in Moscow, the construction of trading house "Friendship", and construction of a technopark "Friendship". Chinese companies are also responsible for implementing one of the largest construction projects in Moscow – a building named "the Tower of Federation" – and the Chinese business centre "Park Huamin".

Another large scale real estate project developed by Chinese investors is the Baltic Pearl housing project in St. Petersburg. The Baltic Pearl project is a mixed use development involving residential, office, retail and hotel facilities, as well as health and convention centers on a 1.64-million-square-meter plot of land constructed in four phases over eight years. Estimated costs of the project are US\$1.3 billion, with US\$45.4 million in shareholder's equity, US\$500 million loan from the Export and Import Bank of China, and the rest financed by off-plan sales.

#### *Transport Infrastructure*

Russia and China are currently linked by three railways, one of them passing through the Chita Region and two other through the Primorsk Region of Russia. Russian and Chinese railways officials are considering several projects, one of them to link the Russian city of Ussuriisk and the Chinese city of Dunin in Heilongjiang province by railroad. Chinese investors are collaborating with the Russian government in the construction of infrastructure for special economic zones and industrial parks in the Far East and Siberia, using Chinese financial resources, labor and know-how. Major infrastructure projects in Russia (construction of roads and bridges, and modernization of ports) may become significant targets for Chinese investments in the future.

The Russian government has announced large infrastructure investments in Eastern Siberia and the Far East to allow exploitation of natural resources in these areas. The availability of local labor to implement these projects is a key constraint. Should these infrastructure projects go ahead, it is likely that Chinese enterprises using Chinese labor could be involved on a large scale.

Several of the planned large-scale infrastructure projects in the Far East and Siberia are already being implemented. One of the key projects is the construction of the first railway bridge over Amur. The 2,197 meter bridge costing US\$230 million will link Nizhneleninskoye in the Jewish Autonomous Region with Tongjiang in Heilongjiang Province and is expected to be completed by the end of 2010. Another bridge connecting Heihe of Heilongjiang, and Blagoveshchensk of Priamurye in Russia has been under discussion by both nations for about 15 years. The three neighboring Chinese provinces of Heilongjiang, Jilin and Liaoning provinces account for about one third of trade between China and Russia.

#### *Banking*

Several Chinese banks (The Bank of China, Exim Bank of China, Industrial and Commercial Bank of China, China State Development Bank) have representative offices in Russia, hold banking licences or have announced their intentions to operate in the Russian Federation. In the past, Chinese banks have been largely excluded from major foreign

markets because of a history of poor risk management and unsatisfactory corporate governance. Chinese banks serve primarily enterprises owned by Chinese investors, including many small and medium-sized businesses which have difficulty accessing finance from Russian banks and lack Chinese government support. Most investment projects in Russia are financed by financial institutions based in Hong Kong and Shanghai or by the Chinese Export-Import Bank.

## **Conclusions**

Chinese investments in Russia follow the same pattern as Chinese investments in other countries. They are primarily driven by (1) the proximity of the market, leading to a large share of investments in Siberia and the Far East, (2) the size of the market, with Moscow and St. Petersburg being important destinations of Chinese investments, and (3) availability of natural resources, particularly timber, oil and gas. A large increase in Chinese investments in Russia can be expected over the next few years. Although natural resources related projects (not only oil and gas related investments but also projects in the forestry sector) and real estate are likely to be the key focus of Chinese investors, investments in manufacturing and infrastructure are also likely to grow. Given the lack of available local labor in the Far East and Siberia, these projects are likely to be implemented with the use of contracts for Chinese labor on a significant scale, provided such labor contracts are approved by the local Russian authorities.

The increasing flows of FDI from China to Russia are likely to complement increasing trade flows in the near future. As a result there will be an increase in competitive pressures on both local companies and foreign investors, not only through trade channels, but also through output of Chinese companies in Russia. The proximity of China to Russia and its abundant labor force which can be deployed in Russia, if needed and approved by the authorities, is likely to give China's investors an important competitive advantage. An important question is whether China's investors would continue competing on price as they have in the past or whether they would also start focusing more on quality and customer service. Another important issue is what standards of corporate governance and business conduct Chinese investors in Russia will have. These questions are likely to be of critical importance for the assessment of the impact of China's investments on Russian economy and should be subject to further analysis.

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# Pashtunistan, NATO and the Global War on Terror: “If you don’t fight, you cannot have peace in Afghanistan”

*Michael Mihalka*<sup>\*</sup>

## **ABSTRACT**

Since 9/11 terrorism has increased and become a prominent feature of ongoing insurgencies. NATO has become increasingly involved in one such insurgency in Afghanistan. However, perceptions of failure in Afghanistan have decreased public support for the mission and undermined support for NATO itself. Although Western public perception is one of overall failure, the situation in Afghanistan itself is quite varied. In the non-Pashtun areas of the country, the situation is improving and reconstruction is perceived by many Afghans as being effective. In Pashtun areas the opposite is true. NATO has not yet developed an effective strategy for dealing with the Pashtun insurgency in part because the Pashtun area straddles the border with Pakistan. Recent elections in Pakistan are likely to decrease cooperation. Attempts to turn the fight over to the Afghans have had mixed success with some progress on the Afghan National Army but very little with the police.

*Keywords* • NATO • GWOT • Afghanistan • insurgency • Pashtunistan • Afghan National Army • Opinion Polls • Pakistan

## **Introduction**

“The Americans are at war. We are on operations.” So goes the Economist report about some British officers lamenting about the relative commitments of the Americans and Europeans to Afghanistan. “The nations contributing to [the NATO mission in Afghanistan], together with the Afghan government, have yet to agree, and to start efficiently implementing, a coherent strategy,” Sir David Richards, former

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<sup>1</sup> “The British Army; Friendly Fire in Afghanistan,” *The Economist*, January 31 2008.

International Security and Assistance Force (ISAF) commander, said in early November 2007.<sup>2</sup>

Thus General Sir Richards sets the strategic context plaguing NATO. The U.S. is engaged in a global war on jihadists (transmuted for public relations effect to the global war on terror or GWOT). The rest of NATO seems to be just along for the ride, confused about strategy and poorly preparing their public for the effort.

After placing the war in Afghanistan in the global context of the war on terror, this article shows how and why support for the mission has declined over time in NATO countries. It shows how many of the countries with troops in Afghanistan have pursued a confused strategy and effectively deceived their public by asserting that peace can be achieved within Afghanistan without fighting. Moreover, this article illustrates how the conflict has to be viewed in the broader context of Pashtunistan, the cross border and often lawless area along the Pakistan-Afghanistan border. Finally it concludes that little more will be forthcoming from the U.S.' NATO allies and that success will ultimately depend on the American themselves and their ability to get the Afghans to take on responsibility for their own security.

### Global War on Terror – the Global Context

The global media has increasingly seen the so-called “global war on terror” as wrapped up in the actions of the United States and its allies in Afghanistan and Iraq. U.S. policy makers complain that the Europeans have not done a persuasive job in convincing their public of the threat posed by unsettled areas such as along the Pakistan-Afghanistan border where the charismatic head of al Qaeda, Osama bin Laden, reputedly is holed up. Indeed, on January 19, 2008, the Spanish police broke up a ring of alleged terrorists who were either of Pakistan origin or who had been trained there. Spain’s chief anti-terrorism magistrate, Judge Baltasar Garzón, claimed: “In my opinion, the jihadi threat from Pakistan is the biggest emerging threat we are facing in Europe. Pakistan is an ideological and training hotbed for jihadists, and they are being exported here.”<sup>3</sup>

Although spectacular transnational terrorism such as occurred on 9/11 New York, in London, in Madrid and Bali is rare, terrorism has been steadily increasing since 2001. After 9/11, the data base at the Memorial Institute for the Prevention of Terrorism reports a big jump in terrorist

<sup>2</sup> Doug Saunders, “Infighting among NATO members snarls Afghan mission, ex-commander says,” *The Globe and Mail*, November 2 2007.

<sup>3</sup> Elaine Sciolino, “Terror Threat From Pakistan Said to Expand,” *The New York Times*, February 10, 2008, <[www.nytimes.com/2008/02/10/world/europe/10spain.html?\\_r=1&hp=&pagewanted=all](http://www.nytimes.com/2008/02/10/world/europe/10spain.html?_r=1&hp=&pagewanted=all)> (February 10 2008).

incidents (see Table 1). The data for 2007 are incomplete and should not be viewed as necessarily reflecting a decrease in terrorist incidents.<sup>4</sup>

**Table 1.** Terrorist Incidents and Fatalities, 1999-2007

Year	Total	International	Fatalities
1999	1171	125	864
2000	1151	106	783
2001	1732	205	4571 [9/11 - 2494]
2002	2648	298	2673
2003	1899	277	2349
2004	2647	395	5066
2005	4995	311	8194
2006	6659	241	12070
2007	2747	145	6927

Source: Memorial Institute for the Prevention of Terrorism <www.mipt.org>

The location of these incidents has also changed. In 1999, 433 of the 1171 incidents occurred in Western Europe, with Spain and France comprising 172 and 108 incidents respectively. In the Middle East 304 of the total 372 incidents occurred in Turkey. In Latin America, 95 of the 104 total occurred in Colombia. These four countries account for 58 percent of the total and the global jihadists are little in evidence. Contrast this with 2006 where 3968 of the incidents occurred in Iraq, making up almost 60 percent of the year's total. Israel and the West Bank have 454 incidents, India and Kashmir 379, Thailand 355, Afghanistan 352 and Pakistan 254. These figures reflect that terrorism is largely a tactic pursued by an insurgency. Transnational terrorism is often aimed at influencing the willingness of outsiders to remain involved in those local insurgencies.

### NATO's Center of Gravity: Public Support for Operations

The jihadists clearly perceive that NATO's Achilles heel is public support for ongoing operations and have acted accordingly. The al Qaeda attack on the United States on 9/11 was motivated (however misguided) by a desire to force U.S. withdrawal from the region. The jihadist attack in Spain on 3/11/2004 was widely perceived as their attempt to influence the national election. In the event, Spanish Prime Minister Jose Maria Aznar's Popular Party lost to Jose Luis Rodriguez Zapatero's Socialists which, once in office, were quick to remove the Spanish troops from Iraq.

In October 2006, a jihadist website cited the completion of a research project analyzing how to defeat the U.S. and its allies in Afghanistan.<sup>5</sup>

<sup>4</sup> Communication with Terrorism Knowledge Base, Memorial Institute for the Prevention of Terrorism, February 11 2008.

Husam Abd-al-Ra'uf, a member of the Media Division of Al-Qa'ida of Jihad Organization in Afghanistan, wrote:

NATO countries, which currently have the biggest share of the Crusader campaign in Afghanistan, do not have the gumption nor the courage and not even the competent military power to defeat the mujahidin – God willing. Just as these countries' governments have been weakened and military forces depleted in the post-Cold War period, so is the popular support for their mission in Afghanistan. Their people are not ready to sacrifice for a cause they consider irrelevant and that does not concern them.

Further, these countries' governments may be forced to withdraw their troops under the burden of huge material and human losses incurred in Afghanistan. If they refuse to do so, they will face a crushing defeat in the first general elections to be held in their countries. If such scenario takes place in one of the prominent countries involved in the battle, in particular Great Britain, the other countries, which are of the same mold, will follow suit. And then the infidel Crusader coalition pact will crumble, God willing.<sup>6</sup>

Indeed, as we will see below, the perceived failure of the mission in Afghanistan has led to a marked decline in support for the mission.

The jihadists have made good on their promises to affect electoral politics in the West and to test the mettle of Western leaders. Although 9/11 was not tied to the U.S. electoral cycle, the Madrid bombings of March 11, 2004 certainly were. More recently, the attack on the Glasgow airport and the failed car bomb attack in London the preceding day followed closely on the transfer of power from Tony Blair to Gordon Brown as British prime minister on June 27, 2007. Interestingly Brown reacted very differently from Blair to the attacks. Instead of calling it as an act of war, he treated it more as a serious crime.<sup>7</sup>

London, of course, has been the target of a series of terrorist attacks, some successful, some not. London mayor Ken Livingstone reported in December 2003 that four attacks had been thwarted.<sup>8</sup> On July 7, 2005, 52 people were killed in a series of attacks on the London transportation system. Later in the month, on July 21, another round of attacks failed.

The jihadists were also intent on exploiting targets of opportunity. On February 27, 2007, while U.S. vice president Dick Cheney was

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<sup>5</sup> Open Source Center, "Translation of Al-Qa'ida in Afghanistan's 'Victory of Islam Study' Analyzing War, Predicting 'Crusader' Defeat," as translated in GMP20061207281002, October 6 2006, <www.opensource.gov>.

<sup>6</sup> *Ibid.*

<sup>7</sup> Jonathan Freedland, "Who Is Gordon Brown?" *The New York Review of Books*, October 25 2007; "PM defiant over 'al-Qaeda threat'", BBC, July 1 2007.

<sup>8</sup> "Four London terrorist attacks 'foiled'" BBC News, December 1 2003.

visiting Afghanistan, the Taliban launched a suicide attack on the base where he was staying. Unable to gain access to the base, the bomber blew himself up at the entrance, killing at least 23.<sup>9</sup> More recently, terrorists attacked the Serena hotel in Kabul January 15, 2008, intending to kill the Norwegian Foreign Minister, Jonas Gahr Støre. Seven died but Støre was unharmed. A Taliban spokesperson confirmed that Støre was indeed the target.<sup>10</sup>

Yet another example of how the jihadists are targeting public support for NATO involvement in Afghanistan can be seen in the spectacular suicide bombing in Kandahar on February 17, 2008. Almost 100 people were killed at a dog-fighting competition by a huge car bomb. Among those killed was the local police chief, Abdul Hakim, who many thought was the major target of the blast. The next day the Taliban targeted a Canadian convoy as it moved through a crowded market in the town of Spin Boldak which was right on the border with Pakistan. Over 38 civilians were killed and many wounded including 3 Canadian soldiers. Were these bombs intended to affect the ongoing debate in the Canadian parliament over whether to extend the Canadian mission in Afghanistan? The head of the Canadian military certainly thinks so. In a speech before the Canadian Conference of Defence Associations, he said: "I cannot say that the suicide bombings of the past week are linked [to the debate in parliament] but I can't say they are not."<sup>11</sup>

A political science professor at Kabul University, Nasrullah Stanikzai, commented: "The attacks show that the enemies of Afghanistan are changing their tactics. Now they are not thinking about civilians at all."<sup>12</sup> He added: "They wanted to cause such big casualties in these attacks to weaken the morale of the government and the international community, to show the world the Afghan government is too weak to prevent them."

### Falling Support for the War on Terror

Globally, the public is becoming increasingly disenchanted with the way the U.S. has led the war on terror. As Table 2, shows countries in Europe

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<sup>9</sup> Abdul Waheed Wafa and Carlotta Gall, "A Mile From Cheney, Afghan Bomber Kills at Least 23," *The New York Times*, February 28 2007.

<sup>10</sup> Interview with Taliban Spokesman Zabiullah Mujahid, NEFA Foundation, January 25 2008, <[www.nefafoundation.org/miscellaneous/nefatalibanintvuo108-2.pdf](http://www.nefafoundation.org/miscellaneous/nefatalibanintvuo108-2.pdf)> (February 12 2008).

<sup>11</sup> John Ivison, Canadian soldiers want 'clarity of purpose,' Hillier says, *National Post*, February 22 2008

<<http://network.nationalpost.com/np/blogs/posted/archive/2008/02/22/canadian-soldiers-want-clarity-of-purpose-hillier-says.aspx>> <February 23 2008>.

<sup>12</sup> Allauddin Khan and Noor Khan, "140 Afghans Killed in 2 Days of Bombings," *Associated Press*, February 18 2008  
<[http://news.yahoo.com/s/ap/20080218/ap\\_on\\_re\\_as/afghan\\_violence](http://news.yahoo.com/s/ap/20080218/ap_on_re_as/afghan_violence)> (February 23 2008).

have become increasingly disillusioned with the way the U.S. is conducting the war on terror. In 2002, over 67 percent of the public favored rather than opposed the U.S.-led war on terrorism. By 2007, support had fallen sharply and the public of most European countries opposed the U.S. approach. The perceived failure to achieve success in Iraq and Afghanistan seems to have factored heavily in this assessment.

**Table 2.** Percentage of public responding “I favor the U.S.-led war on terrorism”

	2002 (%)	2003 (%)	2004 (%)	2005 (%)	2006 (%)	2007 (%)
U.S.	89		81	76	73	70
Britain	69	63	63	51	49	38
France	75	60	50	51	47	43
Germany	70	60	55	50	47	42
Spain		63		26	19	21
Russia	73	51	73	55	52	50
Italy	67	70				41
Sweden						36
Bulgaria	72					51
Czech Republic	82					57
Poland	81			61		52
Slovakia	66					42
Netherlands				71		

Source: Annual Pew Reports on Global Attitudes, 2002-2007.

In a similar manner countries have become increasing disillusioned with U.S. global leadership generally. This is especially true after the 2003 intervention in Iraq. Table 3 shows marked declines in how desirable Europeans find the prospects for strong U.S. leadership in global affairs. Much of the damage occurred as a result of the Iraq War as the desirability of U.S. leadership fell by an average of 18 percentage points. But the decline continued through 2007 with an average decline of a further six percentage points.

**Table 3.** The percentage of the public that views strong U.S. leadership in world affairs as very or somewhat desirable.

