

# How Sanctions Against Russia Affect Central Asian Economies

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The full-scale military invasion of Ukraine by the Russian armed forces and the subsequent series of unprecedented sanctions adopted by Western countries against Russia have led to significant economic consequences not only for herself but also for the whole world, especially for the former Soviet republics which have closest economic and political ties with this country.

## Primary consequences

First of all, it is necessary to distinguish between negative and positive, as well as short- and long-term impacts among these consequences. Moreover, the effect does not much depend on whether the country is a member of the Eurasian Economic Union (Kazakhstan and Kyrgyzstan) or not (Uzbekistan, Tajikistan, and Turkmenistan). In almost all of these countries, Russia is the leading trading partner and one of the most prominent investors. At the end of 2021, the trade turnover with Russia was in Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan in leading positions, 24%, 32%, 21%, and 18%, respectively. Therefore, the state of the Russian ruble could not but affect the national currencies of these countries.

**Table 1. External trade turnover of Central Asian countries by the end of 2021<sup>i</sup>**

	Kazakhstan		Kyrgyzstan		Tajikistan		Uzbekistan	
	bn USD	%	bn USD	%	bn USD	%	bn USD	%
Total turnover	101.5		7.2		6.4		42.1	
with Russia	24.2	24%	2.3	32%	1.4	21%	7.5	18%
with China	18.2	18%	1.5	21%	0.8	13%	7.5	18%
with Kazakhstan	-	-	1.1	15%	1.2	18%	3.9	9%
with Turkey	4.1	4%	0.7	10%	0.4	6%	3.4	8%

The most immediate impact the sanction-caused deterioration of the economic condition in Russia had on the Central Asian states' financial and banking spheres. Much less massive sanctions adopted by the West against Russia back in 2014 had seriously affected the ruble exchange rate - it then fell by almost half against the US dollar, forcing the Central Bank of Russia to significantly raise its interest rate, which, in turn, severely limited the access of businesses and citizens to bank loans. As a result, economic growth slowed down considerably, leading to a long stagnation of the Russian economy and causing, along the chain, similar problems in Central Asian countries. For instance, the Kazakh national currency, tenge, was also in free fall while inflation rose sharply.<sup>ii</sup>

This time, after the adoption of the first packages of sanctions, the Russian ruble had also immediately collapsed, falling from 80 to 120 against the US dollar. But shortly after, the Central Bank managed to stabilize the ruble by raising the interest rate to 20% (a bit later, this rate was reduced to 17%)<sup>iii</sup> and by restrictions on the conversion and export of foreign currency from the country. A radical reduction in imports, caused by the disconnection of Russia from the SWIFT<sup>iv</sup> and measures to restrict Western exports to it, also worked toward returning the ruble exchange rate to its pre-war status. However, despite the stabilization of Russia's financial and banking sector, commercial credit has again become unaffordable for businesses and citizens. As a result of the sanctions, Russia's GDP is expected to drop by 8.5% this year.<sup>v</sup>

The short-term depreciation of the ruble also, as in 2014, led to a sharp drop in exchange rates of the national currencies in Central Asia, too, for example, in Kazakhstan - by 22%, Kyrgyzstan - by 24%, Tajikistan - by 15%, and Uzbekistan - by 7%. Likewise, following the stabilization of the Russian ruble, the courses of these national currencies were soon restored, but not completely. As of April 20, the exchange rate of the Kazakh tenge is still lower than its pre-war status by 4%, the Uzbek soum - too, and the Tajik somoni - by 11%.

The exchange rates of the central Asian countries were affected by the fact that the economies of at least Kyrgyzstan, Tajikistan, and Uzbekistan are dependent on remittances from labor migrants most of whom work in Russia. Since Moscow has introduced significant commissions and restrictions on the purchase and export of US dollars, labor migrants have no choice but to transfer their incomes to their homeland in Russian rubles, which led to an oversupply of this currency in the local currency markets, especially as the migrants and their families prefer to eventually transfer their income into a more reliable dollar equivalent.

### **Decrease in income from labor migrants**

In addition to the short-term impact of sanctions on the Russian economy and, through this, on the economies of the Central Asian countries, there is and will continue to be an increasing effect of longer-term implications caused by the expected recession in Russia. This recession will negatively impact the incomes of labor migrants and the state of Central Asian countries' foreign trade.

