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Plenary Session I

***The New Impetus towards Economic Integration between Europe and Asia***<sup>1</sup>

Background Paper for the

Keynote Address

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at The Fourteenth OSCE Economic Forum  
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With the end of the Cold War and the collapse of the Soviet Union the large economic space of the Eurasian super-continent has also become part of the world-wide globalization process. How this process of integration of Eurasia is proceeding in key areas of cross-continental linkages is of great importance for the future of the region and for the future of the World as a whole. One of the key questions will be whether the regional and global institutions can provide adequate support for this integration process.

**Eurasian integration – the past as prologue**

Eurasia is the land-mass stretching from the Atlantic to the Pacific and from the Arctic to the Indian Oceans.<sup>3</sup> In ancient days, this super-continent was connected by interlocking or

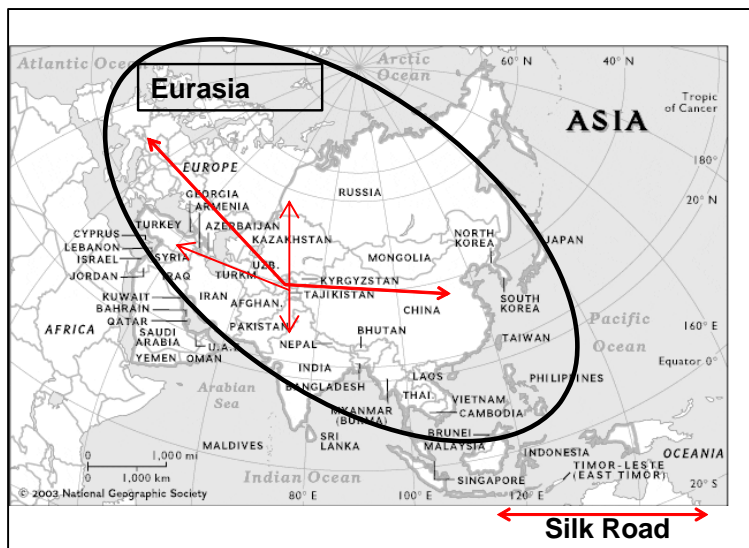
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<sup>1</sup> This paper draws on a longer paper by Johannes F. Linn and David Tiomkin, “Economic Integration of Eurasia: Opportunities and Challenges of Global Significance”, prepared for publication by Cambridge University Press in *Europe after the Enlargement*, edited by Anders Aslund and Marek Dabrowski, forthcoming.

<sup>2</sup> The author served as Vice President for Europe and Central Asia at the World Bank from 1996-2003.

overpowering empires (e.g., Alexander the Great, Genghis Khan, etc.), with trade, population movements, and communication flowing relatively freely, albeit slowly by today's standards – given the technology of the times – across the vast Eurasian space. The Silk Road epitomizes this time of economic connectedness. (Figure 1)

**Figure 1: The Ancient Silk Road**



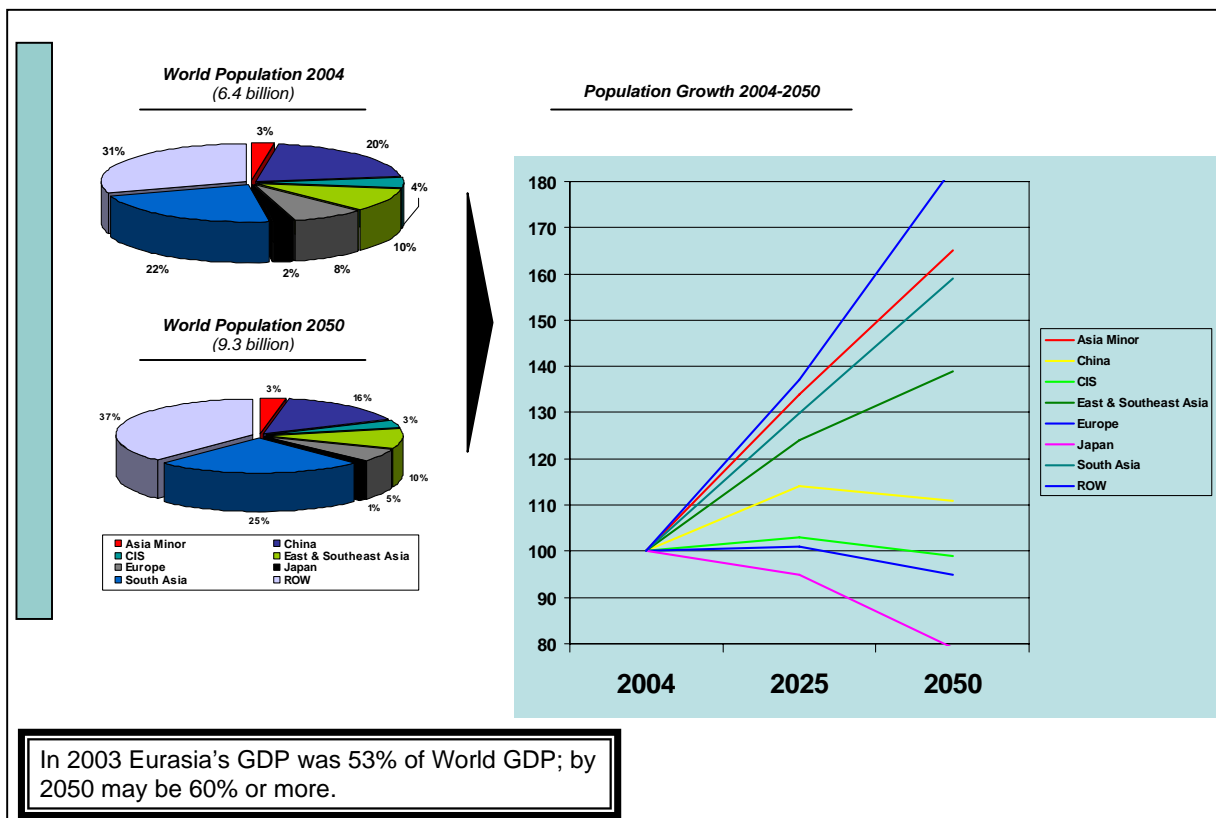
With the discovery of the New World and the development of sea travel, and with the rise of colonial powers and their competition, a process of political and economic disintegration began across Eurasia that reached its height in the 20<sup>th</sup> Century with the barriers of the Iron and Bamboo Curtains, which separated the Soviet Empire and China from the rest of the world. While Western Europe and Japan integrated economically and politically was part of the West across the trans-oceanic divides, the Soviet Union and China until the 1980s were largely isolated from the world's global economic integration trends.

