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**Recent Policies and Performance of the Low-Income CIS Countries
An Update of the CIS-7 Initiative**

Prepared jointly by the Europe and Central Asia Region of the World Bank and
the Middle East and Central Asia Department of the IMF

(In consultation with the staffs of the
Asian Development Bank and the
European Bank for Reconstruction and Development)

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Glossary

AsDB	Asian Development Bank
BEEPS	Business Environment and Enterprise Performance Survey
BSTDB	Black Sea Trade and Development Bank
CAREC	Central Asia Regional Economic Cooperation
CBO	Community-Based Organization
CDC	Computer Digital Control
CEB	Central Europe and the Baltics
CES	Common Economic Space (CIS)
CFAA	Country Financial Accountability Assessment
CIS	Commonwealth of Independent States
CIS-7	Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan
CPAR	Country Procurement Assessment Review
DFID	Department for International Development, United Kingdom
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EU	European Union
EURASEC	Eurasian Economic Community (CIS)
GDP	Gross Domestic Product
GEF	Global Environment Facility
GSAC	Governance Structural Adjustment Credit
GTAC	Governance Technical Assistance Credit
HIPC	Heavily Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDF	Institutional Development Facility
IFI	International Financial Institution
IMF	International Monetary Fund
MC	Ministerial Conference
MDG	Millennium Development Goal
MMR	Maternal Mortality Rate
MTBF	Medium-Term Budget Framework
NGO	Non-Governmental Organization
OECD	Organization for Economic Cooperation and Development
PEIR	Public Expenditure and Institutional Review
PPP	per day per person
PV	Present Value
PRSP	Poverty Reduction Strategy Paper
QFA	quasi-fiscal activity
RIA	Regional Integration Agreement
ROSC	Report on the Observance of Standards and Codes
SATAC	Structural Adjustment Technical Assistance Credit
SEE	South Eastern Europe

SIF	Social Investment Fund
SME	Small and Medium Enterprise
TA	Technical Assistance
TFP	total factor productivity
TTF	Trade and Transport Facilitation
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Fund
UNEP	United Nations Environment Program
UNICEF	United Nations Children's Fund
UNITAR	United Nations Institute for Training and Research
U5MR	Under-5 Mortality Rate
WHO	World Health Organization
WTO	World Trade Organization

EXECUTIVE SUMMARY

During 2001-03, the CIS-7 countries (Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan) experienced annual real GDP growth averaging over 7 percent, which has erased some of the income losses sustained in the first decade of transition and helped reduce poverty. This growth has been driven by robust export performance. The debt sustainability indicators have improved. Most countries have also significantly improved their fiscal performance and have strengthened their public finance institutions. However, developments in many structural areas (e.g., business climate, governance, core public service delivery and trade facilitation) have been mixed, and most countries still face serious challenges. Regional cooperation received an initial boost from the global war on terror, but has progressed more slowly than expected due to lukewarm political commitment in the countries and their larger neighbors.

Reform progress and macroeconomic performance have been increasingly divergent among the seven countries. Some countries need to take substantial further steps to secure the benefits offered by the international community, either by establishing reform track records to unlock official debt relief or by addressing poor investment environments, trade barriers, and governance concerns, so as to attract foreign investment and spur export-led growth. Significant regional barriers to growth and prosperity remain in a number of cases. While there remains some commonality in the problems faced by the CIS-7—notably the need to deepen structural reforms, address governance deficiencies, and implement poverty reducing policies—it is apparent that key issues facing them today have regional specificities that can be better addressed through regional initiatives. These issues include the need to resolve regional and sub-national conflicts, which have imposed high costs and undermined progress, as well as persistent problems affecting regional trade, transit, investment and the environment.

In the two years since the Initiative was launched, donor awareness and coordination for the benefit of the countries have become demonstrably stronger, and donors have responded with debt rescheduling and more concessional assistance. Knowledge creation, cross-country dissemination, and enhanced capacity building are supported by a growing range of donor-assisted activities. With donor and cross-country cooperation increasingly being focused at the sub-regional level, and given the growing divergence in policies and performance of the CIS-7, several of the countries would like to move beyond the Initiative. Sub-regional efforts recently show signs of promise in Central Asia, while Moldova is being drawn into the EU's Wider Europe Initiative. Clearly, the South Caucasus would benefit considerably from improved relations among the three countries, and the international community is expected to focus much more on fostering such relations. In any event, the IFIs will continue to work with all seven countries to define new modalities of cooperation on specific issues, involving sub-regional vehicles as appropriate.

Going forward, improvements in regional relations and accelerated reforms will be important to counter the expected easing in GDP growth in the CIS-7. There is also considerable potential for enhancing development prospects through the PRSP process in these countries. Priorities within PRSPs must be defined more clearly and linked more closely with their budgets. Donors are expected to insist that their assistance be framed within the context of country PRSPs. External assistance should be largely grant-based, and consistent with commitments made with respect to attainment of the Millennium Development Goals in these countries.

This paper is the second report to the Executive Boards since the launch of the CIS-7 Initiative in April 2002. This Initiative was designed to increase donor awareness about the problems of these countries, and to enhance donor and country coordination. This paper presents a review of recent trends and developments in the seven low-income countries of the Commonwealth of Independent States (CIS)—Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan—with a special focus on growth and poverty, external debt and fiscal sustainability, governance and the business climate, and regional cooperation.¹ The paper also describes donor activities in support of reforms in these areas.

I. BACKGROUND

1. **In February 2001, the staffs of the IMF and World Bank, in consultation with the Asian Development Bank (AsDB) and European Bank for Reconstruction and Development (EBRD), issued a paper entitled “External Debt and Fiscal Sustainability in IDA-Only CIS countries.”** The report examined the causes and consequences of the large volume of external debt incurred by Armenia, Georgia, the Kyrgyz Republic, Moldova and Tajikistan since 1991. It concluded that all five countries faced a difficult fiscal and external outlook in the coming decade. While massive external shocks and inadequate policy responses had contributed to this situation, corruption and poor governance, lack of policy ownership, and weak implementation capacity had exacerbated the problem. The paper called for a strengthening of adjustment and reform efforts, coupled with increased concessional assistance—notably from bilateral sources—and debt relief where needed. This study attracted considerable international interest and led to calls for a broader examination of the transition challenges facing the low-income countries of the CIS, whose reform efforts and outcomes appeared to be lagging behind those of other transition economies in Europe and Central Asia.

2. **These concerns led the four IFIs involved in the region to prepare a second paper in 2002, “Poverty Reduction, Growth and Debt Sustainability in the Low-Income CIS Countries,” with a widening of the analysis to cover growth, poverty, governance, and regional cooperation issues, and the addition of two IDA/IBRD blend countries, Azerbaijan and Uzbekistan.** This study was considered at an international conference hosted by the British Government in London in February 2002, which recommended the launching of a special Initiative for these seven countries. *The primary objective of the CIS-7 Initiative was to revitalize the development partnership between the countries and the international community, as well as among the countries themselves, and to achieve faster economic growth and poverty reduction. Specific efforts were aimed at (i) raising awareness*

¹ This paper is based on ten background papers prepared by the staffs of the AsDB, EBRD, IMF and the World Bank, which are listed in the Sources at the end of this document, and referenced below.

about the CIS-7 plight among donors; (ii) improving donor coordination, especially between the four IFIs; (iii) increasing knowledge services and delivering them to the countries; (iv) enhancing capacity building; and (v) promoting regional cooperation. A ministerial meeting in Washington, D.C. formally endorsed the CIS-7 Initiative in April 2002.²

3. **The Initiative has sought to improve the understanding of the development and transition process in the CIS-7, as well as to strengthen the support and consensus for reform within the countries. A large body of analytical work was commissioned in 2002 focusing on the CIS-7 transition experience, including the role of the international community, as well as examining in depth the key challenges facing these countries.** The resulting papers were discussed at a conference held in Lucerne in January 2003, hosted by the Government of Switzerland, with participation from a wide variety of countries and institutions, including international and CIS-7 NGOs and academics. Beyond the Lucerne Conference, topical seminars have sought to deepen the impact on capacity-building in key areas, including the following: participatory approaches to poverty reduction strategies; public expenditure management; energy sector reform; health, education and labor market reforms; financial sector supervision; and public debt management. A number of regional partnership events have also been held, largely for the Central Asian countries and with an emphasis on regional public goods, such as water and energy resources and transport infrastructure.

II. RECENT DEVELOPMENTS IN THE CIS-7 COUNTRIES

A. Growth, Poverty, and the PRSP Process

4. **Since 2000, the CIS-7 countries have achieved substantial, steady and broad-based economic growth.** These small open economies suffered deeper and longer declines at the start of transition than other transition economies, and their tentative recovery in the mid-1990s was interrupted in 1998 by the Russian financial crisis. During 2001-03, the group's real annual GDP growth averaged over 7 percent, and neither the recent economic slowdown in the OECD area nor the Turkish financial crisis of 2001-02 appear to have had a dampening effect on it. This impressive growth conceals significant differences between individual countries. However, with the exception of the Kyrgyz Republic³ and Uzbekistan, actual growth performance in each country has consistently outstripped the forecasts presented at the London Conference in early 2002 (see Table 1).

² Information relating to the CIS-7 countries and the CIS-7 Initiative can be found at www.cis7.org.

³ In the Kyrgyz Republic in 2002, a landslide shut down the Kumtor gold mine, and the economy shrank. In 2003, real GDP recovered strongly.

Table 1. CIS-7: Real GDP Growth
(In percent)

	1998	1999	2000	2001		2002		2003		2004	2005
				London	Latest	London	Latest	London	Latest	Projections	
Armenia	7.3	3.3	6.0	7.5	9.6	6.0	12.9	4.0	13.9	7.0	6.0
Azerbaijan	10.0	7.4	11.1	8.5	9.9	8.5	10.6	8.5	11.2	8.1	13.6
Georgia	10.6	3.0	1.9	3.9	4.7	3.3	5.6	4.8	8.6	4.0	4.0
Kyrgyz Republic	2.1	3.7	5.4	5.0	5.3	4.5	0.0	4.5	6.7	4.1	4.5
Moldova	-6.5	-3.4	2.1	5.0	6.1	4.8	7.2	5.0	6.3	5.0	4.0
Tajikistan	5.3	3.7	8.3	10.0	10.2	6.0	9.1	5.0	10.2	6.0	4.0
Uzbekistan	2.1	3.4	3.3	3.8	4.1	2.0	3.1	3.0	0.3	2.0	2.0
Average	4.4	3.0	5.4	6.2	7.1	5.0	6.9	5.0	8.2	5.2	5.4

Notes: "London" denotes estimates and projections prepared for the London conference on the CIS-7 (February 2002). The latest data for 2003 are preliminary estimates from mid-March 2004. For Uzbekistan, official growth rates are unreliable; data shown are alternative IMF estimates.