For example, in Uzbekistan, remittances from labor migrants reached \$7.6 billion in 2021, mainly from Russia, constituting 11.6% of the country's GDP. In Kyrgyzstan and Tajikistan, this share is even higher - 27.8% and 30.1%, respectively<sup>vi</sup>. But now, the World Bank forecasts a decrease in income from migrants this year in Kyrgyzstan - by 33%, Tajikistan - by 22%, and Uzbekistan - by 21%.<sup>vii</sup>

A significant proportion of migrants from the region have been employed in Russia's massive and, until recently, rapidly developing construction sector. Now that mortgages are becoming too expensive for Russians, a production decline in this sector is likely expected. This means a reduction in both the income of migrants and the demand for labor in this sector. That will entail the outflow of a significant part of labor migrants back to their homeland, which, in turn, may lead to an increase in social tensions there, especially in Tajikistan, Uzbekistan, and Kyrgyzstan.

### **Foreign Trade and Logistics: Challenges and Prospects**

As for foreign trade, there are two essential aspects to bear in mind. First is the fact that a significant share of foreign trade in Central Asia, especially with Europe and Asia, was carried out before the sanctions against Russia adopted this year along the trade and logistics routes passing through its territory, primarily through the seaports in the Baltic and the Black Sea, and in the Far East. Now that the sanctions-caused restrictions on the use by Russia of European ports and its sea vessels have been imposed, as well as due to the boycott by the companies providing container cargo transportation, the question arises as to how the countries of Central Asia will now trade with Europe, North America and Asia. For them, the trade routes connecting the region with China and Iran remain almost the only ones available for the moment.

The countries' leaders in Central Asia are now racking their brains over this issue. In this regard, Uzbekistan has already intensified negotiations and managed to reach agreements with Pakistan and Afghanistan on opening a rail-road and track trade routes that would allow for cargo transportation between Central Asia and the southern seaports of Pakistan, Karachi, and Bin Qasim. As a result, the first cargo from India was already sent and received by Uzbekistan in March this year.<sup>viii</sup> However, the development of this trade route will take a long time before it becomes a full-fledged alternative to the northern ones that have developed over the past century and a half.

In the same context, we should view the revived negotiations between Uzbekistan, Kyrgyzstan, and China on constructing a railway route through the territory of these three countries.<sup>ix</sup> Again, this route will not begin to operate soon.

Finally, in view that the territory of Russia has turned into a logistical impasse even China was forced to promote the project of a bypass combined railway and sea route reaching Romania and other European countries through the territory of Kazakhstan, Azerbaijan, crossing the Caspian and Black Seas, with a total length of 11 thousand km. On April 13, the first cargo from China was sent along this route,<sup>x</sup> thus creating new opportunities not only for China, but for the countries of Central Asian states too.

Another aspect of war and sanctions' impact on the trade activities of the Central Asian states has to do with the region's bilateral trade with Russia. In March, Russia imposed a ban on grain exports from the country, followed by a similar decision by Kazakhstan, which itself had previously imported Russian wheat, but in turn, provided 90% of the needs of its southern neighbors for this product.<sup>xi</sup> As a result, Uzbekistan, Kyrgyzstan, and Tajikistan now face a growing shortage of flour for domestic consumption.

Finally, it is not clear how both sides will settle payments with each other, given that transactions in US dollars and euros are not available for Russia anymore. The parties will have to make payments in rubles and local currencies, which will complicate the

process technically and in terms of pricing, given the uncertain status of the Russian ruble as a unit of account.

### **New opportunities**

In addition to the negative consequences for the economies of the Central Asian countries, there are also some emerging opportunities for them, especially in terms of increasing exports to Russia of certain types of products, primarily agricultural ones. This opportunity has arisen due to the restrictions imposed on the Russian Federation regarding its access to transactions in US dollars and euros and the fact that not too many countries will accept now Russian rubles for the supply of their products to this country. However, there are so far no signals that these new opportunities for Central Asian countries are beginning to be realized, except probably opening some prospects for lifting barriers for the export of some Uzbekistani products to Russia.<sup>xiii</sup> And it is not yet clear whether the growth of exports from the Central Asian countries to the Russian Federation will be able to fully offset the above-mentioned negative consequences caused by the recession in this country.

However, in another area related to IT services, there are already significant changes in a positive direction. Thanks to a reasonably large number of IT specialists in Russia, Belarus and Ukraine, Western companies specializing in this sector have opened their branches there and delegated to local firms and specialists the implementation of many projects or part of these projects on the terms of outsourcing. But after the brutal suppression of mass protests in Belarus in 2020, when a significant part of the middle class became victims of repression, as well as after Russia's military invasion of Ukraine, further cooperation of Western companies with local businesses and specialists turned out to be extremely difficult. Tens of thousands of professionals in this industry have begun to leave these countries, in some cases escaping from repressions, in others because of Western sanctions and a fear of being drafted to the army, and in the case of Ukraine, for safety and security reasons. Many of them rushed to Georgia and Turkey, but also to Central Asian countries.