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<sup>3</sup> The definition of Eurasia in this paper follows standard geographic continental boundaries of Europe and Asia, but excludes the Arab Peninsula.

The opening up of China in the 1980s and the collapse of the Soviet Union in the early 1990s led to the opening up of previously closed borders and the transition from central planning to market economies. This ushered in a historic new phase of Eurasian development by permitting the integration of Eurasian economies with each other and with the rest of the world. This process of integration is now in full swing, connecting some of the largest and most dynamic economies of the world – China, India, Russia – with each other and with an expanding European Union. With two-thirds of the world’s population and over 50% of the world’s GNP Eurasia represents a large share of the world’s economic power, a power that is expected to grow further in relative terms in the coming decades. (Figure 2)

**Figure 2. Global Population Growth and Composition**

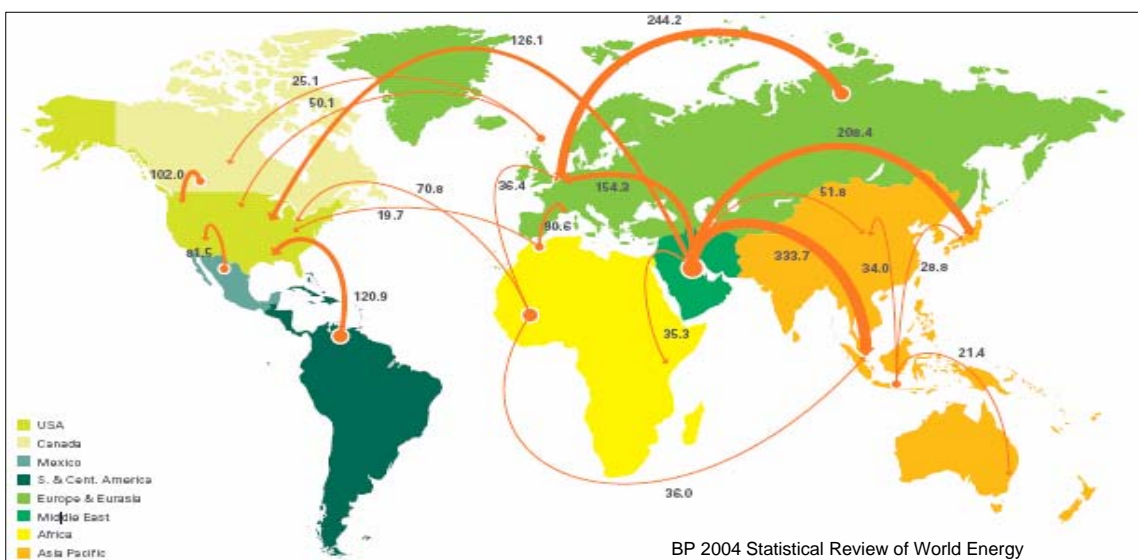


Four areas of transcontinental linkage will be highlighted here briefly – energy trade, non-energy trade, capital flows and communication. Other transcontinental links, such as migration, tourism, drug trade, or health epidemics (such as Avian Flu), also represent important integrating forces, for better or worse, but go beyond the scope of this presentation.<sup>4</sup>