Source: Bank and IMF staffs estimates.

5. **The emergence of the external sector as a major driver of GDP growth, with exports rising by an annual average of about 12 percent, is an important development of the past four years.** This contrasts sharply with earlier transition years, when demand was based mainly on consumption and fueled by unsustainable external borrowing. Still, available evidence suggests that the export performance of the CIS-7 is inhibited by internal and regional constraints. In addition, with a few exceptions, much of this export growth came from natural resources such as oil, aluminum, gold, and cotton. Most countries face a challenge to take advantage of their abundant supply of low-wage semi-skilled labor.

6. **Progress towards macro-stability and the cumulative impact of structural reforms are supporting productivity increases and growth.**⁴ Since 1998, the total factor productivity (TFP) has grown steadily in all CIS-7 countries and across major sectors, led by agriculture, industry and trade.⁵ Industrial growth was concentrated in low value-added commodities and goods (e.g. food processing). Agricultural output also recorded a welcome recovery, but further reforms are needed to attract investment and achieve a lasting turnaround in this key sector. Across most sectors, low investment, including from abroad, constrains growth prospects.⁶ Notwithstanding the progress to date, further structural reforms

⁴ The background paper on growth by Loukoianova and Unigovskaya (2003) provides econometric evidence that there exists a strongly positive correlation between progress toward the goals of growth and reduced income inequality in the CIS-7, and the tools of continued structural reforms and fiscal discipline.

⁵ This finding should be interpreted with caution, as changes in TFP capture increases in productivity, increases in capacity utilization, changes in hidden employment and the reported GDP increase due to the legalization of the informal sector. Higher capacity utilization may also have been spurred by structural reform.

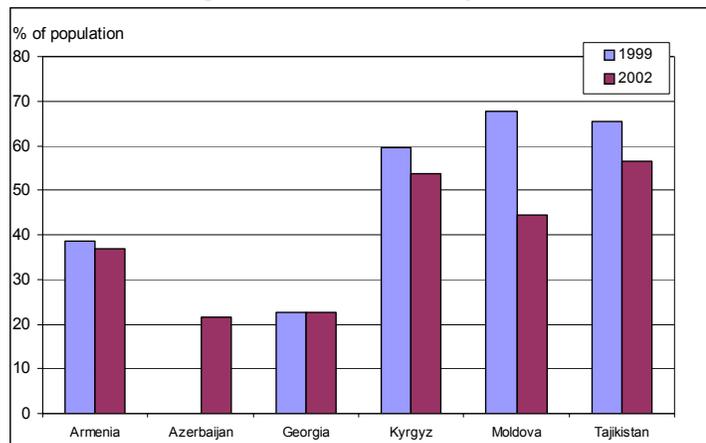
⁶ Azerbaijan is a special case due to the massive investments in the petroleum sector.

are needed in the CIS-7 to improve the business climate, stimulate investment, and enhance the prospects for sustained and broad-based income and employment growth.

7. **The track record of growth-oriented reform in the CIS-7 is mixed.** For Armenia, Azerbaijan, the Kyrgyz Republic, and Tajikistan, the pursuit of structural reforms and sound macroeconomic policies have contributed to improved growth and macro-financial stability. As envisaged in the Initiative, these efforts were supported by policy-based lending from bilateral donors and the IFIs. In the remaining countries, reform efforts have not been sustained, resulting in disappointing economic performances. This has been the case in Georgia, although recent political changes hold out hope for better policy performance. Moldova's reform program went off track in 2003 and international aid has been suspended, pending a renewed structural reform impetus. For Uzbekistan, welcome steps were taken in 2003 to liberalize the foreign exchange regime, but significant further reforms are needed to liberalize the economy.

8. **As shown in Figure 1, the recent robust economic growth has reduced poverty from the peaks recorded in 1998-99.** Countries where the poor benefited most from the economic growth were the Kyrgyz Republic and Moldova. In Tajikistan and Armenia, poverty declined much less, while in Georgia growth apparently has not yet led to any poverty reduction. In many of the CIS-7 countries, declines in poverty levels were strongly supported by large workers' remittances. Based on the commonly used international poverty line of US\$2.15 per person per day,⁷ CIS-7 poverty rates currently range from just under a quarter of the population in Azerbaijan and Georgia to 54-57 percent in the Kyrgyz Republic and Tajikistan. Nevertheless, the CIS-7 are still by far the poorest countries of

Figure 1. CIS-7 Poverty Rates



Note: Rates are based on international poverty line of US\$2.15 per day per person (PPP), corrected using PPP-1996. All data are from surveys using comparable methodology for computing poverty rates. Still, changes in poverty rates presented in the figure are not fully comparable across countries due to data gaps: for Armenia and the Kyrgyz Republic the second data points are 2001, and thus might underestimate the poverty reduction achieved to date; for Tajikistan the second data

⁷ Some authors argue that this rate understates poverty in the CIS-7, many of which have cold winters, making heating and warmer clothing vital. If the poverty line is set at US\$4.30 PPP, about 25 million persons—close to one-half of the CIS-7 population—were deemed in the early 2000s unable to meet their basic needs.

Europe and Central Asia. In recent years, the share of the population in the six countries of the group (excluding Uzbekistan where poverty data are unreliable) living in poverty was about 40 percent, or 13 million people (Box 1).

Box 1. Reducing Poverty in the Kyrgyz Republic

The Kyrgyz economy is characterized by high poverty and moderate inequality. It has made major strides in attaining macroeconomic stability, and since 1996 has shown a significant response to stabilization and structural reforms. GDP growth was significantly pro-poor. Out of every hundred poor people in 1998, 23 people are estimated to have escaped poverty by 2001. Poverty reduction was broad-based, with reductions across all regions and the rural/urban divide.

Despite these gains, about half of the Kyrgyz population still lives in absolute poverty. Transient poverty remains high as well, due to consumption volatility; even the richer households experience transient poverty. The vulnerability to poverty is likely due to the absence of effective saving instruments and imperfect financial intermediation, insurance, and storage markets. Access to public services such as water and sewerage, electricity and heating, or telephone service is very low, yet increasing access to services is a costly way of reducing poverty due to population dispersion. The country's medium-term poverty reduction challenge remains huge, and crucially dependent on the rate of growth and the forces driving it. Further pro-poor growth should be sought by supporting formal job creation, addressing transient poverty, increasing the efficiency of social services such as primary and secondary education and health care, and ensuring access of the poor to affordable electricity.

Source: World Bank (2003). *The Kyrgyz Republic: Enhancing Pro-poor Growth*.

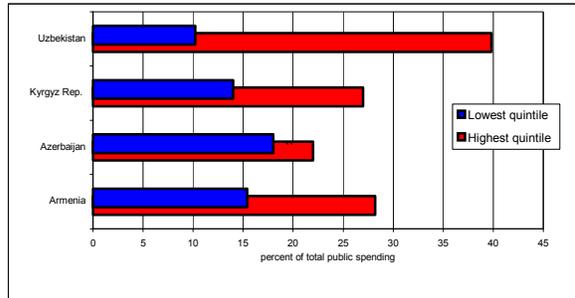
9. **Measured inequality did not decline over the past four years, after increasing sharply in the 1990s.** In 2001-03, consumption Gini coefficients ranged from 0.28-0.30 in Armenia and the Kyrgyz Republic to 0.36-0.37 for Azerbaijan, Georgia, and Moldova, with Tajikistan placed in between.⁸ While current measures of inequality in the CIS-7 remain below measures in many countries at comparable income levels, they have deteriorated rapidly over the past fifteen years, sparking an acute sense of deprivation among those at the bottom of the income distribution, with serious implications for social stability.

10. **Non-income dimensions of poverty, especially lack of access to key social services and infrastructure, may be worsening in the CIS-7.** Surveys indicate that the poor encounter widespread access and cost constraints when seeking health care and, to a lesser degree, quality education. Although primary and secondary education is free and compulsory, poor children have worse attendance and dropout levels than those from better-off families. Lack of textbooks, school supplies and clothing, and the need to help the family discourage school attendance. Information on the incidence of public spending confirms that the poor have inferior access to education and health services, particularly in Armenia and Uzbekistan (Figure 2).

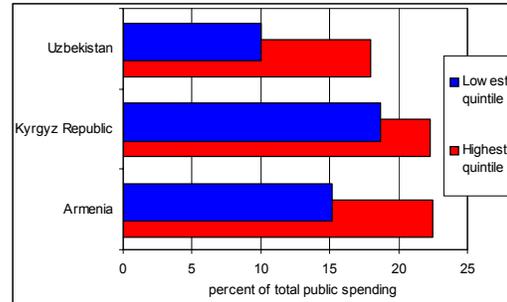
⁸ Comparable data on Uzbekistan are not available.

Figure 2. Incidence of Public Expenditures in the CIS-7

The poor benefit less from public spending on health...



...as well as on education.



Note: Data shown are for the latest available year (1998-2002); comparable data are unavailable for all CIS-7 countries. Armenia's data cover polyclinics and Uzbekistan's cover in-patient care. Data on education are averages for the primary, secondary and tertiary level; inequality is highest at the tertiary level, while access to primary level services is distributed fairly equally.

Source: World Bank (2004). *World Development Report*; Poverty Assessments for the CIS-7 countries.

11. **The CIS-7 sought to address the erosion of human capital by raising social spending from the very low levels of the 1990s, and paying increased attention to the accessibility, quality and efficiency of social services.** The CIS-7 have also initiated reforms to adjust their social services to the requirements and constraints of the market economy. Social development indicators in the CIS-7 are still higher than could be expected for their income levels (see Figure 3), but on some key human development indicators, in particular health outcomes, some of the countries may not meet the Millennium Development Goals. In addition, performance is increasingly divergent. Some countries, Armenia and the Kyrgyz Republic in particular, were more successful in leveraging recent broad-based growth to boost social spending and to reverse the decline in human capital and social protection systems. But it remains to be seen whether the current recovery in social spending will be sustained. In some of the CIS-7, recent in-year budget adjustments indicate that social spending is still not protected and is often cut first in response to fiscal pressures.