	2002 (%)	2003 (%)	2004 (%)	2005 (%)	2006 (%)	2007 (%)
USA	83			85	84	82
France	48	27	24	28	30	28
Germany	68	45	39	40	43	38
UK	72	55	54	53	48	50
Italy	63	46	41	37	34	37
Netherlands	75	57	59	58	51	52
Poland	64	53	39	42	39	40
Portugal		43	32	44	37	33
Spain			18	22	19	18

<b>Slovakia</b>	21	34	19	16
<b>Turkey</b>	16	17	14	7
<b>Bulgaria</b>			21	22
<b>Romania</b>			46	46

Source: Transatlantic Trends 2007<sup>13</sup>

Even the value of NATO has been called into question. Perception in degree to which NATO is deemed essential for security has dropped by an average of 13 percentage points from 2002 to 2007 as can be seen in Table 4. Only in the United States has the perception of the value of the alliance increased.

**Table 4.** Is NATO still essential for our country's security, 2002-2007.

	2002 (%)	2007 (%)
<b>USA</b>	56	60
<b>France</b>	61	55
<b>Germany</b>	74	55
<b>UK</b>	76	64
<b>Italy</b>	68	55
<b>Netherlands</b>	74	66
<b>Poland</b>	64	46
<b>Portugal</b>		59
<b>Spain</b>		49
<b>Slovakia</b>		44
<b>Turkey</b>		35
<b>Bulgaria</b>		58
<b>Romania</b>		62

Source: Transatlantic Trends 2007<sup>14</sup>

A public that perceives the decline in the legitimacy of U.S. leadership makes U.S. calls for greater participation in Afghanistan much more difficult. This is especially true when they view that the mission in Afghanistan as a failure and that their government ought to decrease not increase their forces. Moreover, the continuing and open criticism that the Americans have made of European participation arguably has undercut NATO itself.

### Initial Support, Perceptions of Failure and Decline

Initially, Afghanistan was the good cause. The Taliban were perceived to be gone and countries could go about the good work of reconstructing the country. In 2003, 66 percent of Americans favored extending the UN

<sup>13</sup> German Marshall Fund, Transatlantic Trends 2007, <[www.transatlantictrends.org](http://www.transatlantictrends.org)> (February 20 2008).

<sup>14</sup> *Ibid.*

mission beyond Kabul and 67 percent thought that the U.S. should contribute troops to that mission.<sup>15</sup> Americans supported this mission even though they were uncertain about the security situation there. Around 36 percent thought “Afghan warlords” were in charge of the country, 26 percent answered that the U.S. military was, while only 25 percent responded “a central Afghan government.”

For their part, the Canadian people also initially strongly supported the Afghan mission. In September 2005, 76 percent of the Canadian public supported the mission, slipping to 70 percent in February 2006 and 62 percent in April. The next month, the figure had dropped to 57 percent. More ominously, only 44 percent of the Canadian public supported extending the mission by two years.<sup>16</sup>

In 2004, most public approved of their troops being stationed in Afghanistan as can be seen in Table 5. Only Poland, Portugal and Turkey had pluralities that opposed stationing their troops there. In the United States, 69 percent approved and in the Netherlands, 66 percent, Germany 59 percent, Italy 56 percent and Spain a plurality of 48 percent.

**Table 5.** As you may know [COUNTRY] troops are currently stationed in Afghanistan. Do you approve or disapprove of the presence of [COUNTRY] troops in Afghanistan?

	Approve (%)	Disapprove (%)	Don't Know/Refused (%)
USA	69	26	5
France	55	35	10
Germany	59	38	3
UK	50	41	9
Italy	56	39	5
Netherlands	66	29	4
Poland	24	67	8
Portugal	41	49	11
Spain	48	44	8
Turkey	41	52	7

Source: Transatlantic Trends 2004 <[www.transatlantictrends.org](http://www.transatlantictrends.org)>.<sup>17</sup>

<sup>15</sup> “U.S. Public Supports Expanding Afghanistan U.N. Peacekeeping Force Beyond Kabul,” July 8 2003,

<[www.worldpublicopinion.org/pipa/articles/brunitedstatescanadara/120.php?lb=brusc&pnt=120&nid=&id=>](http://www.worldpublicopinion.org/pipa/articles/brunitedstatescanadara/120.php?lb=brusc&pnt=120&nid=&id=>) (February 2 2008).

<sup>16</sup> “Canadian and Dutch Publics Feeling Stretched by Expanded Military Role in Afghanistan,” Program on International Policy Attitudes, May 26 2006,

<[www.worldpublicopinion.org/pipa/articles/brunitedstatescanadara/198.php?nid=&id=&pnt=198](http://www.worldpublicopinion.org/pipa/articles/brunitedstatescanadara/198.php?nid=&id=&pnt=198)> (February 20 2008).

<sup>17</sup> German Marshall Fund, Transatlantic Trends 2004,

<[www.transatlantictrends.org/trends/doc/2004\\_english\\_top.pdf](http://www.transatlantictrends.org/trends/doc/2004_english_top.pdf)> (February 20 2008).

Given this kind of support it is remarkable how the support has fallen. Now, the public of many of the major NATO countries with troops deployed in Afghanistan view the mission as failing and want their troops removed. Table 6 gives the results of a July-August 2007 poll run by the Angus Reid Monitor.<sup>18</sup> Around two-thirds of the public in Britain, France, Italy, and Germany view the mission in Afghanistan as a failure. In Canada, roughly half do. Particularly significant is the percentage of the public who are not sure. This suggests that the respective governments have done a poor job of communicating the importance of the Afghani mission and the roles played by their respective forces.

**Table 6.** So far, do you think the war against militant groups in Afghanistan has been mostly a success or mostly a failure?

	<b>BRI</b> (%)	<b>FRA</b> (%)	<b>ITA</b> (%)	<b>GER</b> (%)	<b>CAN</b> (%)
<b>A success</b>	16	12	18	15	22
<b>A failure</b>	63	63	66	69	49
<b>Not sure</b>	21	25	16	16	29

Source: Angus Reid Monitor<sup>19</sup>

Not surprisingly the public of many of the countries want their forces withdrawn. Table 7 shows the percentage of the public that favors removal of the forces from Afghanistan in spring 2007.<sup>20</sup> In only the United States and Britain do the public favor keeping their troops in Afghanistan. The public in both Spain and Italy significantly oppose retaining their forces in the country. Polls taken more recently show an even greater margin of the German public wanting their forces to leave. For example in May 2007, Stern magazine ran a poll that showed 63 percent of the German people wanted their forces withdrawn from Afghanistan.<sup>21</sup> This was after three German soldiers had been killed there. In contrast, a February 2008 poll showed that 52 percent of the German public did approve the German mission in Afghanistan within

<sup>18</sup> "Europeans, Canadians See Afghan Mission as Failure," Angus Reid Global Monitor: Polls & Research, August 27 2007, <[www.angus-reid.com/polls/view/17006/europeans\\_canadians\\_see\\_afghan\\_mission\\_as\\_failure](http://www.angus-reid.com/polls/view/17006/europeans_canadians_see_afghan_mission_as_failure)> (February 13 2007).

<sup>19</sup> *Ibid.*

<sup>20</sup> Pew Global Attitudes Project: Spring 2007 Survey, <<http://pewglobal.org/reports/pdf/256topline.pdf>> (February 13 2008).

<sup>21</sup> "Most Germans want to pull out of Afghanistan-poll," *Reuters*, May 23 2007.

the context of the current UN mandate but 80 percent opposed deploying German troops in the South.<sup>22</sup>

**Table 7.** Should the U.S. and NATO remove their troops from Afghanistan?

	Keep troops in Afghanistan (%)	Remove their troops (%)	Do Not Know/ Refused (%)
U.S.	50	42	7
Canada	43	49	8
Britain	45	42	13
France	48	51	1
Germany	44	49	8
Italy	32	55	13
Spain	22	67	11
Sweden	34	45	21
Bulgaria	21	60	19
Czech Republic	45	45	10
Poland	24	63	13
Russia	12	73	16
Slovakia	29	58	13

Source: Pew Global Attitudes Project: Spring 2007 Survey<sup>23</sup>

The United States and other countries fighting in the South of Afghanistan were putting considerable pressure on Germany to do more in the run-up to the NATO defense ministers meeting in February 2008. A poll that appeared in the *Bild am Sonntag* on February 10, 2008 showed that 81 percent favored German troops withdrawing by the end of 2008. Moreover, roughly half rejected deploying troops in the South even if that put the entire NATO mission at risk. The poll also showed that many Germans did not believe that their troops were properly prepared or equipped to conduct such missions.

### Elite Opinion

Elite opinion remains divided over the Afghanistan mission. For every Klaus Naumann, former head of the German military, who says that the mission must be carried out even against public opinion, there is a commentary that dismisses these sentiments.<sup>24</sup> For example, a recent editorial in the *Sueddeutsche Zeitung* noted: “The main argument is of a political nature. Germany's Bundeswehr is a parliamentarian army; its foreign missions are decided by the Bundestag, where a majority to

<sup>22</sup> Mey Dudin, “Germans Do Not Want to be ‘Shirkers’ - Politicians Point to Bundeswehr Casualties in Afghanistan - Dispute Over South,” February 8 2008.

<sup>23</sup> Pew Global Attitudes Project: Spring 2007 Survey  
<<http://pewglobal.org/reports/pdf/256topline.pdf>> (February 13 2008).

<sup>24</sup> “Press Gloom in NATO states over the Afghan Mission,” BBC Monitoring, February 12 2008.

support a lasting engagement in the South is not in sight.”<sup>25</sup> Stefan Kornelius wrote in the same newspaper: “Germans don’t understand why the Bundeswehr are operating in Afghanistan. Many people are asking themselves what is the aim of the deployment.”<sup>26</sup> Jan Feddersen in the *Tagezeitung* makes a similar point: “The Germans will not want to carry out armed combat in another place, not the Hindu Kush or anywhere else. The imaginary army is too far away.”<sup>27</sup>

The elite has become increasingly disenchanted over the last several years with many predicting the demise of NATO. The crisis over Afghanistan would seem to be just another such crisis and recalls the words of Mark Twain upon reading his own obituary: “The reports of my death are greatly exaggerated.” At the Munich Security Conference on February 10, 2008, the U.S. Secretary of Defense Robert Gates said: “We must not – we cannot – become a two-tiered alliance of those willing to fight and those who are not. Such a development, with all its implications for collective security, would effectively destroy the alliance.”<sup>28</sup>

The U.S. is not alone in criticizing the commitment of the allies. Canada has threatened to withdraw its forces unless other countries within NATO provide another 1000 troops to aid them in the Kandahar province.<sup>29</sup> Canadian Prime Minister Steven Harper said: “NATO’s reputation is on the line here ... all the increasing evidence suggests that NATO’s efforts in Afghanistan as a whole are not adequate, but particularly in Kandahar province.” He added: “For this mission to go forward and achieve its objectives and be successful, we do have the need for a substantial increase in combat troops and particular needs in terms of military equipment.”<sup>30</sup> Moreover, “if NATO can’t come through with that help then I think frankly NATO’s own reputation and future will be in grave jeopardy.”<sup>31</sup>

Certainly, laments that NATO will falter have been occurring since the end of the Cold War. NATO enlarged and became involved in the Balkans, “out of area or out of business.” It fought a war against Serbia and won. But “fighting” a counterinsurgency is quite a different problem

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<sup>25</sup> “No Need to Go South,” *Sueddeutsche Zeitung*, February 5 2008.

<sup>26</sup> “Press Gloom in NATO states over the Afghan Mission,” BBC Monitoring.

<sup>27</sup> *Ibid.*

<sup>28</sup> Robert M. Gates, Speech delivered at the Munich Conference on Security Policy, Munich, Germany, February 1 2008, <[www.defenselink.mil/speeches/speech.aspx?speechid=1214](http://www.defenselink.mil/speeches/speech.aspx?speechid=1214)> (February 14 2008).

<sup>29</sup> David Akin, “Stephen Harper on the Manley Report,” January 28 2008, <[http://davidakin.blogware.com/blog/\\_archives/2008/1/28/3492363.html](http://davidakin.blogware.com/blog/_archives/2008/1/28/3492363.html)> (February 14 2008).

<sup>30</sup> *Ibid.*

<sup>31</sup> “NATO’s Afghan mission ‘in jeopardy’”, CNN, January 29 2008, <[www.cnn.com/2008/WORLD/asiapcf/01/29/afghan.canada/](http://www.cnn.com/2008/WORLD/asiapcf/01/29/afghan.canada/)> (February 18 2008).

– there is a real and not simply a hypothetical prospect that NATO might withdraw and hence lose.

Elite opinion has been particularly harsh, especially since the European countries within NATO have substantial forces but seemingly few that they are willing to deploy. Even more remarkable, they lack the right kind of equipment. Neither of these factors are particularly surprising when we look at European forces more closely. Many of them are, in essence, glorified social welfare programs. A real sign of this is that procurement has taken a second seat to personnel costs.

Small wonder then, that the former Spanish Prime Minister, Jose Maria Aznar called NATO a “zombie organization due to the lack of interest from the U.S. side topped by the lack of commitment from the European allies.”<sup>32</sup> The U.S. lost interest after the Kosovo debacle and did not want another war by committee even though NATO had extended Article 5 protection after 9/11. The rise of the EU as a security organization and the continuing desire to cut back on defense abetted the European lack of commitment. But also, and importantly, the Europeans viewed the terrorist threat differently as more a domestic than international problem. Aznar understands this when he says: “To others in the Alliance, the Islamists, radicals, extremists, jihadists or terrorists, do not represent an existential threat to the Western world. Political Islam is considered a phenomenon to be dealt with by intelligence services and police forces as their members are criminals not fighters or warriors.”<sup>33</sup> But he counters that such a perception is wrong, “terrorism is not limited to just some isolated acts of cruelty and violence. It is something more. It is the tip of the iceberg of a radical and extremist Islam that really forms a kind of global insurgency. It is a global phenomenon to say the least.” Moreover, Aznar says that appeasing the many manifestations of terrorists simply will not work.<sup>34</sup> Indeed this whole notion of whether NATO is engaged in a war is at the whole crux of the problems with securing additional combat troops for Afghanistan, over what strategy to take.

Of course, the Europeans are quite right to fear the enemy within. The attacks in London and Madrid came from local Muslims. But they are quite wrong to view the problem as isolated from the global jihad. European countries have failed to assimilate their Muslim populations and they have strong links to their countries of origin, be they South

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<sup>32</sup> Jose Maria Aznar, Speech At The American Enterprise Institute: NATO: An Alliance For Freedom, November 17 2005, <[www.washingtonspeakers.com/prod\\_images/pdfs/AznarJose.NATOAnAllianceForFreedom.11.29.05.pdf](http://www.washingtonspeakers.com/prod_images/pdfs/AznarJose.NATOAnAllianceForFreedom.11.29.05.pdf)> (February 18 2008).

<sup>33</sup> *Ibid.*

<sup>34</sup> Jose Maria Aznar, Seven Theses on Today's Terrorism, Georgetown University, September 21, 2004, <[www3.georgetown.edu/president/aznar/inauguraladdress.html](http://www3.georgetown.edu/president/aznar/inauguraladdress.html)> (February 18 2008).

Asians in the United Kingdom, North Africans in Spain, Algerians in France or Turks in Germany. Moreover these communities are becoming way stations for mujahideen injured in Iraq.<sup>35</sup> Nor does it appear that these countries have developed an effective counter-terrorism strategy. For a while, France received kudos for its approach but compliments came less readily after three weeks of rioting in many of France's largely Muslim populated suburbs in late 2005.<sup>36</sup> The International Crisis Group did not see the hand of jihadists in these riots, but does see the portents for the future:

As neither political Islamism nor the Muslim youth organisations can organise or mobilise their constituencies any longer, and as the rising religious force, Salafism, has no interest in doing so, a dangerous political vacuum has developed, particularly among the young, idle underclass of the suburbs. As a consequence, political demands increasingly are expressed through jihadi Salafism and rioting, fuelled by precarious living conditions, rampant unemployment, social discrimination and, more recently, the perceived vilification of Islam.<sup>37</sup>

The ICG then goes on to say: "For the West more generally, an effort should be made to seriously address the dramas that help mobilise and radicalise European Muslims – Palestine and Iraq in particular – and that constitute the principal grievance invoked by armed movements, whether or not they actually motivate them."

NATO is a consensus-based organization but there is no consensus about how to proceed with the global war on terrorism, or even if there is such a war. This lack of agreement severely hampers the development of a common strategy in Afghanistan. Differences about how to proceed have become wrapped up in the electoral politics of the countries comprising the coalitions.

For example, the new Australian Minister of Defense, Joel Fitzgibbons, has argued that while NATO may have been successful in "stomping on lots of ants, we have not been dealing with the ants' nest". He continued: "We need much more than a military response. This is largely about winning the hearts and minds of the more moderate of the Taliban and other sections of the Afghan community. We need more political advisers in the civil service. There is no administrative infrastructure. We need more training for the Afghan army and the Afghan police. We need someone there as a senior envoy co-ordinating

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<sup>35</sup> Robert S. Leiken, "Europe's Angry Muslims," *Foreign Affairs*, July/August 2005.

<sup>36</sup> "Timeline: French riots," *BBC News*, November 14 2005

<<http://news.bbc.co.uk/2/hi/europe/4413964.stm>> <February 18 2008>.