### Energy trade

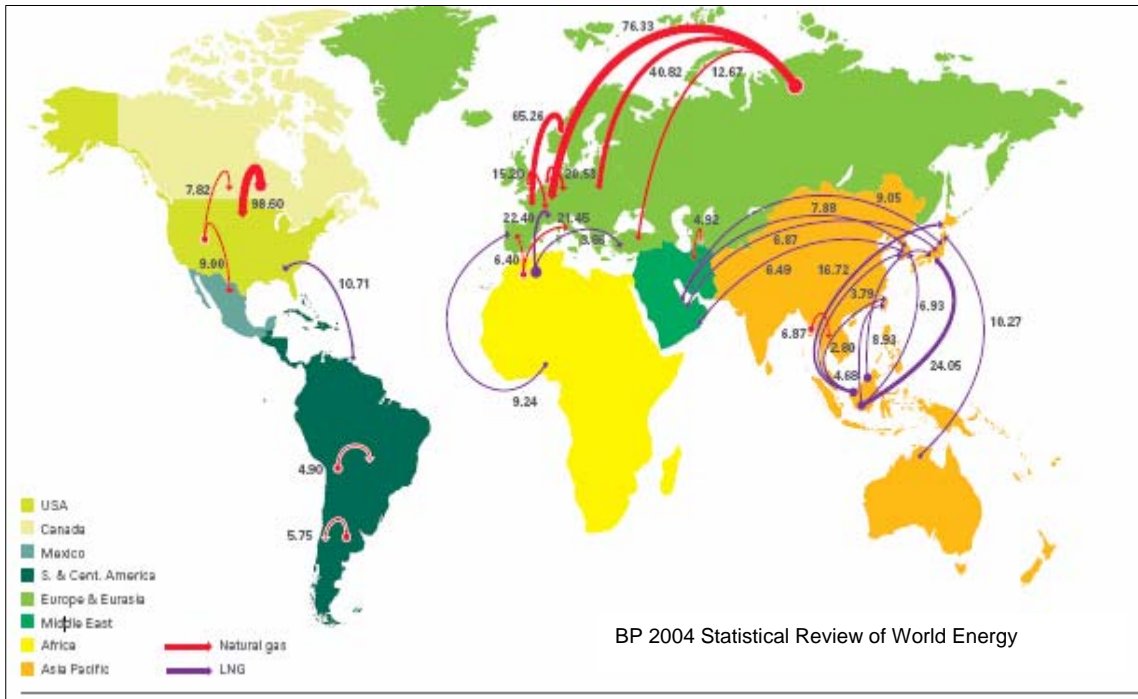
Energy trade is for now the single most important and rapidly growing economic link in Eurasia. The region (excluding the Arab Peninsula) has 25% of the world’s oil reserves, 36% of oil production, and 55% of oil consumption. For gas the region has 57% of world reserves, 50% of production, and 57% of consumption. In addition, the region has very significant untapped hydro power potential, especially in Central Asia. World energy trade, while integrated across oceans into a single market, is physically actually concentrated quite heavily in the large continental spaces – the Americas and Eurasia --, with only limited cross-oceanic trade for oil and virtually none for gas and power. (Figures 3 and 4)

**Figure 4: Major Global Oil Trade Movements, (millions tons)**



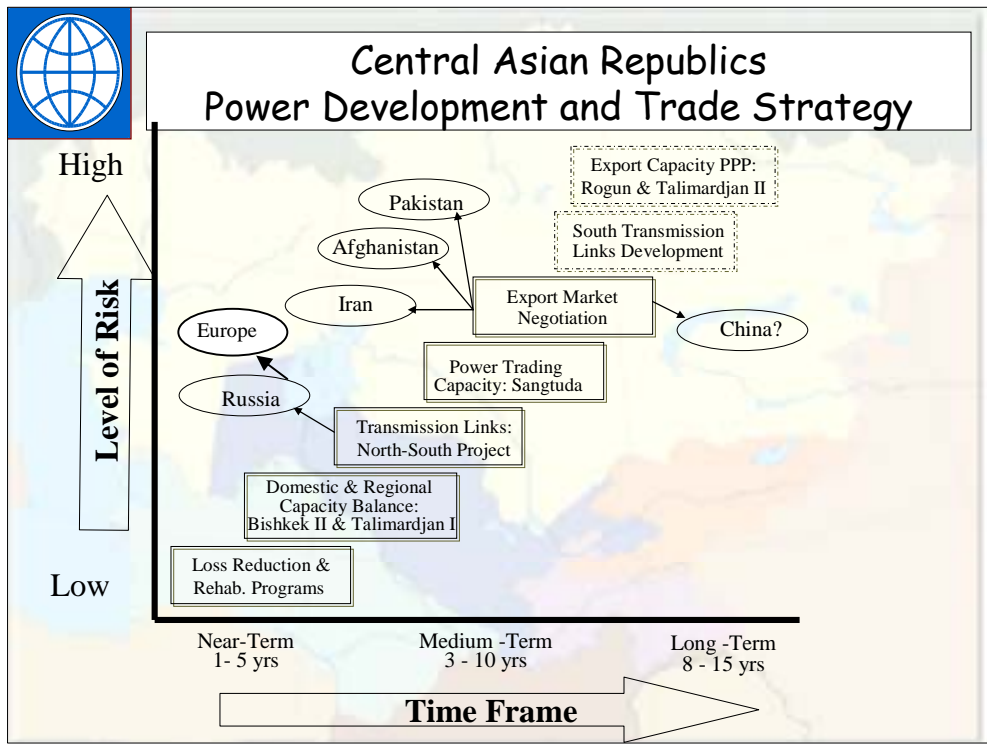
<sup>4</sup> Migration and drug trade are covered in Linn and Tiomkin, op. cit.