12. **Six of the CIS-7 have prepared and made public their PRSPs in recent years, while in Uzbekistan the PRSP process is at an early stage of development.**⁹ It has helped focus the attention of donors and national governments on the need to develop pro-poor policies. PRSPs have been instrumental in improving the transparency and comprehensiveness of the policy process, particularly in the Kyrgyz Republic and Armenia. As a coordinating mechanism, PRSPs have fostered government consultations with civil society on priorities for medium-term poverty reduction strategies, and helped rationalize

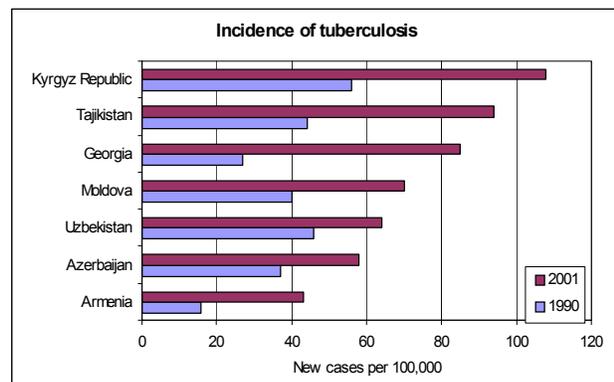
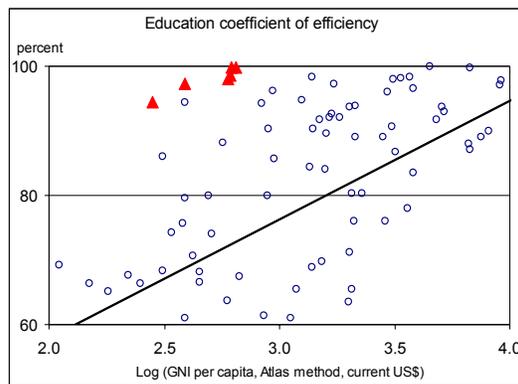
⁹ Kyrgyz Republic and Tajikistan were the first to prepare full PRSPs and published them in 2002. Armenia, Azerbaijan and Georgia have completed and published their PRSPs in 2003, while Moldova's PRSP is very close to completion.

donor assistance. At the same time, Joint Staff Assessments conducted on the CIS-7 PRSPs indicate that their success depends a lot on the prioritization of the program, which is often lacking. On the donor side, greater realization is needed of the fact that the costs of implementing a full-fledged PRSP process can be high, and some of the CIS-7 can meet these costs only with the appropriate level of donor support. At least in some cases, this support is forthcoming: in Tajikistan, the PRSP mechanism helped raise donor support significantly during 2003. In general, PRSPs have helped integrate donor assistance with the priorities of the country and decrease the degree to which aid is donor driven. In several CIS-7 countries, donor-supported community development programs have been introduced, in order to reduce poverty (Box 3).

Figure 3. Social Outcomes in the CIS-7 Countries

Some outcomes are still superior...

...but many are rapidly deteriorating



Note: In the left figure, education coefficient of efficiency equals ideal years to graduate as percent of actual. Solid triangles are the CIS-7. Y-axis scale is restricted, to better distinguish the CIS-7.

Sources: World Bank (2004). *World Development Report*, WHO, UNICEF.

13. **In September 2003, the Executive Boards of the IMF and World Bank reviewed progress in implementing the PRSP approach.** Most observations made for a larger group of PRSP countries generally hold true for the CIS-7 as well, even for those countries that have anchored their economic and social policies and targets on the PRSP. The review found wide-ranging but uneven progress across countries in implementing poverty reduction strategies. Directors welcomed the increasing involvement of parliaments and greater openness of the policy-making processes. They emphasized the need for greater cohesion between PRSPs and other planning documents, including the national budget, as linkage with annual and medium-term budgets remains weak and PRSPs have continued to include numerous uncosted measures. Positive findings included the focus on measures to foster private development and improve the investment climate, increased pro-poor spending in PRSP countries, and tentative signs of improved access by the poor to social services. Many countries need to strengthen aid management to facilitate donor alignment, and coordinated donor technical assistance is crucial.

Box 2. The CIS-7 Countries and the Millennium Development Goals

The Millennium Development Goals (MDGs) promote poverty reduction and human development as the key to sustaining social and economic progress. In broad terms, they aim to cut by half the proportion of people living in poverty by 2015, provide education to all, improve health, and preserve the environment. Although there are varied sources of data on the progress toward these goals in the CIS-7, there is broad consistency across sources suggesting that many of the CIS-7 will be unable to reach their individual MDGs. Meanwhile, some MDGs may be hard to attain because targets are too demanding. This is true particularly for the South Caucasus countries that have broadly better social indicators compared to other CIS-7 countries.

Eradicate extreme poverty and hunger. An estimated 40 percent of the CIS-7 population lives in absolute poverty (defined by an international poverty line of \$2.15 PPP). In Tajikistan and the Kyrgyz Republic poverty levels are among the highest in the transition economies, with 56 percent and 53 percent respectively. Azerbaijan and Georgia have the lowest levels of poverty (respectively 10 and 13 percent). In Moldova and Central Asia poverty is predominantly rural: the rural poor account for over 80 percent of the total.

Achieve universal primary education. At independence, the CIS-7 primary school enrollment (PSE) was close to universal, but in recent years PSE dropped to 85-95 percent of all school age children. It is declining in Armenia, Georgia, the Kyrgyz Republic, Tajikistan and Uzbekistan, which are unlikely to meet this MDG target. Secondary school enrollment and attendance is worse.

Promote gender equality in school. This MDG is likely to be met by all CIS-7 except Tajikistan, which is an outlier and fares much worse than any other transition economy on gender equality. For the CIS-7 as a whole, the ratio of girls to boys in primary and secondary education is close to 100 percent and did not change much over the past 12 years. In Moldova and Armenia these ratios are stable at above 100 percent, while Tajikistan lags at 87 percent. Data for Uzbekistan are less reliable but independent estimates suggest that it is likely to meet the MDG target. The gender distortion is greater in Central Asian countries, and in rural areas in all CIS-7 countries.

Reduce child mortality. Under-5 mortality rates (U5MR) decreased from 37 per 1,000 live births in 1990 to 25 in 2000 for the CIS-7 as a group. However, Tajikistan is markedly worse off than other CIS-7, displaying rates over 100—close to the levels of other low-income countries. Georgia, the Kyrgyz Republic, Moldova and possibly Armenia are unlikely to meet their individual U5MR targets, although in Moldova and Armenia these individual targets may be unrealistic.

Reduce maternal mortality. On average, over 90 percent of the CIS-7 births are attended by a trained medic. As a result, maternal mortality rates (MMR) are relatively low at about 69/100,000 live births, with the three South Caucasus countries having rates in the 20-35/100,000 range. Professional birth attendance is worse in Tajikistan (at only $\frac{3}{4}$) and Azerbaijan (at 88 percent). Tajikistan's MMR is high at 120/100,000, followed by the Kyrgyz Republic (80/100,000). These two countries are unlikely to meet the MMR target. In Armenia and Azerbaijan, MMR targets are unlikely to be reached as they are set at unrealistic levels.

Combat HIV/AIDS, malaria, and other communicable diseases. On this indicator the CIS-7 prospects are the worst: it is unlikely to be met by any of them. Most of the CIS-7 are moving away, not toward this goal. HIV infection rates are growing rapidly in all CIS-7 countries and the risk factors are present for increased rates of transmission. In Azerbaijan reported cases of HIV among females aged 15-24 increased from 2 in 1994 to 128 in 2001, and in Moldova from 3 cases in 1994 to 232 in 2001; only in Armenia does the rates seem to be considerably lower (29 cases in 2001). The incidence of tuberculosis in the early 2000s has almost doubled compared to early independence years. It rose particularly quickly and is very high in the Kyrgyz Republic (108 new cases per 100,000) and Georgia (85/100,000). Meanwhile, the incidence of measles, the most important vaccine-preventable disease is low due to immunization rates well over 90 percent of all under-1 infants. However, the CIS-7 countries are aware of these challenges, and some of them—e.g. the Kyrgyz Republic—are implementing medium term programs to combat communicable diseases.

Ensure environmental sustainability. On the accessibility of safe water and sanitation the CIS-7 countries fare better than on other MDGs, and are likely to meet the target. On average, safe potable water was accessible by over 94 percent of their urban population and 67 percent of rural population respectively. These levels are typical for other low-income countries; but Tajikistan fares much worse - the proportion of its rural population with safe water is only 58 percent. Access to sanitation is better, with 93 percent of the CIS-7 population overall, compared to 43 percent for low-income countries. Access is significantly lower in rural areas, and, surprisingly, in Azerbaijan (81 percent). Georgia, Moldova and the Kyrgyz Republic report over 99 percent access. Continuous data are not available to determine the trend over the past four years, but trends in the first independence decade do not suggest significant deterioration.

Box 3. Community Development in Moldova and Tajikistan

High poverty, weak governance and poor business environment in the CIS-7 countries are formidable obstacles for designing and implementing projects that have tangible effects on poverty reduction. Nevertheless, given technical and financial assistance, communities can do much to improve their own conditions. Recognizing this, the World Bank in collaboration with other donors supports, in most of these countries, the creation of Social Investment Funds (SIF) that aim to increase national capacity for designing, carrying out, and evaluating community-based projects. Both Tajikistan's and Moldova's SIFs have existed for over five years and have been successful in empowering the poor communities to meet their key development needs.

Both SIFs are demand-driven and aim to improve social and economic conditions by providing small grants for community-based education, health, water supply and sanitation, gas supply, small roads/bridges and other services. The SIFs also provided training and technical assistance, helping the communities to define and manage projects. Besides achieving major improvements for target groups, micro projects supported by SIFs generate short-term local jobs and additional business for local private contractors. The projects are also serving as catalysts for the development of civil society by shifting responsibilities to the community level, fostering participation in the local communities, strengthening local government, and offering a vehicle for new partnerships between community-based organizations and local government.