<sup>37</sup> "France and its Muslims: Riots, Jihadism and Depoliticisation," International Crisis Group, March 9 2006, <[www.crisisgroup.org/home/index.cfm?id=4014](http://www.crisisgroup.org/home/index.cfm?id=4014)> (February 18 2008).

this overall strategy.” But at the end of the day, Fitzgibbon understands what the real problem is: “We have to hold the will of our constituencies. If we don't do that we will all be packing up and leaving.”<sup>38</sup> Fitzgibbon should know – his Labor party defeated the former Prime Minister John Howard’s Liberal party in November 2008, in part because Howard supported American policy over Iraq. The Liberal leader Kevin Rudd had pledged to remove Australia’s troops from Iraq but remained committed to keeping them in Afghanistan. Fitzgibbon was also sharply critical of the access that Australia had to NATO’s strategy: “This (situation) is unsustainable. As a Government we can't make informed decisions without access to NATO's thinking. We can't maintain public support for our military operations if we are not able to demonstrate we are masters of our own destiny.”<sup>39</sup>

Electoral and coalition politics have also weighed heavily on the approach to Afghanistan in Germany. The Germans have the third largest troop contingent in Afghanistan but they are severely limited in the kind of combat operations they can conduct. Germans continually refer to their mandate and make a sharp distinction between Operation Enduring Freedom and ISAF. Thus Detlef Puhl argues regarding the Tornado aircraft Germany recently deployed to Afghanistan:

In formulating the new mandate for its Tornado aircraft, the German government took great care in insisting upon a clear distinction between the two missions. The reconnaissance aircraft serve the ISAF mission; results of their reconnaissance missions may be shared with OEF forces only if this is critical for the ISAF mission and ISAF forces. "Close Air Support" missions, in OEF operations for example, are explicitly excluded from the mandate.<sup>40</sup>

German think tanks are also sharply critical of the approach taken by the Provincial Reconstruction Teams:

The introduction of Provincial Reconstruction Teams (PRT) has also contributed little towards stabilising and rebuilding the country. While the US regards the PRTs as a means to win over "hearts and minds", German strategy aims to create positive conditions for civilian aid

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<sup>38</sup> Patrick Walters, “NATO must lift game in Afghanistan: PM,” *The Australian*, December 17 2007, <[www.theaustralian.news.com.au/story/0,25197,22934596-601,00.html](http://www.theaustralian.news.com.au/story/0,25197,22934596-601,00.html)> (February 18 2008).

<sup>39</sup> Patrick Walters, “Minister delivers NATO ultimatum,” *The Australian*, February 11 2008, <[www.theaustralian.news.com.au/story/0,25197,23191663-31477,00.html](http://www.theaustralian.news.com.au/story/0,25197,23191663-31477,00.html)> (February 18 2008).

<sup>40</sup> Detlef Puhl, “Afghanistan and NATO - Do the Germans Do Their Share?” AICGS Advisor, February 19 2007, <[www.aicgs.org/analysis/c/puhlo21507.aspx](http://www.aicgs.org/analysis/c/puhlo21507.aspx)> (February 19 2008).

organisations in unsafe regions with the least possible use of military resources.<sup>41</sup>

Moreover, many of the West European countries associated with Provisional Reconstruction Teams have developed a “barricade” mentality. Supposedly, only 10-20 percent of German soldiers ever leave the base where they are stationed.<sup>42</sup> This belies the whole notion of winning the “hearts and minds” of the Afghani people. Thus many Germans sharply distinguish between an ISAF that provides security for reconstruction and an Operation Enduring Freedom intended to fight the Taliban. Unfortunately the distinction is lost on the Americans.

The German Defense Minister Franz-Josef Jung also continues to make these arguments. In an interview in March 2007 he was unwilling to say the Tornados could be used for combat. Instead he said that they were on a “mission for peace.”<sup>43</sup> Jung also acknowledged a problem with “public perception”, that despite press to the contrary much had been accomplished in Afghanistan. In May 2007, Jung took to lecturing the Americans over their tactics. He chastised the Americans for civilian casualties, arguing: “We have to make sure that in the future, operations do not take place in this way. We don't want the population against us. We have to prevent that.”<sup>44</sup> These comments must have struck the Americans as remarkable since they applied to U.S. operations in the South under Operation Enduring Freedom and not to ISAF. The Germans are stationed in the relatively secure North and do not participate in OEF. In October Jung, rejecting calls for more forces at the NATO Defense Ministers meeting in the Netherlands, continued his argument: “We need security and reconstruction and development, that is the wider concept.” He added, “That's why I think these calls simply for more and more military involvement are misguided. We have 3,500 soldiers in Afghanistan and I think our contribution is significant.”

German resistance to more forces and more importantly to a greater combat role for those forces can be traced to electoral fears. The then-Chancellor Gerhard Schroeder is widely perceived to have won the election in 2002 by touting his resistance to American calls for more aggressive action against Iraq. Jan Techau, Europe director at the German Council on Foreign Relations in Berlin, argues: “Merkel is very

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<sup>41</sup> Timo Noetzel and Sibylle Scheipers, „Die Nato in Afghanistan. Das Bündnis und die Grenzen seiner Strategiefähigkeit,“ *SWP-Aktuell*, August 2007, A44, <[www.swp-berlin.org/de/common/get\\_document.php?asset\\_id=4259](http://www.swp-berlin.org/de/common/get_document.php?asset_id=4259)> (February 19 2008).

<sup>42</sup> *Ibid.*

<sup>43</sup> “German Tornados Will Help to Limit Collateral Damage”, *Spiegel Online*, March 9 2007, <[www.spiegel.de/international/o,1518,470674,00.html](http://www.spiegel.de/international/o,1518,470674,00.html)> (February 19 2008).

<sup>44</sup> “German defense minister calls for changes in Afghanistan tactics,” *International Herald Tribune*, May 14 2007, <[www.iht.com/articles/ap/2007/05/14/europe/EU-GEN-EU-Afghanistan.php](http://www.iht.com/articles/ap/2007/05/14/europe/EU-GEN-EU-Afghanistan.php)> (February 19 2007).

afraid of a re-run of the 2002 election.” He added: “Merkel is scared that that kind of campaign could be pulled off again. This is why the Christian Democrats do not want to hand the Social Democrats the peace issue. As each party tries to prove which is the most pacifist, foreign policy is becoming paralyzed.”<sup>45</sup>

The Italians have views similar to the Germans but are even more reluctant to allow their forces to be used for combat or even to come out of their casernes. An article in an Italian newspaper in December 2007 shows yet again that many of the ISAF countries are not prepared to fight.<sup>46</sup> Colonel Alfredo di Fonzo maintained that when his troops come under attack, they are supposed to return fire and back away. He justified this odd tactic by arguing that any other approach would risk civilian casualties and thus play into the hands of the Taliban. His Afghani interviewer, Sa'ad Mochseni, the owner of Tolo TV, met these comments with derision: “The tragedy is that your rules of engagement were established in the calm period which followed the 2001 conflict. Today they are obsolete, the situation on the ground has changed radically. It is necessary to react. The whole ISAF mission is failing. Unless you want more victims, you must actively hunt down the terrorists. Act like soldiers, you can't weep and threaten to withdraw every time one of your men dies!” In the code of the tribes, many of the ISAF troops act like cowards.

The Dutch experience with Afghanistan is also instructive. In 2004, 66 percent of the public approved of sending their troops to Afghanistan, ostensibly to aid with reconstruction. But in January 2006, when the Dutch government decided to send additional troops, only 33 percent of the public approved.<sup>47</sup> The decision to send an additional 1400 troops with six Apache helicopter gunships was particularly controversial because they would go to the unstable and “untamed” province of Uruzgan. In discussing their deployment, the Dutch Defense Minister evoked the black mark of Srebrenica, where Dutch troops stood by while Serbs captured and subsequently killed several thousand of Bosnians. Defense Minister Henk Kamp said: “It's a dangerous mission, the most dangerous mission since Srebrenica.”<sup>48</sup>

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<sup>45</sup> Judy Dempsey, “Merkel's election fears said to drive Afghan troop refusal,” *International Herald Tribune*, February 5 2008.

<sup>46</sup> Lorenzo Cremonesi, “Kabul, Now It's a Real War”, *Corriere della Sera*, December 14, 2007.

<sup>47</sup> “Canadian and Dutch Publics Feeling Stretched by Expanded Military Role in Afghanistan,” Program on International Policy Attitudes, May 26 2006, <[www.worldpublicopinion.org/pipa/articles/brunitedstatescanadara/198.php?nid=&id=&pnt=198](http://www.worldpublicopinion.org/pipa/articles/brunitedstatescanadara/198.php?nid=&id=&pnt=198)> (February 20 2008).

<sup>48</sup> “More Dutch troops for Afghanistan,” *BBC News*, February 3 2006, <<http://news.bbc.co.uk/2/hi/europe/4673026.stm>> February 20 2008.

The Dutch troops have been engaged in some fierce fighting. In September 2006 their base in Kandahar, which they had temporarily taken over from the Canadians, came under attack. Several Taliban were killed but the Dutch suffered no casualties. Even after this attack, the Dutch commander, Colonel Hans van Griensven said: "We're not here to fight the Taliban. We're here to make the Taliban irrelevant."<sup>49</sup> The Dutch supposedly have adopted a variant of what counter-insurgency experts call an "oil spot" approach whereby they work in one area and hope to grow it. At the same time, the Dutch aversion to casualties has not gone unnoticed. "The Dutch, if the fight starts, they run inside their vehicles every time," said one interpreter. "They say, 'We came for peace, not to fight.' And I say, 'If you don't fight, you cannot have peace in Afghanistan.'"<sup>50</sup> This is a common refrain in Afghanistan.

The other side of a reluctance to fight is an excessive use of airpower with a corresponding increase in the likelihood of civilian casualties. For example in the battle of Chora in June 2007, the Dutch conducted their biggest offensive operation since Korea.<sup>51</sup> According to sources, the local Dutch commander decided to proceed without consulting ISAF or the The Hague. Around 500 Dutch soldiers fought against as many as 1000 Taliban and relied heavily on airpower, including Apaches helicopter gunships, F-16's and F-18's. Several dozen Afghan civilians died including 30 Bosnian volunteers who were killed in a friendly fire incident. Opposition parties in the Dutch parliament claimed that many of these deaths were the result of Dutch fires. The UN report concluded that 33 to 88 people were killed and up to a 100 injured, and called for ISAF to reassess its more "heavy-handed tactics".<sup>52</sup>

In October 2007, ISAF launched its biggest offensive yet in Uruzgan. Over 1500 coalition soldiers, including Afghan National Army and Dutch and Australian Special Forces were used to clear the area around Tarin Kowt. In late 2006, Australian Special Forces had cleared the valley but the Taliban had returned. While ISAF has the forces to clear an area of

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<sup>49</sup> C. J. Chivers, "Dutch Soldiers Stress Restraint in Afghanistan," *The New York Times*, April 6 2007.

<sup>50</sup> *Ibid.*

<sup>51</sup> Eric Vrijssen, "Uruzgan: Het gevecht om Chora," Uruzgan Weblog. <[http://oruzgan.web-log.nl/uruzgan\\_weblog/2008/01/uruzgan\\_het\\_gev.html](http://oruzgan.web-log.nl/uruzgan_weblog/2008/01/uruzgan_het_gev.html)>, (February 22 2008). See also, "Over 100 Militants, Civilians and Police Killed In Massive Afghan Battle," *Associated Press*, June 18 2007, <[www.foxnews.com/story/0,2933,284052,00.html](http://www.foxnews.com/story/0,2933,284052,00.html)> (February 22 2008).

<sup>52</sup> United Nations Assistance Mission in Afghanistan, "AIHRC and UNAMA joint investigation into the civilian deaths by the ISAF operation in response to a Taliban attack in Chora district", Uruzgan on June 16 2007, <[www.rnw.nl/ppp/AIHRCChora.pdf](http://www.rnw.nl/ppp/AIHRCChora.pdf)> Uruzgan Weblog, <[http://oruzgan.web-log.nl/uruzgan\\_weblog/fob\\_cobra/index.html](http://oruzgan.web-log.nl/uruzgan_weblog/fob_cobra/index.html)> (February 26, 2008).

the Taliban, it lacks sufficient numbers to hold and therefore it can never get to build.

The Taliban took on what they saw as vulnerable ISAF forces in Uruzgan and Panjwaye. In both cases, they were initially beaten off but returned. Also in both cases, the coalition forces launched even bigger operations with substantially more firepower from artillery and air. For its part, the Taliban realized that they could not mass against the coalition forces and returned to their new tactics of suicide bombing and roadside bombs.

A very similar sequence of clearing without holding and then having to do over again also typifies the pattern of operations for the Canadians in Kandahar. From 2003 to 2005, the Canadians were deployed in Kabul. In 2006, they moved to Kandahar with a battle group of 2300 troops. Like the Dutch, almost immediately they came under attack from the Taliban. In June and July 2006, heavy fighting ensued in the Panjwaye District. Artillery and airpower turned the tide for the coalition forces. Once the battle ended Canadian forces withdrew and the Taliban returned. This necessitated yet another round of fighting in September in the same year between the coalition forces and the Taliban with the Taliban now using conventional tactics. This time the coalition forces finally succeeded in clearing the area. In December, tanks arrived to support Canadian forces in the area.

On February 21 2008, the minority Conservative government in Canada said that the troops will leave Southern Afghanistan by 2011.<sup>53</sup> "We [referring to the Liberal opposition] both agree that Canada should continue the mission until 2011 and [that] we should leave operational decisions to our commanders on the ground in Afghanistan," Prime Minister Steven Harper told the Canadian Conference of Defense Associations in Canada. "Canada will end its presence in Kandahar as of July 2011, completing redeployment from the South by December of that year,"<sup>54</sup> he added. This declaration reflects a compromise with the Liberal opposition which had said that they would vote against an extension of the mandate for the forces to 2009, unless the government had set a clear deadline for the troops to leave by 2011.

For their part, the British forces in Afghanistan have also come under criticism for their strategy, most notably in the town of Musa Qala. In November 2006, British forces reportedly sealed a deal with the local tribal elders in Musa Qala whereby they would withdraw and cease fighting in the area in exchange for the elders opposing the Taliban. At

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<sup>53</sup> "Canada says troops to leave Afghanistan in 2011," CNN, February 21 2008, <<http://edition.cnn.com/2008/WORLD/americas/02/21/canada.afghanistan.ap/index.html>> (February 22 2008).

<sup>54</sup> "PM: Canada To Leave Afghanistan South In 2011," Agence France-Presse, February 21 2008, <[www.defensenews.com/story.php?i=3385605&c=AME&s=TOP](http://www.defensenews.com/story.php?i=3385605&c=AME&s=TOP)> (February 22 2008).

the time a member of the Afghan parliament and former resistance fighter was severely critical: “The Musa Qala project has sent two messages: one, recognition for the enemy; and two, military defeat.” He added: “This is a model for the destruction of the country and it is just a defeat for NATO, just a defeat.”<sup>55</sup>

His premonitions proved correct. By February 2007, the Taleban had retaken the town, which became a center for drug trading in the province. By December over 2000, Taliban were in the village. ISAF forces along with the Afghan National Army retook the village in a fierce battle from December 7-10, 2007.<sup>56</sup>

### NATO Unlikely to do Much more Militarily

Despite continuing prodding by the Americans and threats of withdrawal by the Canadians, Australians and Dutch, the other NATO countries are unlikely to do much more militarily and then only grudgingly as exemplified with the small German increase in the North. The reasons vary but can be summarized as follows. First, most of the European countries are not culturally disposed to military action. Second, it would be irrational for them to do more. Third, the U.S. and Europe have different strategic visions. Fourth, to do more would contradict the European public’s understanding of the situation in Afghanistan and the politicians would be risking defeat at the polls.

Robert Kagan wrote a notorious piece that received considerable press asserting that the Americans are from Mars but Europeans are from Venus.<sup>57</sup> Most of Kagan’s argument was largely based on anecdotal evidence but opinion polls actually provide considerable support for his views. The following two tables (Tables 8 and 9) actually show that the U.S. differs from other countries in terms of attitudes towards the use of force. Fully 55 percent of the American public agree strongly with the statement, “under some conditions, war is necessary to obtain justice.”<sup>58</sup> Another 29 percent agree somewhat. Only 13 percent disagree. In contrast, 60 percent in France and Germany, 55 percent in Italy and 50 percent in Portugal. In contrast, 74 percent in the UK agree, 60 percent in the Netherlands and 46 percent in Poland (a bare plurality). NATO troops from the UK, Netherlands and Poland all have combat troops in

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<sup>55</sup> Carlotta Gall and Abdul Waheed Wafa, “Peace accord in provincial Afghanistan dividing opinion,” *International Herald Tribune*, December 1 2006, <[www.ihf.com/articles/2006/12/01/news/afghan.php](http://www.ihf.com/articles/2006/12/01/news/afghan.php)> (February 25 2008).

<sup>56</sup> “Afghan troops take Taleban town,” *BBC News*, December 10 2007, <[http://news.bbc.co.uk/2/hi/south\\_asia/7135850.stm](http://news.bbc.co.uk/2/hi/south_asia/7135850.stm)> (February 25 2008).

<sup>57</sup> Robert Kagan, “Power and Weakness,” *Policy Review* (June/July 2002), <[www.hoover.org/publications/policyreview/3460246.html](http://www.hoover.org/publications/policyreview/3460246.html)> (February 19 2008).