**Figure 5: Major Global Gas Trade Movements, (billion cubic meters)**



A highly integrated network of oil and gas pipelines now links Western and Central European consumers with Russian, Iranian and Caspian oil and gas fields and is continuing in develop. More recently, pipelines are also being constructed or under consideration from these key sources of supply to China and Japan, as well as to the Indian subcontinent. Ambitious plans are also under consideration for the development of the hydro resources of Central Asia and the transmission of electricity to consumers in Afghanistan, China, India, Russia and even Central and Western Europe. (Figure 6)

**Figure 6: Power Export Potential from Central Asia to Eurasia**



Source: World Bank

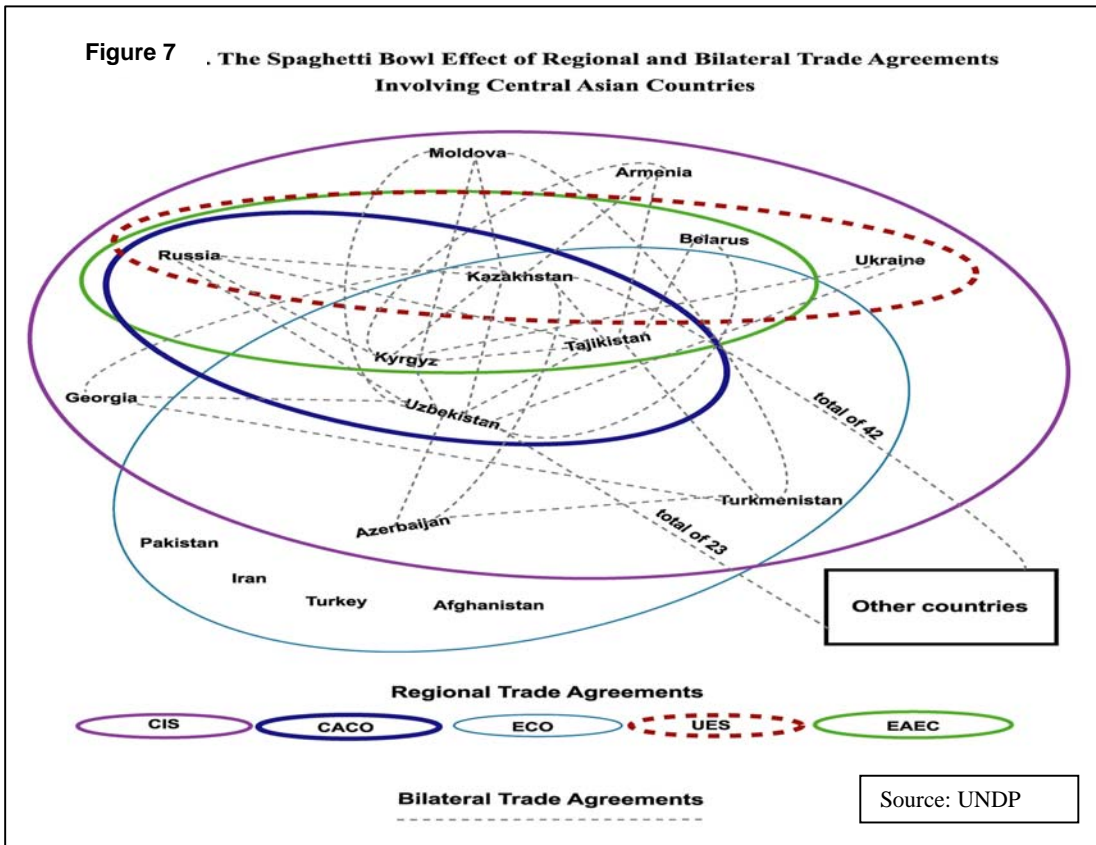
Given the dynamic demand and supply outlook, regional energy trade will remain a major force for integration in Eurasia for some time to come. At the same time there are major challenges to be met for this trade and integration process to unfold smoothly: First, major investments in production and transportation have to be made to overcome the constraints of geography facing energy production and trade in the region. The fact that much of the former Soviet energy infrastructure is obsolete and suffers from lack of operations and maintenance spending creates potential obstacles to further expansion of energy trade. Second, financing constraints can also slow down expansion, with innovative public-private partnerships required to assure an adequate source of funding for very large investments. Third, security concerns in parts of the Region, especially Afghanistan and the long-contested Indian-Pakistani borders, may interfere with energy transmission. Fourth, lack of integrated regulatory structures for the whole

region can present important obstacles. And finally, political competition for dedicated supplies (e.g., between China and Japan), or (the perception of) Russian efforts to maintain a monopoly over energy transport routes and to use them for political purposes, may get in the way of economically rational expansion of energy trade in the region.

### **Non-energy trade**

Non-energy trade in Eurasia currently falls broadly into three principal trading blocs: trade within Europe, within the CIS and within Asia. Of course, there is much trade between North America and Europe and Asia as part of the integrated world wide trading system. However, somewhat surprisingly, trade statistics indicate that not only is inter-bloc trade in Eurasia rapidly expanding, but it is already more important than trade between each of the Eurasian blocs and North America. With the expanding WTO membership in the region – China joined in 2001, and the major CIS countries are expected to join in 2006 or 2007 – the trade policy environment is likely to further improve for the region. There is also a plethora of bilateral and sub-regional trade agreements covering much of Eurasia. However, with the obvious exception of the European Union, these partial trade integration efforts have been at best a mixed blessing due to the many overlapping regional, subregional and bilateral trade agreements sometimes dubbed “spaghetti bowls”. (Figure 7)