SIF-supported projects were highly successful in both countries. In Tajikistan, the Fund far exceeded its original plans, completing 184 micro-projects and reaching nearly six hundred thousand beneficiaries. In Moldova, since the SIF was established, more than 450 micro projects were approved for funding and about 400 of them have been completed, reaching 22 percent of the rural population. About 60 percent of funds went to the poorest communities in the country. New NGOs and CBOs designed to pursue local development objectives were created in more than 400 communities. A targeted component of the project deals with providing improved services for vulnerable children (orphans, children with disabilities and street children) as an alternative to mainstream residential care services. In both countries, the key to success was a strong and motivated staff, close supervision, and special attention to community capacity building and mobilization. The micro projects met priority needs, resulted in a high level of community satisfaction, and brought improvements in living conditions to a large number of poor communities.

B. External Finance and Debt Sustainability¹⁰

14. Building on the earlier steps taken by the IFIs, the Initiative has sought to focus donor support on highly concessional terms to the countries implementing reforms.¹¹

For official creditors as a group, the grant element of new loan commitments to the CIS-7

¹⁰ For a more detailed discussion of the assumptions, underlying trends, and outlook on debt sustainability for the five highly indebted countries, see the background paper by Mathieu (2004). Debt sustainability analyses were not prepared for Azerbaijan and Uzbekistan, as debt is not currently a serious issue in these two countries.

¹¹ The World Bank granted IDA-only status to five highly-indebted countries of the CIS-7 group (Armenia, Georgia, Kyrgyz Republic, Moldova and Tajikistan) in 2000. Shortly thereafter, Azerbaijan and Uzbekistan also obtained access to IDA resources. The CIS-7 also have continued to have access to concessional resources from the IMF, including under the PRGF.

jumped from around 50 percent in the late 1990s to 74 percent in 2002. More recently, Consultative Group meetings for the Kyrgyz Republic (2002) and Tajikistan (2003) have resulted in much higher pledges of donor support and improved concessionality. For Tajikistan, donor support for the PRSP totaled around US\$900 million over 3 years, with grants accounting for 45 percent of the total. By contrast, for Georgia and Moldova, large shortfalls of policy-based grants have been observed, reflecting poor policy implementation.

Recent developments

15. **Significant progress has been achieved over the past two years in reducing the external public debt burden. External debt service indicators have improved for the five highly indebted countries, with debt to export ratios declining in all countries, and debt to revenue ratios declining in most countries (Table 2).** External public debt service ratios for 2003 have on average declined by 20 percent since 2002 to somewhat below even the levels expected at the time of the London conference. This strong improvement has been largely driven by strong macroeconomic performance since 2001, evidenced by high real GDP and export growth, supported by debt relief. However, public and publicly-guaranteed external debt service still represented, on average, over 38 percent of central government receipts in 2003.

Table 2. Indicators of Public and Publicly-Guaranteed Debt Service
(In percent)

	2001	2002	2003		2004	2005	2008	2010
			London Conference	Latest				
Debt service to exports (percent)								
Armenia	9.7	9.9	15.7	7.5	5.4	5.0	3.2	3.0
Georgia	19.3	23.4	14.0	15.6	15.7	15.4	9.9	10.1
Kyrgyz Republic	32.2	27.3	23.2	20.9	20.3	15.6	10.9	9.9
Moldova	16.8	14.1	15.0	16.0	12.9	12.7	14.6	16.3
Tajikistan	11.5	15.0	11.3	10.7	8.0	10.1	10.7	9.8
Average	17.9	17.9	15.8	14.1	12.5	11.8	9.9	9.8
Debt service to government revenue (percent)								
Armenia	15.3	21.4	23.8	20.3	14.9	13.5	7.8	6.7
Georgia	68.9	77.2	45.2	46.2	44.7	42.8	24.4	22.7
Kyrgyz Republic	73.3	60.0	55.1	43.1	39.5	29.0	17.0	14.1
Moldova	58.1	51.6	42.0	54.7	36.2	36.3	44.2	50.5
Tajikistan	33.5	37.0	34.6	26.8	17.3	21.1	20.1	17.4
Average	49.8	49.4	40.1	38.2	30.5	28.5	22.7	22.3

Source: Fund staff estimates and projections.

16. **Against this generally positive backdrop, individual country performances have increasingly diverged.** Armenia has seen its debt service to exports ratios fall to low levels on the strength of a favorable bilateral debt restructuring in 2003 and strong export-led growth. By contrast, Georgia's debt service ratios are higher than projected earlier, as export

earnings have not increased as expected and stop-and-go reforms and political instability have further undercut progress. For Moldova, the low concessionality of debt and a poor record of policy implementation, which has cut-off concessional finance and debt relief, have heightened the public debt burden.

17. **Debt relief granted by official creditors, although generally not on concessional terms, has played a major role in reducing the debt burdens, especially in Armenia, the Kyrgyz Republic, and Tajikistan.** However, in Moldova, non-concessional debt restructurings with commercial and bilateral creditors have given temporary cash flow relief but raised debt service obligations for the future. In Georgia, a debt rescheduling by Paris Club creditors in 2001 was followed by policy slippages, which kept the debt burden-high and resulted in arrears accumulation in 2003.

18. **From a present value (PV) perspective, considerable progress has also been made.** All five countries have seen their PV of debt ratios decline since 2001, both in relation to exports and to government revenue (see Table 3). On average, the PV of debt ratios have dropped by 39 percentage points to an estimated 140 percent of exports in 2003. Armenia's PV of debt to exports has dropped by 68 percentage points to under 100 percent. Armenia and Moldova now have the lowest PV debt to exports ratios. Georgia, the Kyrgyz Republic and Tajikistan have seen less improvement, largely reflecting weaker export growth.

Table 3. Present Value Indicators of Public and Publicly-Guaranteed Debt Burden
(In percent)

	2001	2002	2003		2004	2005	2008	2010
			London Conference	Latest		Projections		
Present value of debt to exports (percent)								
Armenia	165	133	109	97	81	74	66	63
Georgia	176	148	100	145	133	123	100	89
Kyrgyz Republic	252	231	205	223	189	180	168	165
Moldova	137	117	93	95	89	90	96	96
Tajikistan	165	149	130	142	139	132	114	104
Average	179	156	127	140	126	120	109	103
Present value of debt to government revenue (percent)								
Armenia	221	203	153	179	173	163	139	127
Georgia	594	501	301	404	354	323	231	190
Kyrgyz Republic	566	471	368	416	351	318	256	223
Moldova	420	370	265	266	226	237	272	281
Tajikistan	422	351	326	320	275	257	206	176
Average	445	379	283	317	276	260	221	199

Source: Fund staff estimates and projections.

19. **Even stronger progress is evident relative to central government revenue. The group average PV of debt to revenue ratio for 2003 dropped by 128 percentage points**

since 2001 to 317 percent. Here, more uniform progress has been achieved across the group, although Armenia lags with a 42 percentage point improvement. In most cases, strong revenue performance has driven the improvement. Moldova's progress also reflects an absence of new borrowing. Nevertheless, the fiscal burden of debt remains high, especially for Georgia, the Kyrgyz Republic, and Tajikistan.

20. **Compared to projections for 2003 made at the London conference, PVs turned out higher against both exports and government revenue on average by a margin of 10 percent and 12 percent, respectively.** Georgia, the Kyrgyz Republic and Tajikistan have significantly higher PV ratios than expected, while Armenia's and Moldova's ratios have been broadly as expected. *These results nevertheless understate the progress achieved for two reasons.* First, the depreciation of the U.S. dollar *vis-à-vis* other key currencies in the period contributed to an estimated increase in dollar debt levels of between 4½ and 8 percent. Second, commercial interest rates have declined considerably over the same period as world inflation expectations have eased. As the discount rates used to calculate PVs are based on commercial rates, their decline has raised the present value of debt. Using London era discount rates would have lowered the PV estimates for 2003 by between 4.3 percent for Moldova and 11.9 percent for Armenia. In this light, Armenia's progress is all the more impressive: if London era discount rates were applied, Armenia's PV of debt to export ratio for 2003 would have dropped to 85 percent, an improvement of about one-half since 2001.

Medium-term outlook

21. **To assess medium-term prospects, baseline projections were prepared that assume export growth rates will ease substantially from recent rates, but will remain in the healthy range of 5-8 percent in US dollar terms through 2010 (Annex I).** External current account deficits will decline monotonically to around 4-6 percent of GDP on average from much higher levels in the recent past, and government revenue mobilization efforts will lead to income rises of 2½ percentage points of GDP by 2010. Real GDP growth is expected to ease to around 4 percent from 2005 from an average of 7 percent in the past 3 years. This conservative base-case projection also reflects constraints to trade and very low levels of private investment, especially FDI, in many of these countries. The outcome could be better to the extent that these constraints could be addressed, especially in the case of those countries that have significantly lagged in reforms. Improvements in regional relations and accelerated reform in countries like Uzbekistan would enhance growth prospects considerably.

22. **The resulting baseline scenarios reflected in Tables 2 and 3 show sustained, albeit modest, improvement in debt indicators through 2010, but with widely divergent expectations.** The debt service projections show Armenia's ratios declining to very low levels by 2008, by which time it will have achieved sustainability. Moldova is at the other extreme, with public debt service ratios rising steadily from 2005, underscoring its unsustainable debt management and macroeconomic policies. Georgia's debt ratios are expected to drop sharply by 2008, assuming sustained strong policy performance. The Kyrgyz Republic's ratios are generally cut in half by 2008 following the impacts of both a

concessional stock-of-debt operation in 2005 by official creditors and the amortization of the sizeable public sector Kumtor gold mine debt by 2007. Tajikistan's ratios are not expected to improve much over the period.

23. **A similar debt sustainability picture emerges from a present value perspective. All countries but Moldova experience significant improvement in their PV of debt levels, mostly from 2005 onward.** Tajikistan and, somewhat surprisingly, the Kyrgyz Republic will see rather modest improvements in their PVs, notwithstanding the assumed Paris Club stock-of-debt operation in late 2004 for the latter. Also noteworthy is the projected path of debt concessionality—on average only marginally improved—although major increases are projected for Georgia, the Kyrgyz Republic, and Tajikistan. Concessionality for Armenia and Moldova dwindles, but for different reasons, as Armenia graduates and Moldova remains cut-off from concessional assistance. It is hoped, though, that Moldova will resume an acceptable adjustment path sufficient to attract international support and avoid the pessimistic scenario portrayed here.