<sup>58</sup> German Marshall Fund, *Transatlantic Trends 2003*, Topline Data, July 2003, <[www.transatlantictrends.org/trends/doc/2003\\_english\\_top.pdf](http://www.transatlantictrends.org/trends/doc/2003_english_top.pdf)> (February 19 2008).

the South or East of Afghanistan. Moreover, the population in both the UK and the United States are willing to bypass the UN if vital interests are at stake. Thus based on this evidence, the population of Northern European states seem more predisposed to use force than their Southern counterparts. Not coincidentally, these are the same countries that are willing to help out in Southern Afghanistan.

The argument extends as well to countries that are culturally similar to the United States such as the United Kingdom and Australia.

**Tables 8 and 9.**

*16/e. Under some conditions, war is necessary to obtain justice*

	GREAT BRITAIN	FRANCE	GERMANY	THE NETHER- LANDS	ITALY	POLAND	PORTUGAL	EUROPE	U.S.
- Agree strongly .....	35	12	12	22	15	18	16	18	55
- Agree somewhat.....	39	27	27	38	28	28	29	30	29
- Disagree somewhat...	10	28	25	18	20	24	14	21	6
- Disagree strongly.....	13	32	35	21	35	20	36	28	7
- Don't know / Refusal .....	3	1	1	1	2	10	5	3	3
	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %

*16/f. When vital interests of our country are involved, it is justified to bypass the UN (if needed: "vital interest means when stakes are high")*

	GREAT BRITAIN	FRANCE	GERMANY	THE NETHER- LANDS	ITALY	POLAND	PORTUGAL	EUROPE	U.S.
- Agree strongly .....	25	15	14	14	13	12	14	16	36
- Agree somewhat.....	27	22	24	25	25	25	16	24	21
- Disagree somewhat...	22	30	32	34	26	27	23	28	18
- Disagree strongly.....	20	30	27	22	28	17	37	25	20
- Don't know / Refusal .....	6	3	3	5	8	19	10	7	5
	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %	100 %

Source: Transatlantic Trends 2003<sup>59</sup>

Moreover, it is actually irrational for other NATO countries to do more. This argument stems from the fact that the U.S. is providing a social good of global security by acting in Afghanistan in its own national interest. Consider a rich merchant who builds a light house to protect his own ships out of self interest. This merchant cannot prevent the poorer merchants from benefiting from his efforts and each benefits equally. These latter conditions are called non-exclusion and non-rivalness.

<sup>59</sup> German Marshall Fund, Transatlantic Trends 2003, Topline Data, July 2003, <[www.transatlantictrends.org/trends/doc/2003\\_english\\_top.pdf](http://www.transatlantictrends.org/trends/doc/2003_english_top.pdf)> (February 19 2008).

Under these circumstances, the poorer merchants have no incentive to contribute towards the construction or maintenance of the lighthouse. In a similar manner the United States went into Afghanistan out of its own self interest. Indeed the U.S. effectively ignored the NATO's offer to be engaged. Indeed NATO is there in the first place because Germany (and Canada) wanted others to bear the responsibility of the then-UN mission around Kabul. Moreover, the U.S. will continue the fight there because it believes that it is essential to do so. Thus, many European countries perceive that there is very little cost to them if they do not participate. Small wonder that the U.S. has found it so hard to get others to participate.

Today Europe and the United States have decidedly different strategic visions. It was not always thus. The United States has been on the strategic offensive – it would rather take the war to the enemy than have the enemy come to it.

### What is Happening in Afghanistan

Press and NGO reports about the deteriorating situation in Afghanistan abound.<sup>60</sup> American commanders tend to say the situation is improving or at least not getting any worse. For example U.S. General Dan McNeill says that “it's probably stayed about the same,” and says that increase in violence tracks the increase in troops, with approximately 9000 more troops in the country in February 2008 than there were a year ago.<sup>61</sup> Some analysts such as Andrew Cordesman say that the situation is improving in Iraq but not in Afghanistan where the Taliban increased its influence by roughly 50 to 70 percent in 2007.<sup>62</sup> Who's right? In fact, they all are. In certain parts of the country, security is good and reconstruction is improving the day-to-day lot of the average “Afghani.” In other parts of the country, security is indeed bad and getting worse. Moreover, as we indicated above, the increasing use of spectacular attacks by the Taliban through roadside bombs and suicide bombers has led to an increasing perception in the West that Afghanistan is fast becoming a “failed state” as if it were otherwise in recent memory.

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<sup>60</sup> Cf., Paul Richter, “Rice, British confer on Afghan mission,” *Los Angeles Times*, February 7 2008.

<sup>61</sup> Pauline Jelinek, “General Says Afghan Insurgency Steady,” *Associated Press*, February 6 2008, <[http://ap.google.com/article/ALeqM5iWxiu65iLP4CvDJ7BEsBOxu\\_vdwD8UKU74O1](http://ap.google.com/article/ALeqM5iWxiu65iLP4CvDJ7BEsBOxu_vdwD8UKU74O1)> (February 25 2008).

<sup>62</sup> “Cordesman: Despite Gains, Future in Iraq, Afghanistan Remains ‘Uncertain’” *Council on Foreign Relations*, January 14 2008, <[www.cfr.org/publication/15259/cordesman.html](http://www.cfr.org/publication/15259/cordesman.html)> (February 25 2008).

Evidence of the complexity of the situation in Afghanistan can be seen in polls conducted for the Asia Foundation in 2006 and 2007.<sup>63</sup> They found that overall, despite the increased violence in Afghanistan in 2006 and 2007, Afghans remained optimistic about the future direction of the country. In 2007, 42 percent said things were moving in the right direction while 24 percent felt the direction was wrong and remaining 25 percent had mixed feelings. The corresponding figures in 2006 were 44 percent, 29 percent and 21 percent. In other words the situation between 2006 and 2007 remained unchanged.

However, the source of unease did change. Many more people felt in 2007 that security situation was the main reason the country was going in the wrong direction, listed by 48 of those responding to that question. Those who felt that the country was going in the right direction in 2007 cited reconstruction (39 percent) and good security (34 percent). This seeming paradox can only be resolved by looking at the profound regional differences in the country. In the North and Central Kabul area, security remains on the whole good and reconstruction is proceeding apace, whereas in the rest of the country the security situation has begun to deteriorate. An analysis of the perceptions both at the national and local level reveals this pattern. In the North and Central Kabul, people are less likely to list security concerns than those in other sections of the country.<sup>64</sup>

Thus, generalizations about the country as a whole would seem to be inappropriate. The current increase in violence afflicts the Eastern, Southern and Western parts of the country, or areas in which the Pashtuns are in the majority. The Taliban began as a movement among the Pashtuns and their base remains among them in Afghanistan. As we saw above, the recent uptick in violence occurred because ISAF moved into areas where previously the Americans were and no one at all was operating. The Taliban launched offensives against these forces which felt compelled to resort to massive firepower to compensate for their small numbers and unwillingness to take casualties.

Since the Taliban-inspired insurgency has its base among the Pashtuns, NATO will face continuing difficulty in defeating it, especially in the long run. The Pashtun community in Pakistan is just as large in Pakistan as it is in Afghanistan and the border has never been secure. Victoria Schofield has written about the border up to the early 1990s:

By [the] agreement [on the Durand line in 1893] 'tribal territory', as it had been vaguely defined, was cut in two; because of this the border

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<sup>63</sup> "Afghanistan in 2007: A Survey of the Afghan People," *The Asia Foundation*, 2007, <[www.asiafoundation.org/publications/pdf/20](http://www.asiafoundation.org/publications/pdf/20)> (February 24 2008).

<sup>64</sup> Personal analysis based on data provided by the Asia Foundation.

was never a 'frontier' in the accepted sense of the word. It could never be properly sealed, and it made secure those routes of escape which were to plague the British in the first half of the twentieth century, and subsequently the Russians; both were obliged to see fighters come in from one side and flee across the open border to the other. It also sowed the seeds of an embryonic nationalist movement which, on the basis of race and language, would assert its claim to Pashtunistan, the land of Pashtun-speaking peoples.

After the collapse of the Taliban in 2001-2, the leaders reestablished themselves in Pakistan and bided their time. Quetta in particular became a center for Taliban activity. Traveling in Pakistan in 2002, the journalist Elizabeth Rubin "felt as if I were moving through a Taliban spa for rehabilitation and inspiration."<sup>65</sup> The Americans were too focused on rooting out the remaining Taliban and not enough on improving the economic situation. And someone dropped the ball on the poppy crop. The Taliban had outlawed poppies. Poppy cultivation crept back when the Taliban left aided and abetted by the local administration so now it has firmly established itself again. The Taliban currently support and exploit the poppy crop because it helps finance their war against the Americans.

But one of the important keys to solving the Afghan puzzle is the Pashtun community in Pakistan. Any counterinsurgency has great difficulty succeeding, especially in the long run, if the insurgents have a reasonably secure cross-border sanctuary.<sup>66</sup> The Americans realized this which was one of the reasons that they engaged the Pakistan government of Pervez Musharraf. They strongly encouraged him to act against the Taliban in the border areas and financed the frontier troops, up to US\$1 billion a year.<sup>67</sup> But Pakistan had never brought these areas under control. The attacks were half-hearted and the Pakistani government tended to take credit for internecine fighting among the tribes and their allies as evidence of the success of their approach.

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<sup>65</sup> Elizabeth Rubin, "Battle Company is out there," *The New York Times*, February 24 2008, <[www.nytimes.com/2008/02/24/magazine/24afghanistan-t.html?pagewanted=1&hp](http://www.nytimes.com/2008/02/24/magazine/24afghanistan-t.html?pagewanted=1&hp)> (February 24 2008).

<sup>66</sup> Angel Rabasa, et al. *Ungoverned Territories: Understanding and Reducing Terrorism Risks* (Santa Monica, CA: RAND Corporation, 2007).

<sup>67</sup> David E. Sanger and David Rohde, "U.S. Pays Pakistan to Fight Terror, but Patrols Ebb," *The New York Times*, May 20 2007, <[www.nytimes.com/2007/05/20/world/asia/20pakistan.html?scp=1&sq=funding+military+pakistan&st=nyt](http://www.nytimes.com/2007/05/20/world/asia/20pakistan.html?scp=1&sq=funding+military+pakistan&st=nyt)> (February 23 2008); Eric Schmitt, Mark Mazzetti And Carlotta Gall, "U.S. Hopes to Use Pakistani Tribes Against Al Qaeda," *The New York Times*, November 19 2007, <[www.nytimes.com/2007/11/19/washington/19policy.html?scp=2&sq=funding+military+pakistan&st=nyt](http://www.nytimes.com/2007/11/19/washington/19policy.html?scp=2&sq=funding+military+pakistan&st=nyt)> (February 20 2008).

Pervez Musharaff's days appeared to be numbered. His party lost heavily in the recent elections, winning only 40 seats. The two main opposition parties have agreed to form a coalition government. The Pakistan People's party associated with the murdered former Prime Minister Benazir Bhutto secured 88 of the 242 contested seats.<sup>68</sup> Former Prime Minister Nawaz Sharif's Pakistan Muslim League(N) won 66 seats. This election was also seen as a repudiation of the religious parties.

However given the ups and downs of Pakistani's politics, the West should not read this victory of secular parties as an endorsement of the Western approach to dealing with the Islamist forces in the Frontier Areas. Even though support had dropped by half of Osama bin Laden from August 2007 to January 2008, 24 per cent still had a favorable view.<sup>69</sup>

With Musharraf's main support party Pakistan Muslim League(Q) defeated in the recent elections, the civilian government is even less likely to engage in military action and favors negotiations. Thus the new government is unlikely to accept a recent U.S. proposal to step up the use of pilotless drones in the region.<sup>70</sup> In other words, the Taliban will be granted free reign in the border areas.

### What is to be Done?

NATO's approach to Afghanistan appears to be failing at all levels, globally, regionally and locally. The most serious problems are at the global level. Although there is certainly ample evidence that there is a connection between the ungoverned areas in Pakistan and the likelihood of spectacular transnational terrorist attacks on their home soil, NATO countries do not seem to be making the case to their population. Moreover ISAF countries had poorly prepared their population for the likelihood of violence and corresponding casualties in Afghanistan. Rather they sold their deployment of troops to that country as strictly humanitarian ventures. Small wonder that their population feel betrayed and their coalition governments frayed by the relatively small number of casualties they have suffered so far.

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<sup>68</sup> "2008 Elections Results," *Dawn.com*, <<http://dawn.com/events/election08/results/index.htm>> (February 21 2008); "Pakistan parties agree coalition," BBC News, February 21 2008. <[http://news.bbc.co.uk/2/hi/south\\_asia/7257525.stm](http://news.bbc.co.uk/2/hi/south_asia/7257525.stm)> (February 21 2008).

<sup>69</sup> "Pakistani Support for Al Qaeda, Bin Laden Plunges; Moderate Parties Surge; 70 Percent Want President Musharraf to Resign: Results of a New Nationwide Public Opinion Survey of Pakistan before the February 18th Elections," February 2008, <[www.terrorfreetomorrow.org/upimagestft/TFT%20Pakistan%20Poll%20Report.pdf](http://www.terrorfreetomorrow.org/upimagestft/TFT%20Pakistan%20Poll%20Report.pdf)> (February 21 2008).

<sup>70</sup> Eric Schmitt and David E. Sanger, "Pakistan Shift Could Curtail Drone Strikes," *The New York Times*, February 22 2008.

This failure to prepare their public has also worsened the situation in Afghanistan by increasing civilian casualties there. Because they sent small numbers of poorly trained and poorly equipped troops on a difficult mission, they have often had to resort to the extensive, some would say, excessive use of firepower to compensate for their lack of numbers. To be sure, knowing these sensitivities, the Taliban often provoke attacks that they know will lead to civilian casualties.<sup>71</sup>

For their part, the Americans are doing NATO no favors by their continued public criticism of their NATO allies. If the U.S. wishes help in Afghanistan they will have to accept what is on offer. Public criticism only makes the current governments look incompetent and plays into the hands of the opposition parties.

Nor does ISAF seem to have a deep understanding of the intimate connection between the Pashtun areas in Pakistan and those in Afghanistan. The Afghans had warned the Canadians that taking their convoy through the marketplace in Spin Boldak, 100 meters from the Pakistan border, would provoke an attack. In addition there seems to be no effort by the Europeans to engage the Pakistanis. Without efforts to blunt the Talibanization of the border areas within Pakistan, ISAF will be in Afghanistan a very long time.

Nor does ISAF seem to have a clear notion of what to do locally. Part of this confusion can be laid at the feet of the Americans who make a false distinction between counter-terrorism and counterinsurgency that played into European prejudices for “good” humanitarian reconstruction over “bad” combat operations. Without security there can be no reconstruction. German efforts to laud their operations in the North seem all the more forced given the fact they were unlikely all along to face a difficult security situation.

The parade of “wise men” reports that appeared in January and February of 2008 all said that the effort in Afghanistan was under-resourced.<sup>72</sup> The Americans quickly subordinated Afghanistan to Iraq and the Europeans largely put their collective heads in the sand. There were enough troops to “clear,” but never enough to “hold.” Lieutenant-General Michel Gauthier, Chief of the Canadian Forces expeditionary command, said recently:

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<sup>71</sup> Elizabeth Rubin, “Battle Company is out there,” *The New York Times*, February 24 2008, <[www.nytimes.com/2008/02/24/magazine/24afghanistan-t.html?pagewanted=1&hp](http://www.nytimes.com/2008/02/24/magazine/24afghanistan-t.html?pagewanted=1&hp)> (February 24 2008).

<sup>72</sup> Ann Scott Tyson, “NATO's Not Winning in Afghanistan, Report Says,” *Washington Post* January 31, 2008, <<http://www.washingtonpost.com/wp-dyn/content/article/2008/01/30/AR2008013004314.html>> (February 26, 2008); International Crisis Group, *Afghanistan: The Need for International Resolve*, February 6 2008; Senlis Council, *Afghanistan: Decision Point 2008*, February 6 2008.

The 'hold' element of this is particularly challenging," He added. "To hold ground, to make it secure enough, to give the locals and to give international organizations a sense of confidence that it's safe for them to work to make the lives of Afghans better.<sup>73</sup>

But Gauthier also inadvertently also highlighted the other major problem with ISAF, namely, the lack of a clear and coherent strategy.

It really depends on the chain of command in theatre to make those kinds of judgments. Is it more important to have an ability to operate in many different places to disrupt the insurgents? Or is it more important to concentrate forces; be able to hold terrain, to be able to do the three lines of operation in a particular area? More forces give you more options is what it comes down to.<sup>74</sup>

The incoherence in ISAF policy can also be seen in Gauthier's admission that quickly training local militias will not work. Sending the Afghan National Army and the Police along with militia to Zhari and Panjwaii in early 2007 without Canadian supervision only led to failure. At the end of the day, any successful counter-insurgency depends on the locals, but only after they are ready.

So it comes again to the Americans. Unless they are willing to prosecute the war for the long haul, the long war, the Taliban will win yet again – at least in Pashtunistan. The U.S. NATO allies have lost faith in the struggle; their commitment only as good as the last parliamentary confidence vote.

Money can substitute for people. More can be done with the Afghan National Army (ANA) and especially the Afghan National Police (ANP). At the end of the day, the Afghans must claim responsibility for their own security. As the U.S. Counterinsurgency manual says:

Success in counterinsurgency (COIN) operations requires establishing a legitimate government supported by the people and able to address the fundamental causes that insurgents use to gain support. Achieving these goals requires the host nation to defeat insurgents or render them irrelevant, uphold the rule of law, and provide a basic level of essential services and security for the populace. *Key to all these tasks is developing an effective host-nation (HN) security force.*<sup>75</sup> [emphasis added]

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<sup>73</sup> Mike Blanchfield, "Lack of troops slowing Afghan progress. says General," Canwest News Service, February 14 2008, <[www.nationalpost.com/news/world/afghanistan/story.html?id=308955](http://www.nationalpost.com/news/world/afghanistan/story.html?id=308955)> (February 20 2008).