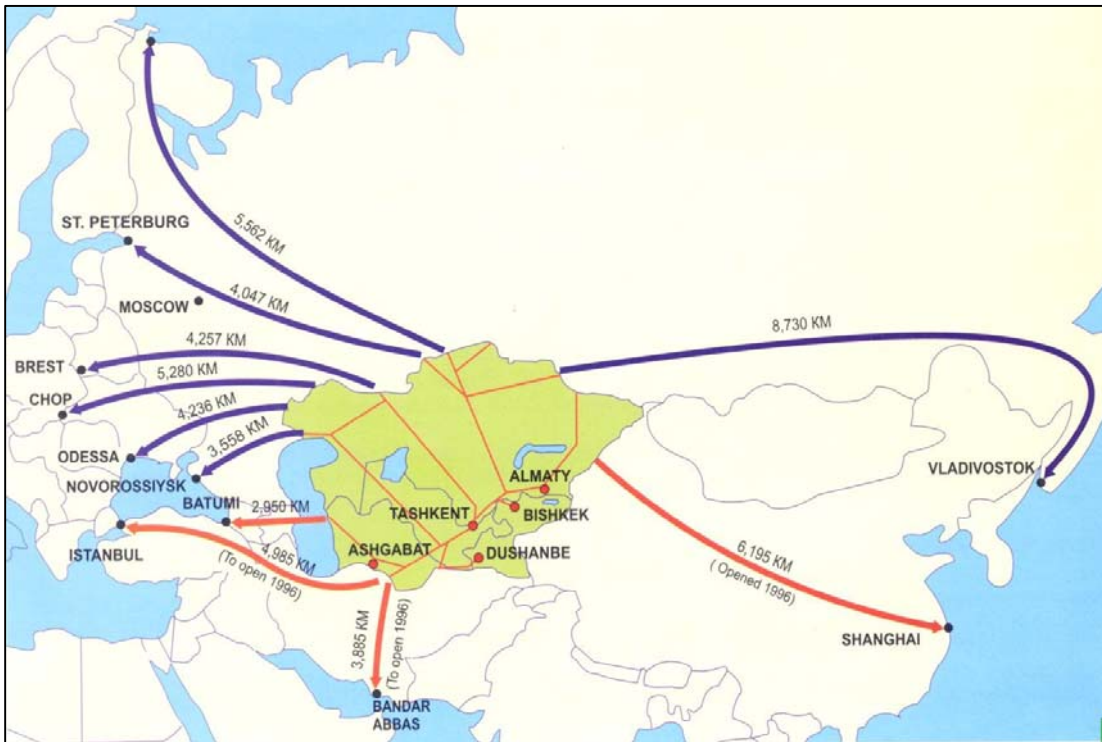
**Figure 7 . The Spaghetti Bowl Effect of Regional and Bilateral Trade Agreements Involving Central Asian Countries**



Given the large continental and land-locked spaces that have to be traversed in trade, transport infrastructure and transit facilitation take on special importance for Eurasian trade expansion, and especially for the land-locked countries and sub-regions of the CIS, including Central Asia. (Figure 8) Important investments in rail and road infrastructure are needed for principal transcontinental transport corridors, and many are currently under consideration as part of the Trans-European Network and TRACECA development plans of the EU coming from the west and as part of the Central Asia Regional Economic Cooperation Program (CAREC) supported by ADB, coming from the east. Kazakhstan and China have ambitious plans to establish a new rail link, which will open up a new transcontinental rail route paralleling the Trans-Siberian Railway. (Figure 9). Air traffic is also expected to expand rapidly across Eurasia; some estimates indicate a four-fold increase in flights between Europe and China by 2020.