Vulnerabilities

24. **Notwithstanding the encouraging baseline projections, the situation in most countries remains fragile and subject to important vulnerabilities, including from external shocks and potential policy reversals.** Even for Armenia, stress scenarios point to high risks. One of the key vulnerabilities stems from a high concentration of exports in commodities like gold for the Kyrgyz Republic, aluminum for Tajikistan, and diamond polishing for Armenia. In addition, significant potential external liabilities from the stock of energy sector arrears pose risks for Georgia (up to 6 percent of GDP; 18 percent of 2003 exports), Moldova (over 6 percent of GDP; 12 percent of 2003 exports), and to a lesser degree in the Kyrgyz Republic.¹² More generally, the countries will need to focus on improving the quality of policies and institutions, which are key areas of concern in determining debt vulnerability. Further, external debt sustainability for these low-income countries will in large measure depend on the degree to which they can balance the potentially conflicting needs to spend more on poverty reduction initiatives and maintain a tight fiscal stance. As noted above, the UN's Millennium Development Goals will be difficult for these countries to achieve; they will be even harder to achieve without strong and sustained non-debt-creating international support.

25. **Therefore, it appears that further debt relief may be necessary for the countries except Armenia.** For the Kyrgyz Republic, a debt reduction operation with Paris Club creditors on Naples terms has been factored into the outlook from end-2004 (as noted in the 2001 Paris Club rescheduling agreement), assuming continued good policy implementation, but even this may not be enough, as indicated above. A similar operation will be necessary for Georgia, once a track record of sound policy implementation is achieved. Tajikistan will

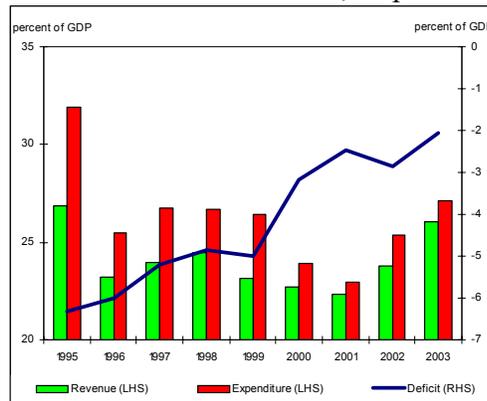
¹² For greater detail see the background paper by Mathieu (2004).

also need to secure a concessional debt reduction operation from official creditors, including Russia. Given the high vulnerability and the uncertainties associated with long-term projections, the recent announcement of the special, more flexible Evian approach for the non-HIPC countries by Paris Club creditors is welcome. The serious short term liquidity risks facing Moldova may also warrant some debt relief, once a strong adjustment program is adopted with the renewal of IFI fast-disbursing assistance.

C. Fiscal Adjustment, Policies and Institutions¹³

26. **In recent years, most CIS-7 states witnessed significant improvement in their overall fiscal situation, and continued to strengthen their public finance institutions.** A major catalyst for change was the 1998 Russian financial crisis. From 1995 to 1999, the average fiscal deficit declined by only 1 percent of GDP. Between 1999 and 2003 the average deficit fell by 3 percent of GDP. The initial focus of this enhanced adjustment was expenditure compression, but with the revival of economic growth revenues have rebounded (see Figure 4). As in other areas, the strength of individual adjustment efforts and corresponding outcomes varied. Overall, though, there remains considerable room for improvement in the quality of fiscal adjustment in the CIS-7. The Kyrgyz Republic, for example, is still running a fiscal deficit close to 5 percent of GDP. In Georgia, deficits were recently contained though the accumulation of budgetary arrears. Revenues remain especially low in Georgia and Tajikistan; in Armenia and the Kyrgyz Republic, they stagnated for the past five years. Both policy and institutional aspects of revenue mobilization need improvement.

Figure 4. CIS-7: Government Revenues, Expenditures and Deficit



Notes: Data shown are simple averages for the CIS-7. To the extent possible, the coverage is for consolidated general government, but in several countries information of local government finances remains weak, and in Uzbekistan information for some extrabudgetary funds is unreliable. Data are on a cash basis and do not reflect budgetary arrears. Revenues include grants. Comparable data are not available for all seven countries prior to 1995. RHS - right hand scale; LHS - left hand scale. Source: World Bank and IMF staff estimates.

¹³ This section draws on Andrews and Shatalov (2004).

27. **There exists significant scope for improving strategic prioritization of budgetary spending, and for reducing non-transparent and wasteful quasi-fiscal activities.** With substantially reduced public finance envelopes, the CIS-7 governments cannot maintain the extensive range of public services which they offered two decades ago. At the same time, private provision can be an attractive solution in many areas, on both efficiency and affordability grounds (e.g. specialized/higher-level education and health services). So far, the governments have been slow in encouraging the entry of private providers. Some expenditure categories vital for long-term growth, such as investment and non-wage goods and services remain volatile and vulnerable to intra-year cuts. By contrast, expenditures on wages, public administration, defense and security remain well protected. Beyond the budget system, the CIS-7 governments still extend substantial quasi-fiscal subsidies to enterprises and households, mainly via controlled utility tariffs and non-enforcement of collections. The energy sector in particular remains a source of substantial quasi-fiscal subsidies to downstream industries. Large off-budget support is also provided via subsidized water tariffs. All such off-budget operations are non-transparent and in the long-term undermine the fiscal stance of a country. Furthermore, since most CIS-7 are net energy importers, quasi-fiscal activities often eventually translate into public debt.¹⁴

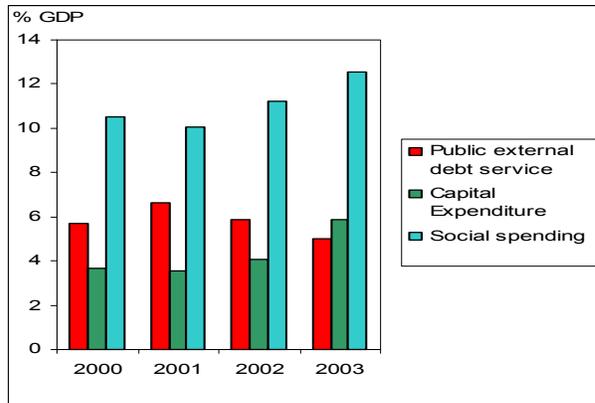
28. **Outlays on debt service have declined over 2000-03, but are still very high in Moldova and Georgia, and significant in Uzbekistan, the Kyrgyz Republic, Tajikistan, and Armenia.** A combination of rising concessionality of new financing and debt restructuring has opened additional fiscal space for most CIS-7 countries. Some of this additional funding was redirected to partly finance a boost in investment, which expanded by almost 3 percent of GDP, and social expenditures, which increased by almost one percent of GDP. These are welcome developments, as they partly reverse harmful cuts in developmental spending of the past decade.

29. **Social expenditures have yet to regain the priority needed to support sustainable growth and rising living standards.** Social spending is well below the levels of other CIS countries (see Figure 5). Its efficiency is also low. Without further prioritization and efficiency gains in social spending, the erosion of the CIS-7 human capital will continue. In some of the CIS-7, inadequate attention is paid to the targeting of poverty alleviation spending. Initiatives to improve the strategic orientation of government, like the PRSPs, have insufficient impact on resource allocation decisions. The formulation of these initiatives often bypasses the central budgeting authority, and their time frames often do not match the budget timetable.

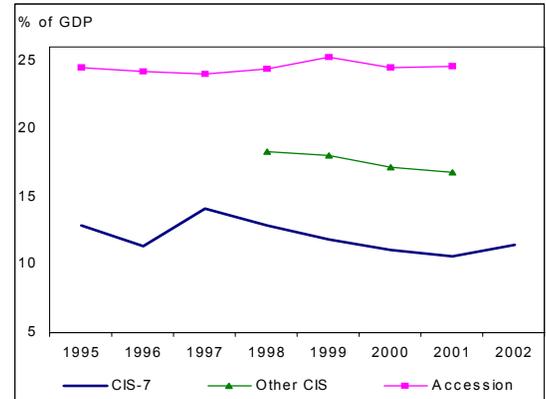
¹⁴ The IMF and World Bank (2002) estimate the annual level of QFAs from 5-10 percent of GDP in Moldova to 20-25 percent in Azerbaijan and Uzbekistan.

Figure 5. Public External Debt Service and Developmental Expenditures

Developmental spending is recovering...



...but social spending is still too low



Notes: Social spending comprises education, health and social security and welfare. For the figure on the left, data are simple averages for Armenia, Georgia, the Kyrgyz Republic, Moldova and Tajikistan. 2003 data are preliminary estimates. For the figure on the right, data are simple averages for three groups: *CIS-7*, *Other CIS* (Belarus, Kazakhstan, Russia and Ukraine), and ten *accession* countries of Central and Eastern Europe.

Source: World Bank and IMF staff estimates.

30. **On the institutional front, the CIS-7 states have continued their progress in improving budgetary execution and audit; yet other important budget management functions did not receive sufficient attention.** Fiscal planning should cover all government expenditures, ensure consistency of budgeted expenditures within a realistic medium-term macro-framework, and prioritize spending. At least one-third of total public expenditures in the CIS-7 are outside the budget, including extra-budgetary funds, externally financed project expenditures, and quasi-fiscal deficits. *Ex ante* public expenditure plans do not fully reflect government priorities, while expenditure allocations tend to be based largely on the updating of allocations from previous budgets. Use of the budget as a public policy tool is undermined by frequent within-year adjustments. The quality of budgetary outcomes is often poor, with pervasive cash rationing and arrears as a result of (i) macroeconomic shocks leading to revenue shortfalls that require cuts in budget expenditures; (ii) unrealistic revenue projections and volatile revenue flows, deriving from political and governance factors and uncertainties of donor financing; (iii) institutional weaknesses in budget planning; and (iv) budget control systems that are not fully effective in cash management.

31. **An important recent development in the CIS-7 is the introduction of medium-term budget frameworks (MTBFs). These frameworks provide a vehicle for strategic prioritization, increasing budget comprehensiveness and transparency, and linking budgets to PRSP programs.** Yet these important budget formulation reforms should be better linked to the more advanced budget execution and audit reforms, and should extend to local governments, which carry out important growth-enhancing spending programs.