In Uzbekistan, the arrival of these specialists coincided with the adoption by the government of the program on developing the IT industry. Back in October 2020, the national strategy "Digital Uzbekistan-2030" was adopted by presidential decree,<sup>xiii</sup> according to which tax and financial incentives were created for the development of this industry. By the end of 2021, Uzbekistan's export of IT services reached \$46 million, compared to \$600 thousand in 2017. This year Uzbekistan is expected to double this figure.<sup>xiv</sup>

As a result of these developments, including the war in Ukraine, the Western sanctions and the conditions being created by Uzbekistan, beginning from late February and already by mid-April, three thousand IT specialists have arrived in Uzbekistan from Russia and Belarus.<sup>xv</sup> Among them were several hundred employees of EPAM Systems, one of the world's leading companies in software development. Such a transfer of IT businesses to this country opens up new opportunities for its economy. These opportunities will realize if the country develops not only an outsourcing business, but also finds a niche in the international supply chain, as Taiwan once did, becoming a leading manufacturer and exporter of electronic chips.

## **Risks**

Since the beginning of the war in Ukraine and the adoption of economic sanctions by the West against Russia, there has been a noticeable rise in trade and economic contacts and relations between the countries of the region, on the one hand, and Russia, on the other, which in addition to new opportunities also creates significant risks for Central Asian states. In view of entire sectors of the Russian economy, including the banking sector, having become targeted by the sanctions, one can expect that the Russian business will begin seeking workarounds to re-enter the world market, sell its products for hard currency, and, at the same time, to bypass the embargo on high-tech products, for example, chips from Taiwan, that was imposed by the western countries and companies. The closest partners and satellites of the Russian Federation, primarily the countries of Central Asia, would be considered by Moscow first as a transit zone in circumventing these sanctions. If earlier the territory of the Russian Federation benefited from being almost an exclusive transit zone for the Central Asian region's trade with Europe and North America, now this region is itself becoming a transit zone for the Russian businesses.

In this mutual re-approaching between the two sides, a unique mediating role is going to be played, most likely, by persons, particularly by the Russian oligarchs of Central Asia origin and companies, given the fact of them enjoying equally close ties with the local and the Russian ruling elites. Their interest lies both in rescuing their businesses and providing intermediary services for the Russian authorities and partners. In this regard, the Central Asian countries got a great temptation to benefit from the current situation, but, at the same time, significant risks, both reputational and in terms of becoming under the secondary sanctions. Suppose the leaders of these countries embark on a slippery slope of behind-the-scenes deals with the Russian ruling and business elites. In that case, this may jeopardize the Central Asian countries' chances to attract serious foreign investments, as well as the prospect of their integration into global production and supply chains, especially in the sphere of the IT industry, where new opportunities are opening up for them due to the progressing brain drain from Russia.

It is essential for the authorities of the Central Asian countries to analyze and find out who they are dealing with and on what terms and conditions, in order to distinguish those areas of economic cooperation with Russia that do not conflict with the sanctions regime and, at the same time, decisively cut off all projects that violate this regime.

## **Conclusion**

Thus, we can state a rather multifactorial impact of the war in Ukraine and Western sanctions against the Russian Federation on the economies in the Central Asian region. This essay touched upon only some aspects of this impact and made a point that not all of these aspects have been or going to be harmful to the Central Asian economies. To the truly negative consequences, we attributed the following two developments:

the expected drop in remittances from labor migrants, that make up a significant part of GDP in the region's countries;

the actual closure of the Russian territory to the transit trade routes between Central Asia, on the one hand, and Europe cum North America, on the other.

However, the logistical and trade restrictions that have arisen have not only negative implications for the countries of Central Asia, but also create stimulating conditions for the development of alternative trade routes. We see already that these routes, which have been so far the subject of discussion for decades, are now beginning to be quickly developed, thereby contributing to both the economic and political sovereignty of the Central Asian countries, and this shift in their policies leads to truly tectonic changes in their development.

In some respect, the region's countries are becoming unwitting beneficiaries of the actions taken by other geopolitical players. This concerns the sudden influx of highly qualified specialists from Russia and Belarus, especially in the IT sector, and the opportunities that have opened up for increasing the export to Russia of some products from Central Asian countries. Uzbekistan has, in particular, quickly taken advantage of the new opening. It is hoped that the accelerated development of the IT industry in this region will improve the conditions for the adoption of modern values by the local societies and will contribute to their economies' integration into the global world, which, in turn, will help to overcome their geographically determined international isolation.

At the same time, the region's countries face the risk of striking deals with the representatives of Russian businesses that violate the sanctions regime. In such cases, seemingly obvious benefits can result in significant reputational losses and ultimately undermine the prospects for attracting Western investments and integrating domestic economies into global production and supply chains.

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