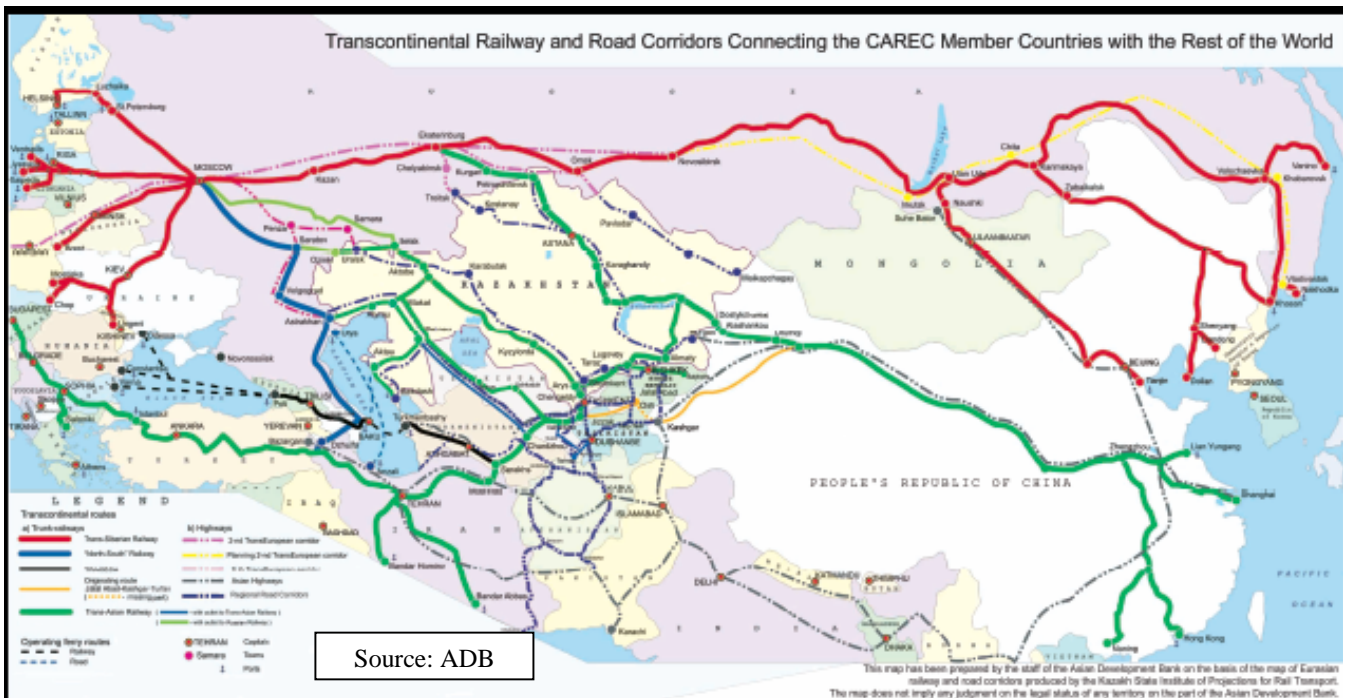


**Figure 8: Distances from Land-locked Locations to Ports in Central Asia**



Source: UNDP, *Central Asia Human Development Report*, New York, 2005

**Figure 9: Transcontinental Rail and Road Corridors in Eurasia**



But improvements in the physical transport infrastructure are not the only factor. Improvements in transit and transit facilitation that allow for a ready flow of transport and trade across borders and within countries are as important if not more so. There are currently huge costs and delays from poor border management and customs administration as well as from corrupt transit management within countries. For Central Asia, it has been estimated that the cost and time of transport to Europe (as well as with other destinations) could be cut in half through better border and transit management.<sup>5</sup> And of course, security concerns again play a major factor in parts of the region for non-energy trade as for energy trade.

The bottom-line on non-energy trade is that, like energy trade, it is a major integrating force for Central Asia. With improved trade policy, transport investments, transit facilitation and behind-the-border reforms much more trade integration can and will take place. The CIS region (plus Afghanistan, Iran and Pakistan/India border) is still a major bottleneck at this stage, although improving compared to 10 years ago. Much of this conference will be devoted to discuss possible improvements in transport infrastructure and services.

### **Investment and capital flows**

So far, Eurasian capital market integration has been limited, but important actual and potential links have been already evident. The contagion effects of the Asian/Russia crisis in 1997-1998, the Russian capital flight (via Cyprus and Switzerland) and the potential shift of reserve holders in Asia and Russia out of the Dollar and into the Euro currency are examples of the close connections in financial markets across Eurasia. Eurasian foreign direct investment (FDI) flows are still limited, but growing. Notably, FDI from the EU to China and Russia, Japanese FDI in South-East Asia and Europe, expanding Russian FDI in the CIS, Turkish FDI in

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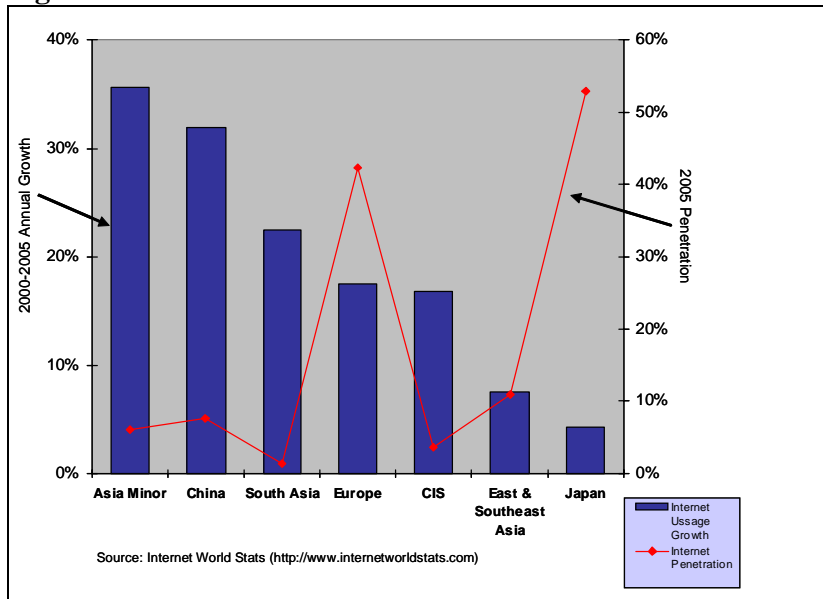
<sup>5</sup> UNDP, *Central Asia Human Development Report*, New York, December 2005

the CIS and Chinese and Indian investments in the Russian and Central Asia energy market are examples of the expanding and diversifying investment flows in the region. Even Kazakhstan is now becoming part of this process, not only as a receiving country for FDI especially in its energy sector, but also as a source of investment flows to some of its neighbors, e.g. Kyrgyzstan. Continued capital market integration is likely, closely linked to trade integration, which has been the typical pattern elsewhere.

### **Communication and knowledge**

Eurasia is quickly becoming interconnected, regionally and world-wide, in terms of communication and knowledge. With improved access to communication satellites, telephony and the internet (including through NATO's "Virtual Silk Highway" project, which is designed to improve internet connectivity in the South Caucasus and in Central Asia) business connectivity is growing rapidly, distance learning institutions and facilities are springing up, and research and other institutional networks are expanding rapidly. This cuts the effective cost of distance and will support other areas of integration. Currently, the poorer parts of the region are less well connected to the internet, but they are also the areas with the most rapid expansion in the rate of connectivity. (Figure 10) This in effect means that no part of the Eurasian super-continent, despite the great distances and land-locked locations, will remain isolated and disconnected from the rest of the world. With the great history and potential of scientific and business knowledge development, and with a strong human capital base in many parts of the region, there is little doubt that Eurasia can and will become a major location more the global knowledge economy.