<sup>74</sup> *Ibid.*

<sup>75</sup> Headquarters, Department Army, "Counterinsurgency" Field Manual 3-24, 2007 <<http://www.usgcoin.org/library/doctrine/COIN-FM3-24.pdf>> (February 26, 2008).

The ANA is moving in that direction but has a long way to go. Army Brigadier-General Joseph Votel, Deputy Commanding General for Operations for Combined Joint Task Force 82, is optimistic: “Afghan national security forces remain the centerpiece of the comprehensive security strategy and constantly are improving their capacity to plan and conduct operations.”<sup>76</sup> But the NATO Secretary-General Jaap de Hoop Scheffer is more sanguine. He said recently on Afghan TV: “NATO has, to some extent, fallen short in training and equipping the Afghan National Army. NATO needs to accelerate this process, and to do more for the national army of Afghanistan.”<sup>77</sup> Many of the problems of the ANA can be solved with more finances, something that does not put the ISAF troops at risk. Putting money into the ANA for training, salaries and equipment is probably the best security return for Euro expended.

Such cannot be said for the ANP. There the system is badly broken. The U.S. interagency report on the ANP says:

Nevertheless, ANP’s readiness level to carry out its internal security and conventional police responsibilities is far from adequate. The obstacles to establish a fully professional ANP are formidable. Among them are: no effective field training officer (FTO) program, illiterate recruits, a history of low pay and pervasive corruption, and an insecure environment.<sup>78</sup>

The Americans made a decision to support the ANA rather than the ANP. This appears increasingly to have been a mistake. The ANP remains largely unreformed and poorly trained. Theoretical training in Kabul on basics, *grundlagen*, does not make the ANP better able to conduct internal security. Rather the ANA model of embedding trainers with the units might work, especially if we view the local police more as paramilitary internal security forces. Some efforts could be made in this direction by taking something equivalent to Operational Mentor and Liaison Team (OMTL) embedded with the ANA and use them with the ANP.<sup>79</sup> Unfortunately for many in ISAF, participating in such an OMTL would be even more dangerous and politically unattractive than embedding with the ANA.

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<sup>76</sup> John J. Kruzal, “Combined Forces Disrupt Insurgents, Bolster Institutions in Afghanistan,” January 8 2008, <[www.defenselink.mil/news/newsarticle.aspx?id=48602](http://www.defenselink.mil/news/newsarticle.aspx?id=48602)> (February 26 2008).

<sup>77</sup> Open Source Center, National TV Afghanistan, February 21 2008, as translated in IAP20080222950033, <[www.opensource.gov](http://www.opensource.gov)>.

<sup>78</sup> Inspectors General, U.S. Department of State and U.S. Department of Defense, Interagency Assessment of Afghanistan Police Training and Readiness, November 14 2006. These assessments are still current.

<sup>79</sup> NATO in Afghanistan, Operational Mentor and Liaison Team (OMLT) Programme, (September 2007), <[www.nato.int/issues/afghanistan/factsheets/omlt.html](http://www.nato.int/issues/afghanistan/factsheets/omlt.html)> (February 28 2008).

As far as reconstruction is concerned, quite a lot has been done in secure areas, but reconstruction there is arguably beside the point. Tajiks, Uzbeks and Hazaras are not likely to support the Taliban in any case. Germany may be proud of its efforts in the North of the country but they do not appreciably improve the overall security situation. What is needed is a *clear-hold-build* strategy in the South and many ISAF troops are happy with clear and have given up on hold. Once more, the problem has to do with resources. As U.S. Senator Joe Biden recently said, “We have spent on Afghanistan's reconstruction in six years what we spend every three weeks on military operations in Iraq,”<sup>80</sup> He added, “How do you spell hope in Dari and Pashtu? A-S-P-H-A-L-T.” Moreover, we should all realize that even after all the fighting is done and under the best possible conditions, donors need to be engaged for 15 to 27 years before they can leave.<sup>81</sup>

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<sup>80</sup> John Heilprin, “Biden warns of failure in Afghanistan,” *Associated Press*, February 25 2008.

<sup>81</sup> Satish Chand and Ruth Coffman, “How Soon Can Donors Exit From Post-Conflict States?” Center for Global Development, Working Paper Number 141, February 2008, <[www.cgdev.org/content/publications/detail/15464/](http://www.cgdev.org/content/publications/detail/15464/)> (February 26 2008).

# Kazakh-Chinese Energy Relations: Economic Pragmatism or Political Cooperation?

*Zhanibek Saurbek*\*

## ABSTRACT

This article presents an account and analysis of contemporary Kazakh-Chinese relations in the energy sector as well as the geopolitical and legal dimensions of such cooperation. The current trends and challenges in the energy industry is also analyzed. In order to understand the specific problems facing the two countries on the issue of energy cooperation, this author examines the major legal instruments between the two and describes the peculiarities of Chinese energy policy towards the Central Asian region. The article also tries to define the dynamics of Kazakh-Chinese energy relations and look at the possible implications and involvement of the Shanghai Cooperation Organization and other regulative principles and institutions.

*Keywords* • Energy • Kazakhstan • China • Kazakh-Chinese relations • Oil and gas pipelines

## Introduction

Kazakhstan with its advantageous geopolitical location and vast deposits of oil and gas has become one of the main participants in the huge energy sector in the Central Asian region. This country is a landlocked state and shares borders with Russia, China, Uzbekistan, Kyrgyzstan and Turkmenistan. Traditionally, Kazakhstan has been an ally and more than a partner to Russia since the two countries have the same cultural, ethnic, language and historic backgrounds. However, Kazakhstan has declared a

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“multivectoral” policy<sup>1</sup> which means a willingness to develop and improve strategic, diplomatic and economic relations with the major geopolitical powers in the international arena, namely, China, Russia, the US, Europe and the Muslim world.<sup>2</sup> Within that list, China ranks as one of the highest priorities for Kazakhstan to collaborate with for many reasons.

### Kazakh-Chinese Collaboration

First of all, the two countries have a common physical border and therefore, they are compelled to maintain relations and to cooperate over a host of issues that affect both of them. Today, China holds a lead position among developing countries because of its fast-growing economy. In addition, it is an active and influential player in the world globalization process. Analysts and experts have made propitious forecasts of the growth potential of the Chinese economy.<sup>3</sup> As the Chinese economy grows at a break-neck pace, its consumption and demand for energy grows accordingly. In fact, Chinese demand increased so dramatically during the last decade and this has prompted Western experts to define China as a “new resource warrior”.<sup>4</sup>

The closest energy rich region for China is the Caspian Sea and Russia with its energy resources in the eastern part of the country. Collaboration in the energy sector with the countries of the Caspian region is developing quickly and even aggressively. China’s demand for oil is expected to more than double by 2030. China actively seeks new sources of supply and this has been recognized as the main priority in its energy security policy.<sup>5</sup> It is not only oil, but includes electricity, coal and gas. In this respect, energy resources from Russia, Kazakhstan and Turkmenistan are very important for the Chinese economy because as

<sup>1</sup> Please see for details: Message of the President of the country to the people of Kazakhstan "Kazakhstan - 2030": Prosperity, Security and Ever Growing Welfare of All Kazakhstanis. Astana, October, 10 1997.

<sup>2</sup> *Ibid*, Chapter “Long-term priority 5: Energy resources”.

<sup>3</sup> Please see K. Medlock and R. Soligo “*The Composition and Growth of Energy demand in China*,” *China and Long range Asia Energy Security: an Analysis of the Political, Economic and Technological Factors Shaping Asian Energy Markets*,” Study sponsored by the Center for International Political Economy (James A. Baker III Institute for Public Policy, Rice University, 1999).

<sup>4</sup> “Resource Warriors,” *Asian Wall Street Journal*, July 23 1997.

<sup>5</sup> Please see for more detailed discussion H. Lee and D. A. Shalmon, *Searching for Oil: China's Oil Initiatives in the Middle East*, Environment and Natural Resources Program, Belfer Center for Science and International Affairs, John F. Kennedy School of Government, Harvard University (2007), pp. 1-34.; P. Andrews-Speed, J.X. Liao and R. Dannreuther “Searching for Energy Security: The Political Ramifications of China's International Energy Policy” <[www.gasandoil.com/ogel](http://www.gasandoil.com/ogel)>, *OGEL* , 3, 4 (2005); M. Ögütçü, “China’s Energy Security: Geopolitical Implications for Asia and Beyond”. <[www.gasandoil.com/ogel](http://www.gasandoil.com/ogel)>, *OGEL* 1, 2 (2003).

Christoffersen puts it, “pipelines through China from Central Asia and Russia would help to diversify Northeast Asian energy supply - reducing the region’s dependence on supplies from the Middle East”.<sup>6</sup>

In addressing its energy shortages, one Chinese strategy is to bid for and buy all the energy infrastructures from other countries and become a new, key strategic player in the international arena. In the early 1990s, China was not an active participant in the international energy industry, but the situation has dramatically changed since 1997 when a Chinese national oil company, the Chinese National Petroleum Company (CNPC) made significant commitments to the oil sector of Kazakhstan.<sup>7</sup> Later on, the number of overseas activities soared and China’s energy strategy became a vital and sensitive issue. In 2004, the Chinese signed deals in Chad, Saudi Arabia, Cuba, Yemen, Morocco, Kazakhstan, Peru, Egypt and Gabon. In 2005, contracts were signed in Uzbekistan, Azerbaijan, Kazakhstan, Canada, Mongolia, the Philippines, and Venezuela, while the Chinese failed in their takeover bids for a South Korean refining company and Unocal.<sup>8</sup>

Looking at China’s geographically diversified portfolio, we could say that China searches not only for economically feasible and profitable projects and benefits, but appears to have aspirations to become a global energy player. China’s energy interests and operations are broad and extend all over the world.<sup>9</sup> This process is highly politicized and has great geopolitical significance. In fact, it is important for Kazakhstan to evaluate and appraise China’s energy development tendencies properly, to create a balanced policy towards this country and find an acceptable and convenient form of collaboration. The regularity of official visits between Kazakh and Chinese officials is major evidence of the strong connection between the two countries.

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<sup>6</sup> G. Christoffersen, “China’s Intentions for Russian and Central Asian Oil and Gas”, *The National Bureau of Asian Research Analysis*, 9, 2 (1998), p. 3.

<sup>7</sup> Here is mentioned the purchase of “Aktobemunaigas” company which develops the oilfields in the Aktobe City (Western part of Kazakhstan). More detailed of this company at <[www.cnpc-amg.kz](http://www.cnpc-amg.kz)>.

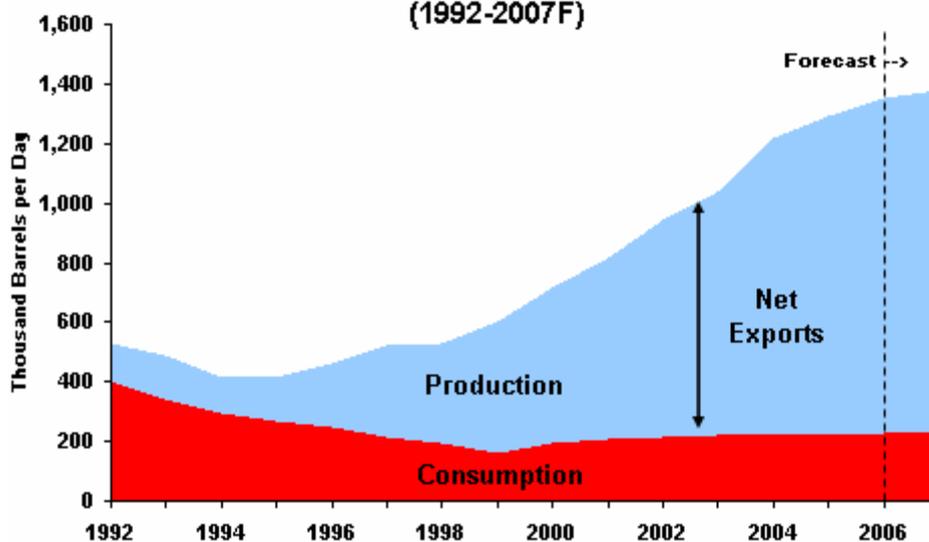
<sup>8</sup> Philip Andrews-Speed, “The Overseas Operations of China’s National Oil Companies”. *OGEL* 3, 4 (2005), p. 1.

<sup>9</sup> For details of Chinese interest in different regions in following articles, refer to: M. Ögütçü and X. Ma, *China’s Quest for Energy Security: the Consolidation of Oil and Gas Supply Links Between China and the Middle East*, *OGEL* 5, 4 (2007); M. Ogutcu. *China’s Worldwide Quest for Energy Security*, (Paris: IEA, 2000); J. Nandakumar, *India-China Energy Cooperation: Attaining New Heights*, *OGEL* 3, 4 (2005).

## Kazakhstan's Hydrocarbons Exports

Kazakhstan, with its vast reserves of oil and gas,<sup>10</sup> and because of its very low consumption of energy, stands as a producing and exporting country to international markets. The abundance of oil produced and the extremely small population of Kazakhstan<sup>11</sup> combined with relatively undeveloped refineries have forced Kazakhstan to seek new, alternative ways to reach potential consumers.

**Figure 1: Kazakhstan Oil Balance (1992-2007F)**



Source: EIA, *Int'l Petroleum Monthly*. Forecast: *Short Term Energy Outlook*

At the same time, the Caspian region, and Kazakhstan, in particular, has a number of problems such as a landlocked geography, which cause serious logistical barriers for the transportation of goods and commodities, including energy. Besides that, the far distance from major consumer centers, constraints of infrastructure, drilling equipment and climatic conditions complicates the development, exploration and transportation of energy. These are the reasons why projects in this region take a significantly longer time to develop.<sup>12</sup>

The hydrocarbons are usually exported in a number of ways -- via pipelines, by rail and by marine transport. Almost the whole oil and gas pipeline network of Kazakhstan was built during the Soviet era and was

<sup>10</sup> According to the *BP statistical review* (2005) Kazakhstan's proven reserves of oil and gas were 39.620 bln. barrels and 105 900 trillion cubic feet accordingly.

<sup>11</sup> The population of Kazakhstan is 15.5 million people. Density of population is about 5,5 people per sq. km. Please see for details the official Statistic Agency data. <<http://www.stat.kz/RU/Pages/default.aspx>> visited February, 2008. In comparison, China with more than 1.2 billion people has a density about 133 people per sq. km.

<sup>12</sup> For an analysis on this issue, refer to: "Unlocking the assets: energy and the future of Central Asia and the Caucasus: a political, economic, and cultural analysis" Baker Institute Study, Published by the James A. Baker Institute for Public Policy, Rice University, April 6 1998, p. 2.

mainly designed for export through the territory of the Russian Federation (Refer to Map 1).

Map 1. Oil transportation routes of Kazakhstan



Source: Presentation by K. Rakhmetova, Head of transportation dept. NOC “Kazmunaigaz” on November 8, 2007 at the conference, organized by Energy Charter Treaty.

Obviously, such dependency on a single country, Russia, could result in potential conflicts or disputes<sup>13</sup> in future. In view of this, Kazakhstan decided to seek alternative routes for its hydrocarbons export, bypassing Russia. However, this decision requires a whole new scale of specific parameters to be developed, such as negotiations with interested parties (including Russia), the conclusion of new interstate/governmental agreements, construction of new infrastructure and perhaps changes to domestic legislation. There are various directions along which Kazakh hydrocarbons can be transported, as stated in Kazakhstan’s Strategy

<sup>13</sup> Russian-Ukrainian gas dispute is a vivid example of such a dependency when economic and legal issues spilled into the political dimension. Please see the description and analysis of it at: Jonathan Stern, “The Russian-Ukrainian Gas Crisis of January 2006,” OIES paper (Oxford Institute for Energy Studies, January 2006); A. Konoplyanik, “Russian - Ukrainian Gas Dispute: Prices, Pricing and ECT,” Russian/CIS Energy & Mining Law Journal, 1, 4 (2006), pp. 15-19; also for Russian-Belarus dispute: Jonathan Stern and Katja Yafimava, “The 2007 Russia-Belarus Gas Agreement,” OIES Comment, January 2007.

2030,<sup>14</sup> among them being through Iran, China and by bypassing Russia into Europe. Pipelines are the most economically effective means for the transportation of hydrocarbons.<sup>15</sup> Thus, the construction of pipelines have been under consideration for long time.