Box 4. The IFIs' Work on Transparency and Budget Management

The 2002 paper on the CIS-7 pointed out the need to deepen public finance reforms, and laid out measures to assist the CIS-7 states in this endeavor. Both the Fund and the Bank have given considerable emphasis to transparency and governance issues in their work.

The CIS-7 countries have been active participants in the Fund's standards and codes initiative. Fiscal Reports on the Observance of Standards and Codes (ROSCs) have been completed for four countries (Armenia, Azerbaijan, Georgia, and the Kyrgyz Republic), while Moldova's ROSC is underway. For one CIS-7 country (Azerbaijan), an update of an earlier fiscal ROSC was completed in 2003. In February 2004, a high-level seminar was held at the Joint Vienna Institute, providing an opportunity for representatives from all CIS-7 countries to discuss past achievements and future challenges in improving fiscal transparency. Financial sector ROSCs were completed for three CIS-7 countries (Armenia, Georgia, and the Kyrgyz Republic); and statistical data ROSCs were completed for four countries (Armenia, Azerbaijan, Georgia, and the Kyrgyz Republic). In most cases, the reports have been published.

The World Bank's response to this challenge was the preparation of public expenditure and institutional reviews (PEIRs) for each of the countries. PEIRs have been completed for five of the CIS-7, while those for Tajikistan and Uzbekistan are close to completion. Governance aspects of public finance received further examination in the World Bank's Country Financial Accountability Assessments (CFAAs) and Country Procurement Assessment Reviews (CPARs). Both of these reports were prepared in 2000-03 for each of the countries. They evaluated the strength of budgetary and financial management, and public procurement arrangements, identifying key risks for public funds and donor programs, and proposing measures to manage these risks. A cross-country dimension to the public finance work was added by two background papers prepared under the Initiative (Betley, 2003; Andrews and Shatalov, 2004).

The governance and transparency reports generally highlighted significant improvement of fiscal transparency and better public financial management capacity across the CIS-7 countries in recent years. Remaining deficiencies include a lack of strategic allocation of public funds; weaknesses in budgetary execution and audit arrangements; non-transparent competitive procurement practices; inadequate monitoring and evaluation in public finance; insufficient enforcement and incomplete legal procurement provisions, with state-owned enterprises sometimes granted privileged status; and the lack of standard bidding documents and training programs.

Voluntary participation is a fundamental aspect of fiscal ROSCs. The Bank's governance and transparency reports (PEIRs, CFAAs, CPARs) have also featured a strong participatory dimension, working with the CIS-7 authorities in defining the most pressing reforms, and outlining steps to further reinforce the public financial management capacity.

The IFIs' governance and transparency work has been strongly supported by the bilateral donors. In many cases, bilaterals (e.g. DFID) co-sponsored the PEIRs, and/or provided national expertise to develop these reports. Extensive capacity-building activities have been undertaken, supported by donor supplied technical assistance credits, institution-building grants, and specialized training.

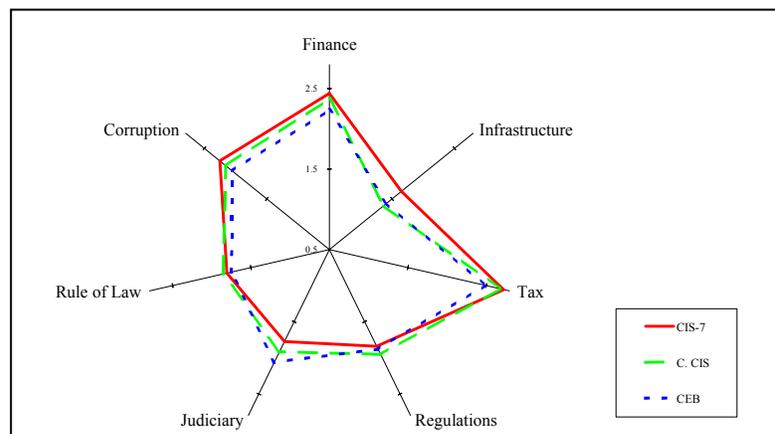
32. Donors have provided financial support to the CIS-7 countries to facilitate fiscal adjustment, and extensive technical assistance in public financial management (Box 4). These efforts have met with some success, but need to be strengthened to impart a more strategic approach to fiscal adjustment and public financial management. For instance, in some cases donor concern with financial accountability has reinforced deficiencies in budgetary systems, such as lack of comprehensiveness, by insisting on ring-fencing their funds. Donor technical assistance has focused primarily on expenditure controls and treasury

systems, while strategic budget formulation has received less attention. Finally, donors have not sufficiently encouraged the CIS-7 to integrate the PRSPs with the regular budgetary process.

D. Governance, Corruption, and the Business Environment¹⁵

33. Over the period 1999-2003, business environment perceptions have improved in most of the CIS-7 countries, particularly with regard to access to finance, the judiciary, control of corruption, and rule of law. They are generally *on par* with other CIS countries, but significantly less positive than for the EU accession countries (Figure 6). The outcomes of recent business surveys vary, but confirm some movement in the CIS-7 states toward deepening reforms and addressing problems that have held back their progress. Successful industry and enterprise restructuring cases in the CIS-7 indicate that in the right environment, businesses can flourish, supporting more vigorous growth (Box 5).

Figure 6. Obstacles to the Operation and Growth of Business in the CIS-7, 2002



Notes: Smaller “diamonds” denote more positive perceptions of a given aspect of business environment. C.CIS are Belarus, Kazakhstan, Russia, and Ukraine. CEB are Croatia, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia. Although some of the differences appear small, most of the differences between CIS-7 responses and those of the other regions are statistically significant at conventional levels, owing in part to the large sample sizes involved.

Source: BEEPS 2002.

¹⁵ This section draws on *Steves et al. (2004)*, which analyzes the findings of the EBRD/World Bank Business Environment and Enterprise Performance Surveys (BEEPS) of 1999 and 2002, as well as on World Bank (2004) *Anticorruption in Transition 2*, which also uses the BEEPS. This section is also informed by other recent surveys conducted by the World Bank, national governments and NGOs.

Box 5. Succeeding Against All Odds: Business Restructuring in the CIS-7

Despite the constraining environment, many businesses were launched or successfully restructured in the CIS-7 countries in the past five years, ranging from traditional low value-added sectors to high-tech, high value-added industries. Significant potential in medium- and high-tech sectors exist in many of these countries. The following two cases are indicative.

Georgia's tea industry was severely affected by economic collapse and by a predominant opinion that it could not compete with the bulk producers (e.g. Argentina, India and Vietnam) as their teas were selling at below the Georgian cost of production. Georgian teas also suffered from a reputation of low quality. In recent years, the Center for Enterprise Restructuring and Management (CERMA) in Georgia explored world market potential, and decided that the country had good prospects in the niche market of specialty teas. This high-margin market has been growing at 15 percent per year. In 2003, CERMA launched a tea industry rehabilitation program by selecting 12 specialty tea producers and assisting them in wide-ranging technological modernization. CERMA helped to establish a quality control center, to assure the constantly high quality of teas demanded by specialty markets. Major technical improvements were seen in unit processes of roll breaking and fermentation and a much better standard of green leaf was obtained. CERMA provided technical assistance to tea processing factories by helping to standardize the usage of existing machinery and purchased new solar drying equipment. It also primed market interest through print and internet-based media. In 2003, the tea producers' association brought its first shipments of hand-made tea to the market. For the year 2004, the association plans to export approximately 50 tonnes of tea to specialty markets of six EU countries and the U.S.A. This may not be much, but it will boost economic growth in rural regions with a population of around 1 million.

The **Armenian equipment automation sector** had ample experience in the design and production of control systems for the aviation industry in the Soviet period. Mshak company was established in 1990 by fourteen skilled engineers specializing in computer digital control (CDC) systems, aiming to carve out a niche in modernization and retrofit of industrial equipment with computer controllers. From 1994 Mshak entered the export business, focusing on the provision of complex engineering solutions for the design and implementation of automation pilots, particularly for machine tool manufacturers. Step by step, the company developed strong brand recognition and good reputation in the CIS, Middle Eastern and some OECD markets. Today, Mshak is one of the top five suppliers of complex engineering management systems to the Russian market, and is one of the few companies in the CIS capable of offering state-of-the-art design and testing of industrial software, and of integrating unique machine and production line automation solutions for international clients requiring specialized design and manufacturing of key high precision components.

34. **Firms' perceptions of the quality of the business environment vary significantly across the CIS-7, and so do their rankings in each of seven individual dimensions of business environment—access to finance, infrastructure, tax, regulations, the judiciary, the rule of law, and corruption.** As measured by the EBRD/World Bank Business Environment and Enterprise Performance Surveys (BEEPS), Azerbaijan scored best on perceptions about most aspects of the business environment, except infrastructure and corruption, while Moldova scored the worst on all aspects except infrastructure and corruption. Georgia scored the worst on corruption, and registered some of the worst perceptions about the rule of law and access to infrastructure. Tajikistan ranked the worst with respect to infrastructure access, and was among the worst in terms of access to finance. Perceptions about access to infrastructure and corruption in Uzbekistan were the best in the CIS-7. Uzbekistan also fared among the best on regulation, while Moldova was among the best in terms of access to infrastructure.

35. **Tax administration issues are perceived by the CIS-7 businesses as the largest obstacle.** These countries fare significantly worse on this dimension than the EU accession countries, although several of the CIS-7 have recently improved. Corruption in customs administration, distortionary trade regulations, and intrusive business licensing are perceived to be significant hurdles. Firms in the CIS-7 were particularly critical of tax administration, rating it as more of an obstacle than firms in other regions. By contrast, firms in the CIS-7 complained relatively less than firms in other regions about tax rates, which are perceived as relatively business-friendly. At the same time, the CIS-7 firms were more likely to indicate underreporting of sales to the tax authorities compared to firms in other regions. The degree of underreporting was also notably larger. Georgia, the Kyrgyz Republic and Moldova have the highest unreported sales among the transition countries. Clearly, however, the BEEPS data understate the actual extent of tax evasion, both because of the sensitivity of the question and because the question focuses on corporate tax liabilities. World Bank country studies indicate that payroll taxes are more often underreported than corporate taxes. As long as payroll taxes remain high in the CIS-7, incentives will remain strong to reduce the tax burden by paying minimal reported wages and providing the bulk of compensation via non-reported/non-taxed channels.