**Figure 10: Eurasian Internet Growth and Penetration**



### **The Institutional Infrastructure and Politics of Regional Cooperation**

In the preceding sections we have documented intensifying trends towards integration of economic activity and communication across Eurasia. Despite these trends, there is currently no overarching institutional framework for regional cooperation, nor should we expect that there will be one soon. However, overlapping initiatives for sub-regional cooperation and integration are expanding throughout the region. These are both a result of the increased economic integration and a factor driving closer integration.

There are many important regional cooperative institutions, none of which however is all-encompassing for Eurasia as a whole:

- ASEM (the Asia-Europe Meeting) is the largest group with 39 members, encompassing the (now-enlarged) EU members, all ASEAN countries and China, Japan and South Korea; CIS and South Asia are not members;

- OSCE, “the world's largest regional security organization whose 55 participating States span the geographical area from Vancouver to Vladivostok”<sup>6</sup>, includes a large number of Eurasian countries, but not East, South and South-East Asia.
- The European Union (EU) with 25 members is the most integrated sub-regional grouping, and with the eventual accession of South East European countries will further increase its reach. The EU’s “Neighborhood Policy” extends to six CIS countries as well as a number of North-African and Middle Eastern countries.
- The CIS is a loose assembly of 13 republics of the Former Soviet Union.
- Various smaller sub-regional groupings involve members of the CIS and some of their Eurasian neighbors; most notable are the Shanghai Cooperation Organization (SCO) with China, Russia and four Central Asian members (Turkmenistan is not a member), the Eurasian Economic Community (Eurasec, with the same membership as SCO minus China, plus Belarus); and the Economic Cooperation Organization (ECO), which includes the five Central Asian countries plus Afghanistan, Azerbaijan, Iran, Pakistan and Turkey.
- Various East and South East Asian groupings, especially ASEAN and SAARC.
- In addition, there are a number of regional groupings supported by or involving multilateral institutions, such as the UN regional economic commissions for Europe (ECE) and Asia (ESCAP), the European Bank for Reconstruction and Development (EBRD) and the Asian Development Bank (ADB). They, as well as the World Bank, have in recent years become increasingly active in supporting sub-regional cooperation and integration initiatives. The Greater Mekong Subregion (GMS) and the Central Asia

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<sup>6</sup> OSCE official website <http://www.osce.org/>

Regional Economic Cooperation (CAREC) initiatives are prime examples of sub-regional cooperation efforts supported by multilateral institutions. Indeed, most aid donors active in the developing countries of Eurasia have now designed sub-regional approaches and strategies in key sub-regions (especially for Central Asia).

Many of these sub-regional institutional frameworks are not operationally focused, in terms of supporting, funding and implementing specific programs and projects designed to support the effective integration of the sub-regions or to address key issues of Eurasia-wide concern (such as integration of the transport, transit, and energy infrastructure and regulatory frameworks). However, these interlocking forums do provide for regular contact and exchange at heads-of-state and at ministerial levels. This itself helps to build trust, smoothes key bilateral relations, and over the long term probably supports selected initiatives that help with sub-regional and even Eurasia-wide integration.

### **The Future of Regional Integration in Eurasia**

This political and policy dialogue at the highest governmental level among the countries of Eurasia is important not least because it may help answer a key question about the future of cooperation and integration in Eurasia: Will the unquestionable gains from economic integration and the increased interdependency, as well as a shared need for economic stability and prosperity among Eurasian countries drive increased political cooperation and peaceful coexistence in the region? Or will long-standing political tensions and new competition for scarce resources, especially for energy, create regional instability and divisions and, with this, serious barriers to the quick economic integration of Eurasia?

There certainly are many sources of potential conflict within the region: In East Asia there are the tensions around North Korea, the competition between China and Japan, and the

simmering tension between China and its Province of Taiwan. In South Asia, there is the long-standing conflict between India and Pakistan. Add to this the unstable situation in Afghanistan, the persistent tensions over Iran and the deep-seated and violent conflicts of the rest of the Middle East, which can spill over in many different ways into the Eurasian political scene. In the CIS there is the potential for conflicts in the South Caucasus and for new unrest in Central Asia, and there is a latent competition between China and Russia. Even in Europe, there difficulties with further EU enlargement, especially around Turkey's accession, and problems with the EU's strict control over its borders. Finally, as already mentioned, competition for energy resources and political use of the energy instrument may well add to the political obstacles to integration. All these possible sources of conflict might destabilize important parts of Eurasia with spill-over effects for the rest of the region and even globally.

