

Beyond borders—Reconsidering regional trade in Central Asia

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This paper investigates the barriers to trade in Central Asia. While much of the existing literature on international integration of FSU countries has focused on the quantities traded, we use relative prices to shed some light on impediments to trade. We find that the impact of borders on price variations across different locations in Central Asia is much smaller than conventionally thought. While prices vary significantly across the region, variations within one country are just as large as variations across countries. We hypothesise (although we cannot prove) that this is due to obstacles to trade, and in particular rent seeking by enforcement agencies at the numerous internal check points. The paper also confirms that in relative terms, the borders with Uzbekistan are considerably more difficult to cross than those with Kazakhstan or the Kyrgyz Republic. *Journal of Comparative Economics* 36 (3) (2008) 453–466. Union de Banques Suisse (UBS), London, UK; The World Bank Ukraine, Ukraine; EBRD, London, UK.
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1. Introduction

Over the past decade and a half the trade regimes of the former communist countries have changed fundamentally, both in relation to the rest of the world and within the former communist block. While the liberalisation of trade relations with the non-CMEA (Council for Mutual Economic Assistance) countries has received considerable attention, less work has been done to investigate the dynamics and structure of trade patterns inside the former Soviet Union.

This paper focuses on intra-regional trade in Central Asia, defined in this paper to include Kazakhstan, the Kyrgyz Republic, Tajikistan and Uzbekistan. The fifth former Soviet republic in Central Asia, Turkmenistan, could not be included because of lack of reliable data. These four countries did not exist as independent nations prior to 1991, they share a common Soviet legacy and have similar languages and cultures. With the collapse of the Soviet Union, they found themselves suddenly separated by borders that cut across main transportation routes and sometimes through formerly integrated settlements. The resulting border wars, including temporary or permanent border closures, high

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levels of trade protection (in the case of Uzbekistan), significant delays and reported corruption at customs and inland check-points, have been prominent topics in the press, but also among policy makers. The main motivation of this paper is therefore to investigate how independence and the creation of new national borders have affected the degree of integration between these four former Soviet republics. We find that contrary to much of the anecdotal evidence, borders between Central Asian countries do not add that much to trade costs, in particular compared to trading costs within each country.

The paper concentrates on the most obvious economic manifestation of barriers to trade—the fact that prices for tradable goods will differ significantly across countries when arbitrage is not profitable due to trade barriers. This approach was first used by Engel and Rogers (1996) for the US and Canada and extended by Parsley and Wei (2001). It allows one not only to estimate the severity of trade barriers across countries but also to simultaneously estimate integration inside countries. With respect to the former Soviet Union it has been used by Berkowitz and de Jong (2003) to study market integration within Russia. Morshed (2003) provides a rare application to developing countries in estimating the border effect between Bangladesh and India.

In the context of Central Asia, the use of price variations to estimate the impact of regional trade barriers has the advantage that it is not based on official trade data. These data miss the crucial shuttle trade so prevalent across the region. Our approach also does not suffer from biases introduced into official trade data by the significant weight of trade in gas and electricity, which may overshadow the extent of disintegration of trade in consumer goods and other manufactures (Linn, 2004). However, deviations from the law of one price may be due to factors other than trade barriers. Gorodnichenko and Tesar (2005) point out that within country heterogeneity in trade costs, persistence in real exchange rate shocks and nominal exchange rate volatility can affect estimates of the border effect using price data. Controlling for these factors reduces the border effect between the US and Canada and the US and Japan to economic insignificance. In this paper, we follow Gorodnichenko and Tesar in controlling for within country heterogeneity. We also control for the effect of nominal exchange rate volatility and confirm that this significantly reduces estimates of the “border effect”.

The extent of regional integration is investigated using two independent data sets. First, using regional disaggregated consumption price indices for food and non-food goods, the time dimension is exploited to analyse price dispersion and the significance of trade barriers. This part of the analysis includes only Kazakhstan, the Kyrgyz Republic and Uzbekistan. Second, a price survey of 31 consumer goods is implemented in all territorial sub-regions (oblasts) of Kazakhstan, the Kyrgyz Republic, Tajikistan, Uzbekistan and two Russian oblasts close to the border of Kazakhstan (see Appendix A for the survey methodology). The price survey allows absolute price differences across locations in Central Asia to be directly compared.¹

Overall, both data sets confirm that regional market integration in Central Asia remains quite high. Based on the first data set, borders are found to have a significant effect on price dispersion, and that this effect is much larger between Uzbekistan and its neighbours than between Kazakhstan and the Kyrgyz Republic. However, almost the entire estimated border effect is due to volatility in the bilateral nominal exchange rate (which we control for by dividing the product price series by the overall CPI in each country). Once changes in the nominal exchange rate are controlled, the border effect even between Uzbekistan and its neighbours becomes quite small and comparable to estimates for other borders around the world.

The fact that borders seem to matter less than is often thought in Central Asia is also confirmed by the second data set. According to the price survey, price dispersion inside Kazakhstan is large enough to contain all prices found elsewhere in Central Asia. In other words, the cost of shipping a good from one end of Kazakhstan to the other is often higher than shipping the same good across the border into the Kyrgyz Republic, Tajikistan or Uzbekistan. However, price differences are often not trivial—in the range of 30–50 per cent on average. This suggests that trade barriers beyond the border remain significant obstacles for market integration both within countries and within Central Asia.

The paper ties in with three different strands of literature. First, it is a contribution to the large literature on the “border effect” initiated by McCallum (1995) and Engel and Rogers (1996) but for the first time using data from transition economies. For a recent survey see Anderson and van Wincoop (2004). Our results are in line with more recent findings questioning the economic significance of the border effect (e.g. Gorodnichenko and Tesar, 2005).

¹ The approach relies on being able to compare prices of homogeneous goods across markets—variations in actual or perceived quality could also contribute to price variations across space thus introducing noise into the measure of trade barriers based on price differences. A basket of goods that is as homogeneous as possible has been chosen, but some noise is likely to remain.

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