### Energy and Trade between Kazakhstan and China

As mentioned previously, one of those potential routes is towards China. Both Kazakhstan and China, are actively developing mutual relations in a number of sectors. According to the *Kazakhstanskaya Pravda*, a Kazakh newspaper, a total of 105 bilateral agreements and treaties have been signed between the two countries, of which, more than 30 were aimed at regulating trade relations. Among the Eastern European countries and the Commonwealth of Independent States (CIS) members, Kazakhstan is the second largest trade partner to China and there is still a lot of potential for further growth in this sector.<sup>16</sup> The trade balance between the countries was about US\$3.3 billion in 2003. However, it increased rapidly and by 2006, bilateral trade reached US\$8.36 billion, and during first half of 2007, the estimated figure was already US\$5.97 billion; reflecting fruitful cooperation in the economic, trade and transportation sectors.<sup>17</sup> The Kazakh President stated that, “the volume of commodity trade turnover between Kazakhstan and China will reach US\$10 billion in 2007. According to previous plans, this figure was to be reached only by 2010”.<sup>18</sup>

Kazakhstan, without a doubt, factors significantly when China considers its strategic and economic policies. Particular attention has been paid to Kazakhstan’s energy resources and for the right to enter into the Kazakh energy market. This aim was achieved by purchasing a production company, a refinery in the South of Kazakhstan, and the construction of two oil pipelines.<sup>19</sup> According to P. Andrews-Speed, such

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<sup>14</sup> Strategy 2030 or Message of the President of the country to the people of Kazakhstan "Kazakhstan - 2030": Prosperity, Security And Ever Growing Welfare Of All The Kazakhstanis is a conceptual strategy which covers practically all aspects of political, economic and social aspects of Kazakhstan until 2030. This document can be read at the official site of the President of the Republic of Kazakhstan: [www.akorda.kz](http://www.akorda.kz).

<sup>15</sup> For a description of oil and gas pipelines cost-effectiveness compared to other means of transportation, please see the publication of P. Stevens, *Cross-border oil and gas pipelines: problems and prospects*, (Washington, D.C.: ESMAP, 2003).

<sup>16</sup> “Positive dialogue between two neighbours,” *Kazakhstanskaya Pravda*, May 18 2004.

<sup>17</sup> “Chinese President visits Kazakhstan, signs important agreements,” Official news bulletin published by Kazakh embassy in USA and Canada. More information at <<http://www.kazakhembus.com/NB4-200807.html>> (February 1 2008).

<sup>18</sup> *Ibid.*

<sup>19</sup> In fact, CNPC (Chinese National Petroleum Corporation) which won the deal buying PetroKazakhstan for US\$4.2 billion, is also a shareholder of the following companies “CNPC Aktobemunaigas” fourth production company in Kazakhstan; Joint Stock

energy collaboration has many specific characteristics which distinguish it from other economic sectors.

Key among them: (1) the primary energy resources are state-owned; (2) energy is regarded as a vital input to any modern economy and thus, the security of supply is a serious concern to the government; (3) the energy sector dominates the economy with large-scale, capital intensive projects, through a relatively small number of domestic and international companies; (4) the financing of such projects requires the new approach of preparing complicated and developed legal documentation for the parties; (5) the long-distance transportation of energy by pipeline or by wire (for electricity) is a “natural monopoly which gives disproportionate power to the commercial operator, to the supplier of the energy and to any transit state and therefore, such transportation infrastructure is commonly governed by an international treaty.”<sup>20</sup>

All of these components can be applied to Kazakh-Chinese energy context. China has become the second-largest oil consuming country in the world, thus the security of supply is of paramount importance. Kazakhstan is ready to cooperate with China in various energy projects; however, because of the distance involved and location of resources, there is need to construct new infrastructure and to substantially modernize the existing ones. All these would have to occur in tandem with political, legal and economic developments. International treaties are also applicable in this context, since both countries have signed a number of agreements and are members of international and regional organisations such as the United Nations, the Shanghai Cooperation Organization, and both participate in the Conference on Interaction and Confidence – Building Measures in Asia (CICA).

### **The Legal Basis for Kazakh-Chinese Pipelines – Key Points**

From a legal perspective, the energy agreements between the two countries are well-developed. Many documents at the governmental level were signed during the visit in 2004 of the Kazakh President, Mr. N. Nazarbayev, to Beijing. Among them are documents relating to trade-economy, energy, and agricultural relations, as well as the establishment of a Kazakh-Chinese Collaboration Committee to be co-chaired by the Deputy Prime Ministers from each country. These energy sector agreements related to the construction of the Atasu-Alashankou oil pipeline from Western Kazakhstan to the Western part of China, access of Chinese oil companies to Caspian oil development and the

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Company “Munaitas” (Kenkiyak-Atyrau project) and “Kazakhstan-China pipeline” (Atasu-Alshankou project), - 49 and 51 percent of shares respectively.

<sup>20</sup> Philip Andrews-Speed, “Energy Security in East Asia: a European View”, Presented at the Symposium on Pacific Energy Cooperation 2003, February 12-13 2003, Tokyo.

participation of Kazakh oil companies in Chinese oilfields in the South China sea.

The recent construction of the Atasu-Alashankou pipeline is one of the most discussed projects in Central Asia. As reflected in Map 2, it forms part of the chain of a longer and ambitious “Kazakhstan-China” pipeline, which would run from the Western part of Kazakhstan to the Western part of China upon completion. Phase 2 of the pipeline has already been completed while the pipeline for Phase 3, between Kenkiyak–Kumkol is under construction at the moment and expected to be completed at the end of 2009.

The Kazakhstan-China pipeline project is significant for many reasons: it highlighted the observance of the agreements reached between these two states; it contributed to the diversification of Kazakhstan’s hydrocarbon resources through alternative routes; and it resulted in the extension of Kazakh supplies directly to the consumer without transit through a third country. In the long-term it will contribute to the transit potential of Kazakhstan,<sup>21</sup> bolster the regional integration of Central Asia, stimulate the Kazakh economy in terms of development of local infrastructure and the creation of new jobs, etc., strengthen Kazakh-Sino economic relations, and improve a favorable investment climate in Kazakhstan.

Moreover, this project has significant geopolitical and economic sense for both Kazakhstan and China. For Kazakhstan, it is a new milestone for the country to be able to manage such a strategic and significant project independently, without the involvement of third parties, international companies or institutions. As for China, it is also a good experience to carry out such a transboundary project because the Chinese have learnt valuable lessons from this project, which would be useful when it engages Russia in the construction of pipelines between the two countries.<sup>22</sup>

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<sup>21</sup> Here it is worth noting the idea of transport corridor Western Europe –Western China, where Kazakhstan will use its transit potential. Please refer to the article “The Prime-Minister gave two months to make a decision for financing transport corridor Western Europe-Western China” available at <<http://www.kz-today.kz>> (February 1 2008).

<sup>22</sup> Russia has been discussing a China-bound pipeline project nearly a decade or more. Analysis of such a discussion and description of the problem can be found at S. Blagov, “Russia walks thin line between Japan and China,” *Asia Times*, April 28 2005, <[www.atimes.com/atimes/Central\\_Asia/GA05Ago1.html](http://www.atimes.com/atimes/Central_Asia/GA05Ago1.html)>, (February 1 2008).

**Map 2.** Kazakhstan-China pipeline project.

Source: [www.petroleum-economist.com/maps](http://www.petroleum-economist.com/maps)

In order to realize the energy projects between Kazakhstan and China, several agreements were signed. A brief analysis of the most important ones will be provided here so that readers would understand the legal nature of such cooperation between these two countries. Among the first of the vital agreements was the *Common Declaration about basis of friendly relationships between Republic of Kazakhstan and People Republic of China* (1993).<sup>23</sup> This document defined the development of relations on the principles of mutual respect, sovereignty, territorial integrity and other general principles of international law. Specifically, trade-economy issues were denoted, the key ones being in the industry sectors, transport routes, energy (oil, gas and electricity), and space research.<sup>24</sup>

Later, the Agreement on collaboration in oil and gas sector (1997)<sup>25</sup> was concluded between the Governments of Kazakhstan and China. Here it was stated that the development of mutual collaboration between the two countries in the oil and gas sector has significant importance for the further improvement of friendly and neighborly relations, and that it would meet the interests of the people of both states. It was stated in the agreement that the governments of both states will undertake all necessary measures and actions to support and encourage the establishment of direct connections between corresponding agencies,

<sup>23</sup> This Declaration was signed in Beijing, October 18 1993.

<sup>24</sup> Article 5 of the Declaration.

<sup>25</sup> This agreement was signed on September 24 1997.

enterprises and companies; and will research further approaches to develop the oil and gas sector and the extension of its scope. In this document, the parties supported the construction of a pipeline which would connect the Western part of Kazakhstan with the Western region of China. China approved the Chinese National Petroleum Corporation (CNPC) as the company responsible for the construction of a pipeline, the financing arrangements and the preparation of the Technical-Economical Justification of the project. In return, Kazakhstan agreed to provide land lots and construction sites for the construction of a pipeline, guaranteed to provide pipeline security, and also stabilized the export duties for oil and import taxes for the necessary construction equipments.

Analyzing these documents, it should be noted that a legislative basis was formed to realize the project and construct the pipeline itself. Those agreements expressed the political will of the two countries and defined the general principles and rules of construction of such a pipeline. Later, the project was realized at governmental and national oil companies' level. Subsequent agreements were based on the abovementioned documents and developed established principles further.

Later, a whole set of relevant documents were signed, the most notable being The Common Declaration between Republic of Kazakhstan and People's Republic of China of further improvement of all-round collaboration in 21st century (1999).<sup>26</sup> This Declaration confirmed the dynamism in the relationship between the states in different sectors and expressed the wish to improve strategic coordination in all sectors. The collaboration of Kazakhstan and China in the energy sector was mentioned: "Parties aspiring to use the huge potential abilities of a mutual coordination in the energy sector will take common measures to precipitate the preparation of the Technical-Economical Justification of a Kazakh-China pipeline with the purpose of improving collaboration between the countries."<sup>27</sup>

Another very important document regulating Kazakh-Chinese relations in the energy sector is the Programme of collaboration between the Republic of Kazakhstan and People's Republic of China for the years 2003-2008. This document was signed by the President of Kazakhstan, Mr. N. Nazarbayev, and his Chinese counterpart, Mr. Hu Jintao on 3 June 2003. This document declared the strategic importance of collaboration in the energy sector for both states. In particular, it stated the necessity to strengthen the process of collaboration in the oil and gas sectors, and also to make efforts to support and realize the project. In it, it was also stated that the parties will continue to determine the expediency of constructing a pipeline which will connect Kazakhstan with China. In

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<sup>26</sup> The Declaration was signed in Beijing, on November, 23 1999.

<sup>27</sup> Clause 4 of the Declaration.

addition, the parties reached agreement to encourage and support Chinese companies who participate in the development of Kazakh oil resources in the Caspian region.

### **Different but Complementing Goals**

A milestone in Kazakh-Chinese energy transportation relations was the visit of the President of Kazakhstan to China in 2004. This visit activated the processes within the energy sector, and set in motion existing agreements through practical steps. At the same time, agreements were signed between the governments and national oil companies of both countries. These agreements provided a concrete set of actions for the realization of the project, for instance, the establishment of a Project Company, definition of shareholders and their shares in the project, finance, construction, tariffs, etc.

When analyzing the aforementioned set of legal instruments, it should be noted that a legal framework and basis for this particular project, the Atasu-Alashankou pipeline, was created.

It should be noted that while the first commitments were made in 1997, the practical realization of the project only begun after the visit of the Kazakh President to China in 2004. Therefore, the logical question is to ask why the period of realization of such a project is so long and whether this project has been influenced by political motives on top of than economic gains. In fact, the first joint group of Kazakh and Chinese experts<sup>28</sup> produced an unsuccessful report about the feasibility of a Kazakh-Chinese pipeline project in 1998 because of undefined proven reserves of oil and gas onshore in the Caspian region and low prices for oil in the international market. However, many factors changed, resulting in accelerated efforts on both sides to cooperate in the sphere of energy: oil prices have soared in the international markets, the Chinese demand for energy has been growing rapidly since then, the failure of a similar project between China and Russia meant the China paid more attention to make this project succeed,<sup>29</sup> various potential investors (China, the US and Turkey) have visited Kazakhstan and many of them were ready to finance energy projects in Caspian region to acknowledge their “strategic” interests by assuming the political risks, costs of pipeline

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<sup>28</sup> The Chinese National Oil Development Company (CNODC) and the Kazakh National Oil transportation Company “Kaztransoil” (KTO) signed an “Agreement about mutual preparation of technical-economical justification of a Western Kazakhstan-China pipeline” in June, 13 1998 in Almaty. The result was unsuccessful at that stage, that was perhaps why this project was postponed.

<sup>29</sup> The ambitious project Angarsk-Dajin (Russia-China) with Petrochina and Yukos as main parties has not been realized as planned.

infrastructure and other impediments.<sup>30</sup> It was only with such development that the two governments returned to discuss the construction of a pipeline.

Looking at the legal agreements, it should be noted that all agreements apply in one direction only. In other words, all agreements established the right of China to operate in Kazakhstan, to develop production fields, transportation area (construction of pipelines) and provide other advantages. In return, there were no specific terms relating to Kazakh companies' activities within China. This bearing is a reflection of a reality that should be pointed out. There are in fact many similarities between the two countries such as rapid dynamic growth of economy, possession of a large territory and ambitions to be a regional leader. However, both of them have serious distinctions as well. In respect of their mutual relations the countries are in diametrically opposed positions. China is an importer, a consumer with increasing demand for energy; Kazakhstan, is a producer and is considering a partner only for the purpose of diversifying transport options for its hydrocarbons. Hence, their approach to collaboration and objectives for such a partnership is completely opposite. For instance, the Kazakh energy policy established a priority to diversify the resources, search and launch of new alternatives of transportation, whereas the Chinese' main objective is to provide security of supply and feed the growing economy of the country with all possible options. Obviously, the approach and treatment of energy resources is different, because two countries are pursuing the diametrically opposed goals, though the key point to note is that the goals of these two complemented each other, which explains why the project was able to develop in a relatively smooth manner. However, all common energy projects in this region have another important geopolitical component that should to be pointed out, namely, the involvement of Russia.

### **The Russian Dimension**

Kazakhstan is situated between Russia and China. These two states are significant geopolitical powers in the international arena. In fact, the construction of a pipeline bypassing Russian territory is not likely to meet with enthusiastic support but rather with critical and cold comments from the Kremlin. The reason is simple; transportation of oil directly to the consumer substantially reduces the dependency of Kazakhstan on Moscow and weakens the Kremlin's influence in the

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<sup>30</sup> For a comprehensive analysis, see: M. Ogutchu, "Kazakhstan's expanding cross-border gas links implications for Europe, Russia, China and other CIS-countries," *Mineral Law and Policy* (Centre for Energy, Petroleum, University of Dundee, UK) (September 27 2006).

region. On the other hand, Kazakhstan cannot act without being mindful of the Kremlin's geopolitical strategy and plans. Moscow understands all the current economic and political parameters of its allies and neighbors, such as growth of oil production in Kazakhstan, impossibility of transporting extended volumes of oil through the Russian pipeline network, the baffling, complex process to transport it into international consumer markets, the endeavors of Kazakhstan to keep a proper balance between the European Union, the US, Russia and China, peak oil prices and the increased Chinese demand for energy. Moreover, Russia cannot offer any joint projects to realize the transportation of Kazakh hydrocarbons, except of course, the Caspian Pipeline Consortium project.<sup>31</sup>

In addition, there is a so-called "pragmatic approach" in Russia, where they stressed the Russian companies' self-interests as main priority, instead of working to synchronize the economic and strategic interests of two countries.<sup>32</sup>

Nevertheless, the official Kremlin stance has been to accept the collaboration between Kazakhstan and China where Russian companies have also been involved.<sup>33</sup> In this way, Russia seeks to constitute itself not only as a politically dominant power but also as a reliable economic partner and ally. Obviously, this project has multiple geopolitical effects. Besides Russia, Uzbekistan also has a keen interest in Kazakh-Chinese energy relations and wants to join this collaboration since it is now a member of the Shanghai Cooperation Organization (SCO).<sup>34</sup> The recent example is the Kazakhstan-China gas pipeline where Uzbekistan would also be involved as a supplier of gas. Another example is Turkmenistan and its interest to join a Kazakh-China gas pipeline with its gas reserves.

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<sup>31</sup> However, the discussion about extension of the amount of transported oil is not successful at the moment. Information about this particular project can be obtained at the official website of the Caspian Pipeline Consortium <[www.cpc.ru](http://www.cpc.ru)>.

<sup>32</sup> Please see an article by L. Vardomskii, "Kazakhstan-Russia: Competition for 'pipe'", <[www.zakon.kz/our/news/news.asp?id=30101758](http://www.zakon.kz/our/news/news.asp?id=30101758)>, (January 10 2008). Here we can mention Gazprom with its monopoly position and transit and selling of Central Asian gas to Europe on international prices, although the purchase of it by Gazprom carrying out on low prices.

<sup>33</sup> Recently, Transneft (Russian national oil transportation company) has started to transport first amounts of oil through this pipeline to China.

<sup>34</sup> SCO, actually, has transformed its name after admittance of Uzbekistan of Shanghai Five in 2001. A more detailed writeup can be obtained at <[www.sectsc.org/](http://www.sectsc.org/)>. Uzbekistan also has its own energy cooperation with China, For example, the China National Oil and Gas Exploration and Development Corp (CNODC) and Uzbekneftegaz, an Uzbek national holding, signed an agreement on joint prospecting and exploration of oil and gas deposits in Uzbekistan. Please see more details at C. Len, "Energy Security Cooperation in Asia: An ASEAN-SCO Energy Partnership?" OGE, 5, 4 (November 2007).