36. **Access to finance is another major problem faced by CIS-7 firms.** In Tajikistan and Azerbaijan, financing from family and friends accounts for the majority of funds.¹⁶ Other important sources of financing are internal funds or retained earnings; in Moldova, they are reported to be as high as 80 percent of total financing. This pattern of financing sources limits business development and has much to do with the cost and particularly with the maturity of bank loans. Loan terms average just 14 months compared to 32 months in the EU accession countries. While these may be rational terms in light of the lenders' risk considerations, they severely constrain investments that require longer maturities. The average annual real cost of bank loans exceeds 10 percent for the CIS-7 group.

37. **CIS-7 firms perceive access to infrastructure as a less serious obstacle, although it still ranks high compared to more advanced transition economies.** This holds true for all four key elements of business infrastructure: telecommunications, electricity, transport, and access to land. Poor infrastructure creates problems for businesses, particularly with power outages, and connection delays for electricity and fixed line telephones. Perceptions range from very high in the Kyrgyz Republic and Tajikistan to more modest in Armenia and Azerbaijan. Inadequate capacity and poor design and maintenance of public infrastructure in the CIS-7 contribute to the problem. Remaining policy deficiencies, such as monopolistic practices in the telecoms sector (particularly with regard to connections to fixed telephone lines) may impair the CIS-7 countries' ability to develop knowledge economy sectors.

¹⁶ In most CIS-7, a large part of financing is accounted by remittances from relatives employed abroad.

38. **Government regulation was perceived to be less of an obstacle in 2002 than in 1999, but it is still high on the list of concerns.** Most business surveys suggest that the “time tax”¹⁷ may have declined in the CIS-7 over these years, but vary as to the extent of this decline. For example, a recent World Bank survey in Armenia showed that managers spent almost 11 percent of their time dealing with state or local authorities, while the 2002 BEEPS suggested the time tax was only 3 percent.

39. **The rule of law is generally viewed as deficient.** The CIS-7 have weaker institutions for crime prevention, detection and deterrence, and this affects firms’ performance. In 2002, on average 9 percent of firms in the CIS-7 reported losses from crime, with the highest percentage in the Kyrgyz Republic, where 28 percent of firms reported such losses.

40. **Although firms in CIS-7 reported, on average, that the functioning of the judiciary is less problematic for their operations and growth than was reported by firms in the CEE and Baltics, these results should be interpreted with caution.** The CIS-7 firms also sought court arbitration much less frequently than firms in advanced transition countries. Only 26 percent of CIS-7 firms had been to court, as compared to 44 percent in the CEE and the Baltic states. This result suggests that CIS-7 may consider the courts to be not very relevant and therefore not an obstacle for their operations. Among firms that have been to court, perceptions of honesty, impartiality, and affordability of the courts were worse for the CIS-7 than for the accession countries. There is also significant variation within the CIS-7: Georgia and the Kyrgyz Republic consistently score the worst on all five dimensions of the judiciary, with the largest shortcomings in terms of the speed with which the courts adjudicate disputes. In questions about the need to bribe when going to court, Georgia, the Kyrgyz Republic and Tajikistan again receive the worst ratings among the CIS-7. In the Kyrgyz Republic and in Uzbekistan, bribe payments at court became more common by 2002, whereas in both Armenia and Azerbaijan such payments were becoming less frequent.

41. **Administrative corruption is still a severe problem, although perceptions of the frequency of bribery improved over 1999-2002 in some CIS-7 countries.** In 2002, CIS-7 firms reported the heaviest bribe taxes among all transition countries (on average more than 2 percent of annual revenues), ranging from over 3.7 percent in the Kyrgyz Republic to 0.9 percent in Armenia. Again, the direction of change in perceptions in individual countries was very diverse. The frequency of bribery fell sharply in Armenia, Azerbaijan and Uzbekistan, while it rose slightly in Georgia, the Kyrgyz Republic and Moldova.¹⁸

¹⁷ Amount of time spent by managers in dealing with public officials regarding the application of laws and regulations.

¹⁸ Corruption data not available for Tajikistan for 1999.

42. **Interfirm trust, measured by the level of prepayment demanded by firms from their customers, was slightly higher in the CIS-7 than in the central CIS, but much lower than in EU accession countries.** Prepayment ratios for these groups were 35, 40 and 10 percent of total sales, respectively.¹⁹ Inter-firm trust is particularly weak in Azerbaijan, Tajikistan and Uzbekistan, all of which have prepayment levels in excess of 40 percent of sales, and are among the lowest trust transition countries. In Georgia and Armenia, in stark contrast, prepayments are close to five percent, well below the EU accession countries. In the CIS-7, networks based on personal contacts of enterprise insiders or contacts with government officials are perceived to be of little help in building trust. On the contrary, family networks are perceived to be very instrumental for trust-building between firms.

E. Capacity Building

43. **Dedicated technical assistance (TA) and significant additional resources from IFIs and bilateral donors targeted institution building in core areas.** At the IMF, dedicated accounts established by Italy, Japan, the Netherlands, and Switzerland financed a range of activities, with an increased emphasis on regional events. The EBRD's legal transition program has also continued to provide assistance funded by grants for the drafting of laws on secured transactions, bankruptcy, telecommunications, foreign investment, and leasing. The World Bank has used both grant-based and loan-based vehicles to support capacity building.

44. **The Lucerne Conference in January 2003 helped the countries and donors identify the main areas where assistance was needed in knowledge creation and the capacity building** (Table 4). Since then, a wide array of events have been held, covering implementation and monitoring of national PRSPs; obstacles for regional cooperation in transport and information communications, SMEs, power and water use, tourism, and mobilization of investment; financial sector development; and human development. Overall, the focus of technical assistance and capacity-building activities was shifting toward poverty reduction strategies, governance and accountability issues both in the public and private sectors, and judiciary and public administration reforms. The IMF has continued regular TA to individual countries, provided through visits of experts and staff and resident advisors. Azerbaijan, the Kyrgyz Republic, Tajikistan and Uzbekistan benefit from TA in Public Debt Management launched in 2002 with the support from the Swiss Government and coordinated by a resident adviser in Bishkek. The IMF's fiscal affairs department held two tax policy and administration seminars for senior officials from the CIS in 2002 and 2003 focusing on indirect and direct taxation, respectively, financed by Italy and Japan. Four one-week workshops on different applied aspects of public debt management have been held, some with participation of other donors (UNITAR, UNCTAD) and three more are planned for 2004. The World Bank is preparing a conference on public expenditure management to

¹⁹ Higher level of prepayment denotes lower interfirm trust.

provide CIS-7 countries with an opportunity to compare their experiences in reforming public finance systems and to follow up with fiscal policy work.

Table 4. IFIs' Technical Assistance to the CIS-7, 2000-03

Country/ type of support provided	Area of support									
	Poverty reduction strategies, community development	Governan ce, anti- corruption and judiciary	Public finance (tax policy and administration, public expenditure, procurement, etc.	Public Administ ration reform	Trade and Trade Facilitatio n	Water and energy	Financial and Private sector develop ment	Social Safety nets	Environ ment	Monitoring and evaluation
Armenia										
Credits		X	X					X		
Grants		X	X		X		X		X	X
Azerbaijan										
Credits							X			
Grants	X	X	X					X	X	X
Georgia										
Credits										
Grants		X	X		X				X	X
Kyrgyz Republic										
Credits	X	X	X	X				X		X
Grants		X	X		X	X			X	
Moldova										
Credits		X								
Grants	X		X				X	X	X	X
Tajikistan										
Credits		X	X							
Grants	X		X	X	X	X		X	X	X
Uzbekistan										
Credits			X							
Grants			X		X	X	X	X		X

Source: IMF and World Bank staff estimates.

45. Over the period 2000-03, the World Bank granted TA credits to Armenia, Azerbaijan, the Kyrgyz Republic, and Tajikistan, covering issues ranging from civil service reform and strengthening the accountability of government finances, to regulatory framework for private sector development, to governance and strengthening the voice and participation of civil society. Some of these operations are co-financed by other donors (e.g. DFID provides co-financing to the Kyrgyz Republic' GTSAC/GTAC, while GTZ was in important partner in implementing Armenia's SATAC). Furthermore, the World Bank approved grants from the Institutional Development Facility (IDF) to support capacity-building e.g., on environmental management (Moldova, Uzbekistan), governance, anti-corruption and public procurement (Armenia, Azerbaijan), treasury development and judiciary reform (Armenia, the Kyrgyz Republic) statistics and macroeconomic management (Armenia, Georgia). Notwithstanding the progress, needs—especially in Tajikistan—will remain high for some years to come.

F. Regional Cooperation

46. **The CIS-7 are in search of new, more efficient modalities of regional cooperation, since regional integration agreements (RIAs)²⁰ in which they participate have so far produced modest economic gains.** Even on critical issues, such as trade, water and energy, cooperative schemes have been unreliable. Cultural and political dimensions of nation building, isolationist policies of some of the countries and/or their larger neighbors, and differing rates of growth are still slowing regional cooperation.

47. **Trade and transit arrangements in the CIS-7 countries and neighbors are still quite distorted and require reform.** From this perspective, regional integration should be consistent with the multilateral obligations and aspirations of the individual countries, and avoid promoting inefficient trade diversion. Harmonization of trade rules with multilateral standards, liberalization of transit regimes, and removal of non-tariff barriers deserve top priority. Moreover, a political commitment to trade liberalization from the largest of the CIS-7 countries—Uzbekistan—would represent a major breakthrough for the region. The CIS free-trade block, to which the CIS-7 countries belong, has beneficial features, such as agreements on mutual recognition of standards and generally non-restrictive rules of origin. However, the most recent trend has been to pursue deeper integration within the CIS via narrower “clubs.” For example, EURASEC includes five countries, of which only two are among the CIS-7; and a more recent CES initiative does not include the CIS-7 at all.²¹ If this trend were to continue, the CIS-7 countries could be left out of these newer, more advanced and potentially more effective integration mechanisms in the CIS, and they would run the risk of promoting trade diversion.