Fortunately, there have been increased efforts within Eurasia to address many of these issues: The EU has become more actively engaged in its dialogue with key regional players, including China, Russia, Iran, and in the context of key sub-regional initiatives (ASEM, EU Neighborhood, the TACIS Central Asia regional strategy, etc.). Both China and Russia have shown increased interest in an engagement in Central Asia. China and Russia, as well as other regional players, have been supportive of the post-9/11 engagement of the US and of NATO in Afghanistan with the goal of a peaceful, democratic and prosperous nation. India and Pakistan not only show signs of wanting to settle their long standing Kashmir conflict, but also are increasingly looking to cooperate over access to the energy sources of Iran, Central Asia and Russia. ASEAN and China in November 2004 agreed to closer cooperation in moving towards the creation of a free trade zone between them. These tendencies towards peaceful cooperation bode well for a stable long-term future for Eurasia and for continued economic integration.

## **Conclusions and Implications**

While the evidence on Eurasian economic integration so far remains partial and fragmentary, one can conclude that over the last 20 years there has been a remarkable process of establishing ever closer and more complex economic links throughout this enormous region. No doubt these trans-Eurasian links are not yet nearly as tight as they are across the Atlantic or the Pacific. But the trends are unmistakable: For better, and in some cases for worse, economic integration in Eurasia will continue at a fast pace with the potential of catching up in terms of intensity with the economic integration that characterized transatlantic, transpacific and trans-American economic relations. While competition for energy resources and long-standing political tensions may complicate and in some areas slow down this process, I am hopeful that Eurasia will find peaceful and cooperative solutions for these tensions. Ultimately there is much to be gained for all concerned, both within the region and globally. Indeed, the economic integration and political cooperation across the Atlantic and the Pacific over the last 50 years – against the backdrop of many violent conflicts of the past and despite the competition and occasional tension among the partners – are pointing towards a similar outcome in Eurasia as a distinct and hopeful possibility.

What are the policies that can help bring about this favorable scenario?

- Major investments in transcontinental and sub-regional infrastructure are required to support increased regional trade and communication.
- These investments need to be accompanied by improvements in and by harmonization of the policy and regulatory regimes across countries for transit of goods, services and people.
- Early universal membership in the WTO is preferable to reinforcing the “spaghetti bowl” of (sub-)regional trade agreements.



- Major investments in energy production and transport are needed, but should be matched by cross-border agreements on regulation and by measures to improve efficiency of energy use so as to reduce pressures on energy prices and on the environment.
- Region-wide agreements are necessary to address competing claims for access to regional energy resources by key players (EU, China, India, Japan, US) and to restrict the use of energy as a political tool.
- Private and public networks of knowledge, business and civil society groups should increasingly take a transcontinental view for Eurasia as a whole, rather than clinging to purely country or sub-regional perspectives. Of course this should not be to the exclusion of linking with global as well as trans-oceanic networks.

The key actors in bringing about these policy actions are in the first instance the governments of the largest countries in the region. For the immediate future, it is likely that the EU will have to play a lead role in opening up a Eurasia-wide perspective of cooperation and integration. However, for the longer-term, there is no question that the quartet of China, EU, India and Russia represents the key players that need to cooperate constructively and deliberately in supporting the effective integration of Eurasia. Together they will have to pay particular attention to ensure that the fragile border regions of the South Caucasus and of Central Asia become stable and prosperous parts of an integrated Eurasia; and that the shared problems of an unstable and conflict-ridden Middle East neighborhood and of a poor and fractious Africa to the South are effectively addressed by the world community.

If the key players in Eurasia each take on constructive roles in shaping a common trans-continently integrated economy, then the US can and should restrict itself to play a relatively minor, supportive role. Should intra-Eurasian political frictions prevail, then a more active role by the US might be needed to help settle such conflicts in a peaceful and least disruptive manner.

More generally, in view of the inevitable growth of China and India as strong economic and political players, and in view of the emergence of a new super-continental economic bloc in Eurasia, it would be desirable to develop global economic and political steering mechanisms that help bind all major players together into a cooperative institutional structure for managing a highly integrated but multi-polar world community. One way to achieve this is to expand the membership of the Group of 8 (G8) summit mechanism, for example by raising the current ministerial-level G20 to a summit-level mechanism.<sup>7</sup>

Key multilateral institutions, such as the UN agencies, the World Bank and the regional development banks, will have to play an active role in helping the regional integration of Eurasia, both at the sub-regional and at the overarching regional level. This will require cooperation among these agencies. But it will also require within these agencies a clearer vision and action to cut across the frequently constraining internal bureaucratic boundaries of regional and sub-regional organizational units. There are encouraging signs that this is beginning to happen, but more concerted and effective steps of inter-agency and internal cooperation are needed. For the case of Central Asia, CAREC is a promising example of growing cooperation among the countries of this sub-region and their key neighbors (China and Russia) with the concerted support of the key international financial institutions (ADB, EBRD, IMF, IsDB, UNDP, World Bank).

OSCE as a multilateral institution with a clear mandate of supporting security, openness, cooperation and harmony among its Eurasian member countries, and as an organization that includes important non-Eurasian members, in particular the US, can serve as an important bridge

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<sup>7</sup> The G20 consists of the major industrial and emerging market economies. It currently brings together ministers of finance and central bank governors, but there are proposals to elevate the G20 into summit-level forum. (Bradford and Linn, 2004)

among the key players in Eurasia and in North America. In doing so, OSCE might be well advised to see itself as a catalyst of transcontinental analysis, monitoring, dialogue and networking, rather than as an operational entity that develops and implements programs and projects of economic integration on the ground. The latter type of engagement would require substantial financial resources and professional capacity, which are not likely to be available, and could risk adding to the at times bewildering multiplicity of already existing operational international organizations that are attempting to assist on the ground.