## Conclusion

We note that political cooperation and the geopolitical interests of both Kazakhstan and China intersect through economic pragmatism and profit gaining. Moreover, we can say that the interests of the two countries are in agreement and a successful collaboration is a result of it. Mutual cooperation has great potential, including within the energy sector, and the proposed Turkmenistan-Kazakhstan-China gas pipeline project is evidence that more could be done in the area of energy cooperation in Central Asia and the energy rich states' diversification strategy. For Kazakhstan, it is important to develop and improve relations with China in a wider multilateral context. It should be noted that Kazakh-Chinese energy relations have evolved from a one-dimensional, trade and energy based affair into a complex partnership that combines growing inter-dependence in various sectors of the economy with the active involvement of border countries.<sup>35</sup>

In essence, this means that these states need to harmonize and synchronize their legislation, particularly, tax, customs, investment and civil laws, and modify national and international policies. Moreover, this process cannot be done in isolation, by excluding other states.

The active involvement of neighboring states and all other interested parties in this process is a necessary factor for Central Asia's resources to be fully reaped.<sup>36</sup> Also, in discussing cooperation within Central Asia, we cannot exclude the Russia's influence. In advocating energy cooperation in Central Asia, Russia would certainly have a role to play. The question is: to what extent and in what form would Russia's participation be? This would primarily depend on: (1) the number of options the energy rich Central Asian states have on the table; (2) how comfortable they are with regards to Russia's involvement in the various projects, and (3) what benefits and value Russia could offer if it becomes a stakeholder in these energy projects.

Future cooperation must be in the following formats. First of all, the creation of a sensible, regulatory, institutional framework governing cross-border energy flows across Caspian states and China, based on a consensus among the stakeholders, needs to be considered. A good example of such cooperation could be the Energy Charter Treaty,<sup>37</sup> which

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<sup>35</sup> Among other vital areas of cooperation are the transboundary water issues between Kazakhstan and China and the TransKazakhRailwayTrunkline Project which will connect China with Turkey, Iran, Turkmenistan and some European countries.

<sup>36</sup> N. Swanstrom, "An Asian Oil and Gas Union: Prospects and Problems," *The China and Eurasia Forum Quarterly* 3, 3(2005), p. 83.

<sup>37</sup> For a general description and analysis of Energy Charter Treaty, please refer to A. Konoplyanik and T. Walde, *Energy Charter Treaty and its role in international energy. Journal of Energy Natural Resources Law (JENRL)* 24, 4 (November, 2006). Also, *The Energy Charter Treaty: an East-West gateway for investment and trade*, (London, the Hague: Kluwer Law International, 1996); T. Walde, "Energy Charter Treaty: selected topics" Centre for

created a balanced and efficient framework for international cooperation, and standards of international rules and principles between the net exporters of energy and importers. It is a more effective form of cooperation rather than bilateral agreements between the countries. This initiative therefore plays an important role in the modern energy industry and “makes a significant contribution to build a legal foundation for energy security, based on principal of open, competitive markets and sustainable development”.<sup>38</sup>

Second, the problems of cooperation can be tackled by specific multilateral organizations such as SCO and others. The SCO is a promising trans-regional organization which could act as a platform to mitigate rivalry and distrust by entrenching interdependent links between member states. Kazakhstan needs to pay special attention to all neighbors, including China which has a capacious and stable market.

Kazakh-Chinese energy relations and the construction of the Kazakh-Chinese pipeline in particular could provide a basis for further collaboration between all Central Asian countries, and between Russia and China. This collaboration should not be limited by energy interests but should rather be treated as a starting point for the transformation towards a complex partnership with the inclusion of substantive and sensitive issues in the region. Successful energy relations are evidence of economic effectiveness and political cooperation between them. These relations are the result of successful cooperation through well-elaborated projects like Aktobemunaigas, PetroKazakhstan, and the Kazakhstan-China pipeline.

The basis for future collaboration has been established and the possible involvement and participation of third countries can be expected. However, the mutual interstate collaboration cannot be limited only by the oil and gas projects, but with other various areas. Among those prospective issues should be international terrorism, trade, transboundary issues, regional integration, migration, environmental regulations, narco-trafficking, money laundering just to name a few. Ultimately, all coordinated actions between the two countries will contribute to economic prosperity and a balanced legal and political policy together with regional energy and political security.

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Petroleum and Mineral Law and Policy Journal, University of Dundee, 1995. Official website <[www.encharter.org](http://www.encharter.org)>

<sup>38</sup> Energy Charter Treaty official website, “About the Charter: Principles and Key dates of the development of the Energy Charter”, <[www.encharter.org/index.php?id=7](http://www.encharter.org/index.php?id=7)>, (January 10 2008).



# Big Business and High-level Politics in Kazakhstan: An Everlasting Symbiosis?

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## ABSTRACT

This article argues that there is a symbiosis between elite business groups and top politicians in Kazakhstan. It suggests a typology for the different kinds of symbiotic relationships that exist and highlights the activities of a number of prominent figures in Kazakhstani politics and economy. The article asserts that the rapidly changing weight and status of big business groupings due to the shifting fortunes of a booming economy may have an impact on politics. Moreover, the underlying dilemma associated with the future transfer of power when President Nursultan Nazarbaev ultimately leaves politics introduces considerable degrees of uncertainty to national politics as well as to the business sector. The result is that even as Kazakhstan appears as a tightly managed democracy, the political system is neither static nor inherently stable.

Keywords • Kazakhstan • Economy • Business • Politics • Interest groups  
• Informal politics

## Introduction

The managed democracies in the post-Soviet area are neither static nor inherently stable. In Kazakhstan, politics are defined by the tight but fluctuating relationships between top politicians and big business groups. Two features constantly inject dynamism and change into this structure. One is the rapidly changing weight and status of big business groupings due to the shifting fortunes of a booming economy; the other is the underlying dilemma and uncertainty associated with the future transfer of power when President Nursultan Nazarbaev ultimately leaves politics.

This article assesses why and how the symbiosis between politics and business is such a central feature of politics in Kazakhstan. It highlights some key characteristics of politics–business links and provides an

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overview of some of the most central business groups. It ends by discussing the prospects for change.

### Key Features of Kazakhstani Politics

Most of the post-Soviet countries have evolved into “managed democracies.” These are countries where “elections are held, but the results are known in advance; courts hear cases, but give decisions that coincide with the interests of the authorities; the press is plural, yet with few exceptions dependent on the government.”<sup>1</sup> The formal political process, in other words, is tightly controlled and managed by the country’s political leadership.

This system is accompanied by a passive electorate and deficiencies in political interest formation. Some exceptions aside, few political entrepreneurs link up systematically with distinct sections of society in order to define grievances or formulate political demands and agendas. A recent survey conducted by the Risks Assessment Group in Kazakhstan found that the population showed scant interest in politics and voiced few political demands towards the government, aside from wanting continued guarantees of economic freedom.<sup>2</sup>

Managed democracy and electoral passivity in Kazakhstan make – aside from a few prominent exceptions – formal politics relatively static, homogeneous and consensus-based.<sup>3</sup> Moreover, the tightly managed formal political process leaves ample scope for informal politics. With few institutional checks on state conduct and with little scrutiny on the part of the electorate, the top political leaders are free to choose which political questions should be openly debated in formal institutions and which should be left as formally undisputable decisions to be taken by themselves. The latter type constitutes a substantial part of government decision making in Kazakhstan – and major informal political battles are played out around these closed decision-making processes. Importantly, these political battles tend to focus on narrow issues associated with

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<sup>1</sup> Perry Anderson, “Russia’s managed democracy,” *London Review of Books*, January 25 2007.

<sup>2</sup> Risks Assessment Group, “Business, society and political elite: partnership or confrontation?” Almaty, June 2007. The research for this report included an expert poll where 85 experts from Kazakhstani political parties, NGOs, business companies and analytical organizations participated.

<sup>3</sup> There are, of course, some exceptions to this. These include the considerable shifts in party politics in recent years with the pro-presidential parties Asar and Agrarian Party-Civic Party Bloc merging with Nur Otan. On the opposition side, among other developments, the moderate opposition party Ak Zhol split in two into “Naghyz Ak Zhol” and “Ak Zhol” in 2005. There are also a number of specific issues where grass-root mobilisation is a key feature and where bottom-up pressure helps propel difficult issues on to the national policy agenda. One such issue is the challenges associated with the shortage in housing in urban areas.

demands and interests of the sole highly politicized group in Kazakhstan – the business community.<sup>4</sup>

Business groupings do not compete in order to ensure that their political ideals are incorporated into state strategies or social development. Rather, the key focus of intra-business elite struggles is on being able to attract attention and recognition from the head of state, seeking to influence the latter in a way favorable to the immediate business concerns of a particular group.

In addition to these surface-level intrigues geared towards eliciting favorable political decisions on issues such as tax and market regulations, at a more fundamental level there is disagreement within the business community over whether today's system, with its peculiar symbiosis between politics and business, should be preserved or changed – and here different business groupings take different positions. This underlying battle has, as will be discussed below, increased in intensity and importance apace with the growing uncertainty over what will happen when President Nazarbaev leaves Kazakhstani politics.

### **The Business – Politics Symbiosis: a Typology**

Observers of business and politics in Kazakhstan stress the central division between big business, with its high profit margins, and smaller business entities, where profit margins are more moderate.<sup>5</sup> In the latter category, businesses operate more or less independent of politics. Admittedly, the smaller businesses face some challenges associated with bribes and government corruption, but on the whole many of these actors are now operating freely and under conditions not unlike those of a fully fledged market economy with fair and equal competition. This is especially true of businesses operating in larger cities like Astana and Almaty.

By contrast, within the category of big business and high profit margins, relationships with segments of the political elite are tight. We argue that the label symbiosis is an appropriate characteristic - where symbiosis is defined as: “a mutually beneficial partnership between... [entities] of different kinds”.<sup>6</sup>

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<sup>4</sup> In this way, from a European perspective, these political disputes appear as disagreements between groups that would in many party-based and democratic political systems have formed part of the same constituency for parties, e.g. the Conservative Party in the United Kingdom or the Popular Party (PP) in Spain.

<sup>5</sup> Interview 12 October 2007, Almaty, deputy country director, deputy chief of party, consultants at Pragma Corporation.

<sup>6</sup> Entry for “symbiosis” in *The Chambers Dictionary* (Edinburgh: Chambers Harrap Publishers, 1993).

To a considerable degree in Kazakhstan, big business is dependent on and vulnerable toward the top political elite. The success and survival of any given business enterprise will hinge on access to government “resources” like licenses for acquiring land and construction permits; sufficient electricity supply; favorable tax arrangements; and, for those businesses that were privatized in the 1990s, continued guarantees of ownership rights.

The institutional environment can easily become challenging for major business enterprises – but good government connections can mediate this. Beyond providing safeguards, close links with the government can also yield considerable benefits. Political connections can be used to produce favorable government regulations and government actions that work to the detriment of competitors (domestic or foreign), distorting market mechanisms to the advantage of the business entity with the most powerful political connections.<sup>7</sup>

For the political leadership there have been important advantages associated with the politics–business symbiosis. By letting big businesses be controlled by a few selected groups with close ties to high-level government officials, the top political leadership has secured for itself considerable indirect control over the economy and the actors in it.<sup>8</sup> In this way, government interferences have not only been motivated by economic greed – they also stem from interests in maintaining maximum levels of political control over politics and the economy alike.

We may identify at least three types of political links that businesses can have to the top political elite.

First, there are companies that do not have any distinct “patron” or affiliation with groups in the government, but which nevertheless have various trusted contacts that on an ad hoc basis may defend the business interests of these companies – in other words, groups that rely on a form of extensive and sophisticated lobbying.

Second, some businesses have what is often referred to as a “roof” (*krysha* in Russian) within the government. This entails protection from one powerful person in the top political circle, someone who has a network of his “own people” in positions further down the government machinery and in a range of government sectors – particularly in tax inspection and the financial police. The business enterprise works closely

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<sup>7</sup> For an excellent account of the relevance of informal government connections in Kazakhstan and the serious effects of government measures on the commercial viability of an oil company, see Kimberly Marten, “Russian efforts to Control Kazakhstan’s Oil: the Kumkol case,” *Post-Soviet Affairs* 23, 1 (2007), pp. 18–37.

<sup>8</sup> Interview, political analyst, Almaty, September 12 2006. Controversies around the Kazakhmys company illustrate the process of “managed privatization” and the deliberate efforts to ensure that owners of the new companies would be loyal to the top political leadership: see “Privatizatsiia Kazakhmysa mozhnet byt’ osporena,” [Disputed privatization of Kazakhmys] *RosInvest.Com*, October 17 2005, <[www.rozinvest.com](http://www.rozinvest.com)>.

with this “roof”, which also takes a considerable cut of the profits. In a few cases these “roofs” will also control several “raiders” – employees in the police or other power structures that can “attack” businesses through intense demands for tax payments or through other types of threats, including physical ones.

Third, a number of businesses belong directly to top-level bureaucrats and politicians, even if they are not formally registered as such. Many top figures have developed business activities as a sideline to their political activities. Moreover, quite a few mid-level government officials and politicians also seem to have been invited or encouraged by the top political leadership in the 1990s to acquire privatized enterprises. Needless to say, these political figures have had ample opportunities to create an institutional environment favorable to their business activities.

Considerable degrees of trust underpin many of the networks and relationships that tie political and business spheres together in Kazakhstan. Kinship relations have been among the important assets that have enabled actors in business and political spheres to generate trust. Other assets utilized have included common educational background, old Soviet communist party or *Komsomol* membership, sport affiliations and army networks. Regarding kinship, even if this is a central feature in many networks, it is a mistake, as argued elsewhere, to see Kazakhstani business and politics as primarily driven by kinship and clan logics.<sup>9</sup>

### **Key Business Groups**

The typology presented above becomes clearer from close examination at some of the most prominent business groups in Kazakhstan today. Below we assess the activities of some of these groups and highlight what kind of links they have with the government.

The Eurasian Natural Resources Corporation, ENRC (formerly the Eurasian Industrial Association, EIA), controls a large share of Kazakhstan’s metal and mining industries. Companies in the group’s portfolio include Pavlodar Aluminium and several chrome-extracting mines and processing sites. Informal estimates put the value of the group’s assets at US\$15 billion. The group was formed by Alexander Mashkevich, Patokh Chodiev and Alijan Ibragimov, and entered the mining and metal sector early in the privatization process of state assets launched under the premiership of Akezhan Kashegeldin in the mid-1990s. ENRC developed tight links with the top political leadership. Some newspapers reported that Alexander Mashkevich, originally a

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<sup>9</sup> See Leila Alieva and Stina Torjesen, “The insignificance of clan in Azerbaijan and Kazakhstan” forthcoming article 2008. For a similar argument see also Barbara Junisbai “Democratic choice of Kazakhstan. A case study in economic liberalization, intraelite cleavage and political opposition,” *Demokratizatsiya*, Summer 2005.

citizen of Kyrgyzstan, was known in the late 1990s in political elite circles as “the family cashier” (*semeinyi kassir*).<sup>10</sup> The dense web of political connections enjoyed by the group became evident when ENRC in 1997 ensured that a foreign co-investor, the Trans World Group (TWG), was forced to leave Kazakhstan. TWG’s departure was mainly due to a set of targeted government measures that rendered the group unable to operate successfully in Kazakhstan. Once TWG was out of the way, ENRC was left with sole control over the joint investment projects.<sup>11</sup>

ENRC seems to have relied on highly sophisticated lobbying efforts aimed at the top political leadership. Some political figures are also believed to have been close associates of ENRC, possibly even serving as “roofs” – although there is not enough information publicly available to back up such an assertion. These top political figures could include the former Governor of Pavlodar province (*oblast*) Danial Akhmetov, later Prime Minister (2003–07) and Minister of Defense (2007–), and, possibly, Nurtai Abykaev, former Head of the Presidential Administration (2002–04) and Chairman of the Senate (2004–2007). In 2000, Danial Akhmetov’s predecessor as Governor of Pavlodar and later leading opposition figure, Ghalymzhan Zhaqiyarov, demanded that there should be a reduction in tax privileges enjoyed by ENRC’s enterprises. At the same time, Kazakhstan’s Prosecutors Office argued for a need to check monetary transactions undertaken by the group since 1997. This campaign against ENRC was, however, never completed and Galymzhan Zhakiyanov was dismissed from his government positions not long after. The present chief executive of ENRC is Dr. Johannes Sittard.<sup>12</sup>

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<sup>10</sup> Andrei Grosin, *Kto est kto v sovremennom Kazakhstane. Zanimatel’no – o klanovykh gruppировkakh* [Identifying the persons in modern Kazakh clans] (Instituta Stran SNG Moscow, 2005) p. 3.

<sup>11</sup> TWG provided some of the initial financing to ENRC’s business initiatives. TWG and ENRC therefore appeared as joint owners of companies operating in Kazakhstan’s metal and mining sector. ENRC was involved in a major business dispute with TWG in 1997–1999, which was taken to the High Court of the British Virgin Islands, where some of the joint ENRC/TWG firms were registered. The legal case in 1998 concerned five metal plant facilities: the Aksu ferro-alloys plant, the Aktubinsk ferro-alloys plant, the Donskoi Mine, the Pavlodar Aluminium plant and the Sokolovsky iron ore mine and plant. The High Court issued a ruling largely supporting TWG, but the political leadership in Kazakhstan continued to assist ENRC. Resolutions in Kazakhstan anti-monopoly committee as well as rising transport prices for raw material transportation challenged the activities of TWG. ENRC in turn successfully removed TWG from Kazakhstan’s mineral and mining sector. See “It’s lawyers at dawn in the wild east,” *The Guardian*, March 1 2000.

<sup>12</sup> Dr Johannes Sittard is former chief operating officer of Ispat International owned by ArcelorMittal Steel (now Arcelor Steel) and was in charge of the acquisition of the Karaganda Metallurgical Works (Kermet). In an interview for the BBC programme “Money” (broadcast July 24, 2002) Sittard seemed to confirm that Ispat had paid an intermediary company linked to the ENRC group a considerable sum of money “because it was very important to get help with the local authorities and the tax issues”. Dr Sittard

ENRC, like many of the other larger industrial groups in Kazakhstan that emerged in the 1990s, is in a vulnerable position due to the lack of transparency that surrounded its acquisition of key assets in the privatization process. This makes the group dependent on political support from the country's top leadership, backed up by continued informal political (rather than institutionalized and legal) guarantees that the privatization deals will not be re-assessed. ENRC therefore has an interest in preserving the political status quo, and has taken considerable measures to support President Nazarbaev. In November 1999, Alexander Mashkevich founded a pro-presidential party, the Civic Party, which later merged with the Agrarian Party to become the Agrarian Party-Civic Party Bloc. In December 2006 the Agrarian Party-Civic Party Bloc merged with President Nazarbaev's party Nur-Otan.<sup>13</sup>

The business holdings of *Timur Kulibaev* constitute another major economic cluster in Kazakhstan. Kulibaev has, according to *Forbes Magazine*, a personal fortune of US\$2.1 billion, and he is strongly associated with Kazakhstan's fourth largest bank "Halyk" (estimated assets US\$7 billion).<sup>14</sup> He has a close relationship to the President of Kazakhstan through his marriage to one of Nazarbaev's daughters, Dinara, and this gives him a unique and privileged position among the top business figures in Kazakhstan. Kulibaev has not held political posts in the government, but has occupied several important economic positions. Recent posts include deputy CEO of the major state holding firm Samruk and chairman of the board in the state oil company KazMunaiGas. Kulibaev is believed to have pursued a strategy of deliberately, strategically and successfully placing loyal individuals in the state apparatus, development institutes, oil industry and private businesses. Various private companies have also, periodically, informally aligned themselves with Kulibaev.<sup>15</sup> This gives him a position similar to that of a "roof", although he does not have the same dense network of contacts in the law enforcement structures that other "roofs" may have and he does not formally belong to the top political leadership of the country. Kulibaev was removed by President Nazarbaev as head of Samruk in August 2007, but Kulibaev still maintains a considerable reputation and status in Kazakhstan's business and policy circles. He now serves as the chairman of the KazEnergy Association – an association

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later left Ispat in favour of the job as Chief Executive of ENRC, see <<http://news.bbc.co.uk/2/hi/business/2146757.stm>> (April 14 2008).

<sup>13</sup> Ryan Kennedy, "Consolidation of political parties strengthens president's hand," *Central Asia-Caucasus Analyst*, January 24 2007.

<sup>14</sup> See: *Forbes* website, <[http://www.forbes.com/lists/2007/10/07billionaires\\_Timur-Kulibaev\\_9QF5.html](http://www.forbes.com/lists/2007/10/07billionaires_Timur-Kulibaev_9QF5.html)> (April 14 2008).

<sup>15</sup> Interview, Almaty, October 15 2007, with representative of a Kazakhstani oil industry interest group.

consisting of the major foreign and local oil companies operating in Kazakhstan.

Timur Kulibaev's considerable standing at the time of writing this article (autumn/winter 2007) contrasts sharply with the recent fate of another presidential son-in-law: *Rakhat Aliev*. Previously married to Nazarbaev's eldest daughter Dariga Nazarbaeva, he served as Deputy Head of the National Security Council 2000 to 2001 and later Deputy Foreign Minister.<sup>16</sup> While heading the National Security Council Aliev established a sophisticated network of loyalists in the law enforcement structures and is believed to have had links with a number of "raiders".<sup>17</sup> When Aliev was at the peak of his power in the early 2000s he seems to have been one of the central "roofs" in Kazakhstan, with substantial influence in security branches of the government and in key business sectors. Following a complex set of political intrigues and his divorce from Dariga Nazarbaeva in 2007, Rakhat Aliev has fallen out of favor with President Nazarbaev. Employees loyal to him in the law enforcement have been removed; he is wanted by Kazakhstani police; and his economic assets have dwindled.<sup>18</sup> Nurbank (valued at US\$700 million) with which Aliev had been closely associated, experienced (temporary) moves by major clients to terminate their accounts in efforts to distance themselves from Aliev.<sup>19</sup> The severe economic consequences that Aliev's political downfall have entailed for him personally stand as powerful testimony to the way informal political arrangements underpin economic activity in Kazakhstan. In 2008 Aliev was convicted in absentia for allegedly having "stolen from the state" and "led an organized criminal group" while serving as a high ranking government official.<sup>20</sup>

The above groups are characterized primarily by a mix of two types of government-business relations mentioned earlier: "roofs", and government officials owning businesses directly. The two final groups we will highlight in the following are, by contrast, best described as relying on the third type of government-business relationships: sophisticated lobbying. The patron of one of Kazakhstan's largest banks Kazkomertsbank, *Nurzhan Subkhanberdin*, was previously linked with Timur Kulibaev, but is now thought to be operating more independently. Kazkomertsbank, valued at US\$7 billion, is a central financial institution

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<sup>16</sup> For a discussion of Aliev's performance and political agenda while in the National Security council see IWPR "Rakhat Aliev – crime fighter," RCA no 15, August 11 2000.

<sup>17</sup> Muhamedjan Adilov, "The criminal network of Rakhat Aliev," *Respublica* (newspaper), June 15 2007.

<sup>18</sup> Iskander Amanjol, "Division of empire of former son-in-law," *Svoboda slova* (newspaper), May 24 2007.

<sup>19</sup> "What happened with the banking system of Kazakhstan?" <www.Kub.kz>, May 16 2007.

<sup>20</sup> Bruce Pannier, "Kazakh President's Ex-Son-In-Law found guilty of coup plot," RFE/RL March 28 2008.

and large-scale investor in major business enterprises not only in Kazakhstan but also increasingly elsewhere in the Commonwealth of Independent States. In Kazakhstan, its extensive investment portfolio has ensured that the bank serves as one of the cornerstones of the national economy.

In the 1990s several close affiliates of Subkhanberdin in the government, in addition to Timur Kulibaev, might have offered “roof-like” protection for Kazkomertsbank’s activities – although Kazakhstani observers consider the banking sector to be the most transparent and best regulated sectors in Kazakhstan, thereby reducing the potential scope, role and need for “roofs”.<sup>21</sup> Former Deputy Prime Minister Oraz Zhandosov and former Minister of Labour and Social Protection Alikhan Baimenov were among Subkhanberdin’s close associates, but these withdrew from the government and formed the opposition party Ak Zhol in 2002.<sup>22</sup> This left Kazkomertsbank with less firm backing from central personalities and cliques within the government. Today, Kazkomertsbank’s relations with the government elite are most appropriately labeled as sophisticated and ad hoc lobbying. Interestingly, the bank’s success has also given it considerable independent power and leverage vis-à-vis the government. Its central position in the national economy means that the country’s economic well-being is dependent on Kazkomertsbank performing well – and this reduces the scope for the political elite to put pressure on the bank.

The second group that relies predominantly on lobbying is Bank TuranAlem (estimated value US\$7 billion) and its patron *Mukhtar Ablyazov*. Ablyazov was Minister of Energy, Industry and Trade in 1998–99, but then left the government structures and actively supported the political opposition. Ablyazov was imprisoned briefly in 2003 on charges that seemed politically motivated, possibly stemming from his membership (2001–03) in the “politsoviet” of the opposition party Democratic Choice of Kazakhstan and his alleged financial support to anti-government political groups in Kazakhstan. Head of the board of directors of Bank TuranAlem since May 2005, he has been closely involved with the bank ever since it was founded. There have been persistent rumors in Kazakhstan that Bank TuranAlem has continued to serve as a source of funding for anti-government NGOs and political parties.<sup>23</sup> The anti-government profile of the Bank TuranAlem group makes any close ties to the top political elite within the government difficult, so it seems unlikely that the group relies on “roofs” within the government. In this respect, TuranAlem shows that some large business

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<sup>21</sup> Interview, political analyst, Almaty, October 11 2007.

<sup>22</sup> Grosin, *Kto est kto v sovremennom Kazakhstane.*, p. 5.

<sup>23</sup> Zamir Karajanov, “The prospects of the Kazakh opposition,” *Svoboda slova* (newspaper), August 3 2006.

actors can operate in Kazakhstan without “protection” or indirect ownership by government bureaucrats – and instead rely predominantly on ad hoc lobbying on specific issues. Like Kazkomertsbank, the sheer size and centrality of this bank in the national economy provide protection against overly destructive government interference and grant it some measure of independence.

### **An End to the Business–Politics Symbiosis?**

The typical perception among political observers in Kazakhstan has been that President Nazarbaev has carefully managed a complex system of competing groups, where his key aim has been to ensure that no one player becomes too big or too threatening politically. He is seen as an arbitrator who has skillfully ensured a balance of power between the major business groupings.<sup>24</sup>

Nevertheless, in a booming economy the structure is becoming increasingly complex – with intense and changing dynamics and new players constantly emerging. Some observers see President Nazarbaev now as reactive rather than pro-active in maintaining and manipulating the balances among the big groupings. This raises the question of whether the system of symbiotic business/politics groupings has become impossible to govern.

Moreover, the certainty that the ageing President Nazarbaev will have to be replaced sometime in the foreseeable future introduces profound uncertainty to the system – since having good links to the top political officials may no longer be a sufficient guarantee for economic safety in the long run. When Nazarbaev leaves, new key political figures will emerge – and none of the business groups can really be sure of whether their political contacts will remain well-placed. In fact, there are indications that most businesses would actually prefer *not* to have a system based on informal political contacts and networking.<sup>25</sup> It is now perceived to be safer and preferable simply to run a clean and legitimate business that does not require large-scale political engagement. Business actors today seem to want more transparency and clearer rules of the game.

Barbara Junisbai (2005) has highlighted how in the autumn of 2001 the controversy over the privatization of Halyk Savings Bank and government pressure on Mukhtar Ablyazov’s business activities triggered a political mobilization of some segments of the business elite. The demands put forward by this mobilized group included calls for better economic governance and a halt to the unchecked actions of law

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<sup>24</sup> Interview, political analyst, Almaty, October 16 2007.

<sup>25</sup> Risks Assessment Group, “Business, society and political elite.”

enforcement agencies.<sup>26</sup> Junisbai notes that the challengers, “sought to restructure the political game in such a way that fair, more transparent rules would govern to protect their business interests and curtail the presidential family’s ability to monopolize the country’s banking and business sectors.”<sup>27</sup> This mobilization resulted in the formation of two political parties: the Democratic Choice of Kazakhstan (DCK), the more radical of the two, and Ak Zhol. The two parties attracted prominent businessmen and high-level government officials sympathetic to the reform agenda. The two parties were forceful political players in the immediate years after 2001, but government pressure and internal splits ensured that the two movements eventually lost their momentum. Nevertheless, this mobilization – albeit temporary – of reform-friendly segments of the Kazakhstani business elite is strong evidence of the underlying tensions in the country’s business and politics. As Junisbai asserts: “...economic liberalization, escalating competition among economic elites for their share of the economic pie and their growing instrumental commitment to the rule of law seem to be the source of genuine political change.” For the time being, the Nazarbaev presidency has weathered the storm caused by the challenger Ak Zhol and DCK, but there is no guarantee that similar intra-elite struggles will not erupt in the future.

At present, however, Kazakhstan is trapped: On the one hand a significant cohort of the business elite wants to push for greater transparency, less informal dealings and less meddling in business by politics and vice versa. But, given the repercussions suffered by DCK and Ak Zhol supporters, these players are well aware of the difficulties they will encounter in the short run if they advocate “open rules”. This might be interpreted as a challenge towards the government, and may jeopardize the required short-term political favors and positions now needed by specific businesses to operate. In turn, many business actors continue to nurture their symbiotic relations with government insiders – although the prospect of political reshuffling when President Nazarbaev leaves the political scene has introduced a new degree of uncertainty into these relations.

Moreover, smaller-scale, more moderate challenges to the informal dealings in politics and businesses in Kazakhstan have persisted. A recent example is the activities of the Association of Oil and Gas Contractors of Kazakhstan. This is an organization that, aside from protecting the interests of local contractors vis-à-vis multinational oil companies, advocates better regulation and greater transparency by the government. In October 2007 the organization voiced open criticism against the

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<sup>26</sup> Junisbai, “Democratic choice of Kazakhstan”, p. 5.

<sup>27</sup> *Ibid.*, p. 6.

government for its management of the oil industry.<sup>28</sup> Many of the over 100 members were hesitant as to whether “going public” with their criticism was the right strategy, since it might endanger their informal contracts with government officials. In the end, however, the leaders of the association decided they were strong and independent enough to put forward the criticism.<sup>29</sup> Such small-scale and issue-specific challenges seem set to continue in Kazakhstan. Moreover, the prospect of WTO membership for Kazakhstan could also provide an impetus for limited and gradual reform in certain economic sectors.

## Conclusion

Political arrangements in today’s Kazakhstan are unsustainable, and changes can be expected in the informal approach to doing politics and big business, from the next five to ten years and onwards. On the other hand, the present consensus among the elite now seems to focus on change through evolution – and this makes it unlikely that alterations in the mode of operation of the top political and economic elite will be a factor that triggers large-scale popular mobilization and political upheaval. We have in recent years witnessed different kinds of power transfers unfolding in different parts of the post-Soviet space, ranging from, among others, the relatively orderly change of guards in Turkmenistan after President Saparmurat Niyazov’s death to revolutionary change in Ukraine. Business groups are likely to have played prominent parts in these power transfers – and the business sector certainly seem poised to do so in Kazakhstan as well when the time comes. While prediction is impossible, for Kazakhstan a relatively orderly succession by a chosen “heir”, seems, at present at least, to constitute the most likely scenario.

Nevertheless, the situation in Kazakhstan does raise the overarching question as to whether the post-soviet managed democracies can continue being “managed” when the economy is booming. New economic players constantly emerge – how can these be accommodated, let alone controlled, politically? Lilia Shevtsova offers an interpretation of Vladimir Putin’s presidency, which shares a number of features with common characterizations of President Nazarbaev’s rule, Shevtsova notes: “[Putin] has created a ‘spider-web’ of various clans and interest groups...Putin creatively used the infighting between these groups to prevent any one clan from being able to monopolize power”.<sup>30</sup>

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<sup>28</sup> “Agip kochevriazhitcia, a KMG besdeistvuyet,” *Zona Kz*, October 8 2007 <[www.zonakz.net](http://www.zonakz.net)>

<sup>29</sup> Interview, Almaty, October 15 2007, with representative of a Kazakhstani oil industry interest group.

<sup>30</sup> Lilia Shevtsova, “Vladimir Putin” *Foreign Policy*, 164 (January-February 2008).

Azerbaijan also offers an interesting parallel to the situation in Kazakhstan: the Azerbaijani economy is dominated by a small number of oligarchs and their patronage network. These oligarchs have considerable personal loyalties to President Ilham Aliev and the president bases in large parts his political power on informal ties to these strongmen.<sup>31</sup> Yet, Azerbaijani politics and the economy are becoming increasingly complex in conditions of double digit growth figures. An increasing plurality of economic players may result in a plurality of political players.

The informal “spider webs” of power and interest groups in the post-soviet managed democracies seem, when put under close scrutiny, fragile and difficult to administer over the long term. Managed democracies, in other words, may not be as stable as their carefully constructed facades indicate.

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<sup>31</sup> Alieva and Torjesen, “The insignificance of clan in Azerbaijan and Kazakhstan,” forthcoming article 2008, p. 36.

## Submission Guidelines and Process of Selection

Many of the articles are solicited, but authors are encouraged to send their work directly to the Editor who will suggest changes and determine the relevance of the articles for each issue. Articles can also be sent to any of our senior advisors, but the Editor has full responsibility on accepting or refusing individual articles. Shorter articles will be responded to within a week, whereas the response to longer analytical pieces could take up to three weeks. Some articles will be dealt with by the editors immediately; most articles are also read by outside referees. Copyright of articles remains with *Central Asia-Caucasus Institute and Silk Road Studies Program*, unless another agreement has been reached.

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**Regular Articles:** Articles should be in-depth and offer a long-term analysis of the particular problem. References are preferred to support your evidence according to the Chicago system. The articles should aim at 7000 words. Each article should be summarized in an abstract of not more than 150 words and include keywords.

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**References.** All authors should adhere to the Chicago reference system in their articles. These should appear in the form of footnotes. References to books and articles should be contained in the notes and not in a separate reference list. Provide translations of non-English language titles.

Articles from Journals: Phil Williams, “Transnational Criminal Organizations and International Security,” *Survival* 36, 1 (1994): 96.

Books: Patrick L. Clawson and Rensselaer W. Lee III, *The Andean Cocaine Industry* (New York: St. Martin’s Press, 1998)

Newspapers, News-agencies & Magazines: Toby Harnden, “Drug Trade ‘Reaches to Afghan Cabinet,’” *Daily Telegraph*, February 5 2006.

Electronic Sources: George Bush, “Principles of Ethical Conduct for Government Officers and Employees,” Executive Order 12674, April 12 1989, pt. 1, <[www.usoge.gov/exorders/eo12674.html](http://www.usoge.gov/exorders/eo12674.html)> (October 30 1997).

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**Figures & Tables.** All figures and tables must be discussed or mentioned in the text and numbered in order of mention. Define all data in the column heads. Figures and tables should be of good quality, and contain full references to the original source.

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