48. **The CIS-7 group does not offer a natural framework for cooperation: these countries belong to three different sub-regions (Central Asia, South Caucasus, and South-Eastern Europe), and gravitate towards different economic centers.** Integration of the small domestic markets of CIS-7 countries is unlikely to generate significant gains. On the contrary, gains can be significant if integration involves larger and wealthier countries—CIS-7 neighbors such as China, Iran, Kazakhstan, Russia and Turkey, or OECD countries. Expanded cooperation with the EU, in addition to significant economic gains, is likely to

²⁰ Most of these agreements involve only members of the CIS block. All CIS-7 countries except Tajikistan also signed cooperation agreements with the EU; Moldova and the South Caucasus countries signed regional integration agreements with other Black Sea basin countries.

²¹ Eurasian Economic Community (EURASEC) comprises Belarus, Kazakhstan, the Kyrgyz Republic, Russia, and Tajikistan. Common Economic Space (CES) includes Belarus, Kazakhstan, Russia, and Ukraine.

have a “policy lock-in” effect.²² However, given that the CIS-7 already enjoy preferential access to the EU under the GSP regime for their exports, additional gains can be reaped only if behind-the-border issues²³ in the CIS-7 and non-tariff barriers in the EU are resolved. This requires, *inter alia*, the CIS-7 countries investing in compliance with the EU technical regulations and standards.

49. **In recent years, the CIS-7 have begun to shift attention to more focused sub-regional cooperation agendas.** This trend is particularly pronounced in Central Asia, where Kazakhstan, the Kyrgyz Republic, Tajikistan and Uzbekistan are promoting a Central Asia Regional Economic Cooperation framework (CAREC).²⁴ This framework is driven by annual ministerial conferences (MC), which were launched at about the same time as the CIS-7 Initiative (Spring 2002). The second MC was held in November 2003 in Tashkent, and was followed by technical meetings focusing on three priority areas—transport, trade facilitation, and water and energy. The third one is planned for September 2004 in Almaty. The process is open to neighbors: Azerbaijan, China and Mongolia already participate while others (Afghanistan, Iran, Pakistan, Russia and Turkey) were invited to join and some already attend CAREC events as observers.

50. **Since the launch of CAREC in 2002, progress is evident in each of the three priority areas. In this context, the IFIs mobilized sizeable resources contributing to enhanced economic connectivity within the region and with world markets, and to the rational use of vital resources such as energy and water.** In trade and transport facilitation (TTF), CAREC is helping to mobilize investment for rehabilitation of transportation lines and to improve the policy environment, cooperation, and physical infrastructure of customs. Support from the World Bank and UNDP focused on the policy environment and practical TTF solutions, while the EBRD’s Trade Facilitation Programme provided direct support to private sector growth. In the energy sector, ADB and EBRD support concrete steps toward a regional power market, while the World Bank has carried out analytical work on the energy and water nexus that could underpin future progress. Participating countries currently focus on expediting the implementation of joint projects and regularizing the work of technical committees. This progress probably would have been even more impressive if several of the

²² Participation in a RIA may provide a commitment mechanism for important policy measures by raising the costs and thus decreasing the likelihood of policy reversal. This mechanism is less likely to work within RIAs that involve only the CIS-7 and their neighbors.

²³ These issues include the facilitation of physical, procedural, and administrative steps involved in trade transactions, and in particular transport and cross-border operations.

²⁴ Turkmenistan’s neutrality means that it is generally inactive in regional organizations, but pursues bilateral relations with neighbors and other countries.

countries in the region, Uzbekistan in particular, put regional cooperation higher on their policy agenda.

51. **Benefits from regional cooperation to the three South Caucasus countries could increase dramatically if long-standing conflicts in the region were resolved.** Particularly significant could be gains from the resolution of the Nagorno-Karabakh conflict. Closed borders and trade restrictions, including with Turkey, impose high economic costs. Factionalism within Georgia's national boundaries further raised economic costs for Georgia and its neighbors. So far, only limited progress has been made under the Caucasus component of the EU-led transport project linking Europe, Caucasus and Asia (TRACECA). Regional cooperation has also received a boost from the Black Sea Trade and Development Bank (BSTDB),²⁵ which opened in Spring 2000. The EU, the EBRD, the World Bank and other donors support several transborder projects in the South Caucasus in the environment, telecommunications, and natural resources areas. A South Caucasus Initiative is being formulated under the leadership of the German Government.

52. **Moldova has the possibility of substantially enhanced relations with the EU under the evolving "new neighbors policy."** However, this requires a genuine commitment and substantial efforts by the country itself to modernize administrative and judicial procedures. These conditions have been lacking so far, which has limited Moldova's gains from regional integration with the EU. In 2001 it joined the Stability Pact for Economic and Security Cooperation in South Eastern Europe (SEE), which is focused on the TTF agenda. Still, Moldova's trade and investment cooperation with the EU, Eastern Europe, and even the CIS is below potential, due to both its unwelcome investment climate and problems with the implementation of its formally liberal trade regime, as well as the significant non-tariff barriers maintained by Moldova's neighbors and the EU. Moldova's situation is further complicated by the lack of resolution of the Transnistria conflict. Budget support loans from the EU and most bilateral donors were suspended in mid-2003, in response to the accumulation of external arrears and the lapsing of the adjustment program supported by the IMF. Some project financing and technical assistance from the EU and other donors continues covering cross-border initiatives, including two GEF-supported projects in the environmental rehabilitation and the carbon trade.

53. **Stronger coordination among donors is required to unlock fully the benefits of regional cooperation.** Bilateral donors and the IFIs strongly support integration processes among CIS-7 countries and with other countries via capacity building in many areas. Central Asia and Southern Caucasus regions both have many active donors, reflecting the strong interest of the outside world in these strategically important regions. Moldova has been recently losing donor attention due to its reform setbacks. Multiple donor activities may

²⁵ BSTDB was established by the Organization for Black Sea Economic Cooperation (BSEC), which includes countries of the Black Sea basin—Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Turkey, and Ukraine.

imply potential duplication and conflicting advice. The Initiative led the way in improving coordination between development agencies active in the CIS-7 countries.

54. **In the last two years, sub-regional cooperation frameworks have further expanded the donor coordination agenda.** For example, under the CAREC, the IFIs reduced duplication by focusing on one priority area each, with the ADB leading the TTF work, EBRD concentrating on business climate and governance issues, and the World Bank leading work on the water/energy nexus. Building on the strengths of the CIS-7 Initiative, the World Bank and other IFIs formulated a Central Asia Regional Framework (i) offering a shared vision of regional issues and ways to address them, (ii) enhancing the effectiveness of national programs by maximizing synergies between regional objectives and national assistance strategies, and (iii) setting the basis for a dialogue between the countries and their donors. Given the past experiences, the framework advocates a cautious approach, based on the premise that reaching results is a long-term effort in which stakeholders commitment is critical. For instance, the World Bank is pursuing regional projects only when countries' buy-in reaches a critical level, and where the advantages of regional projects over national ones are clear.

Trade potential²⁶

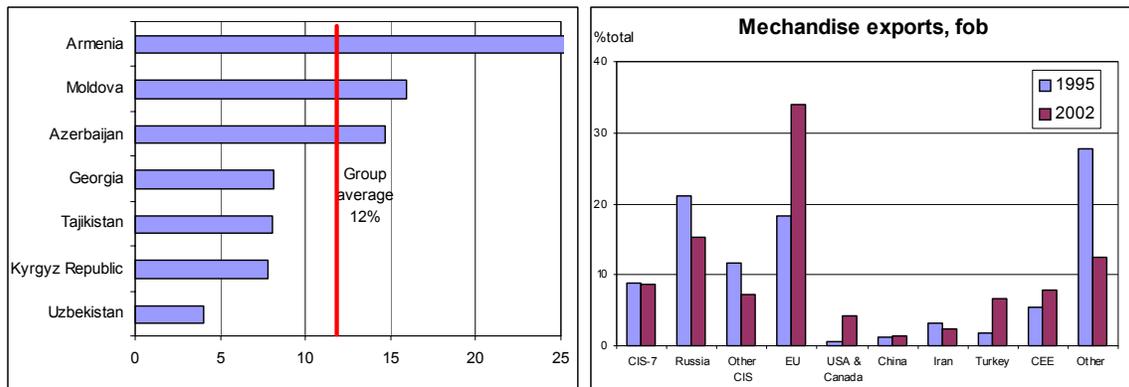
55. **The trade performance of the CIS-7 since 2000 has been significantly better than in the 1990s.** The average 2000-03 growth rate of exports of goods and services in dollars reached 12 percent. Particularly outstanding was Armenia's performance (Figure 7).²⁷ To a large extent, recent export growth is a rebound from the crisis of the 1990s. These growth rates will become sustainable only if substantial impediments to exports are addressed.

56. **The CIS-7 continued to reorient their trade toward non-CIS partners, primarily the EU (Figure 7 and Table 5).** This has been especially the case of the South Caucasus and the Kyrgyz Republic on the export side. By 2002, the EU was taking almost 35 percent of total merchandise exports of the CIS-7. Turkey and North America are two other rapidly growing export destinations; taken together they received over 11 percent of the CIS-7 exports in 2002.

²⁶ This section is based on Shiells (2003), which in turn draws on Elborgh-Woytek (2003), Freinkman et al. (2003); Michalopoulos (2003); EBRD (2003a), chapter 4; and Babetskii et al. (2003).

²⁷ A significant portion of the CIS-7 exports are fuel, ores and metals, which experienced price hikes in international markets over 2000-03. This was particularly beneficial for Azerbaijan and Uzbekistan. However, World Bank and IMF staff estimates indicate that export volume growth was the main reason for the rise in the value of exports in this period.

Figure 7. Growth Rates and Geographical Composition of CIS-7 Exports



Note: In the left figure, growth rates are simple averages for 2000-03 for exports of goods and non-factor services for Uzbekistan and for exports of goods and services for other countries. In the right figure, data are for merchandise exports only; CEE1 are countries of Central and Eastern Europe.

Source: World Bank and IMF staff projections, IMF Directions of Trade.

57. **The composition of CIS-7 exports did not change much: these countries remain primarily exporters of resource-intensive commodities.** In general, they have been unsuccessful in penetrating new markets with processed goods, which are still exported mostly to other CIS countries. More recently, encouraging signs emerged in Armenia and Moldova, with the increasing use of inward processing schemes, under which European and other producers incorporate CIS-7 firms into their value chains, by supplying to the latter inputs and procuring their outputs. Diamond cutting in Armenia and apparel in Moldova are the focus of fledging inward processing businesses. Still, export patterns based on capital-intensive resource extraction and processing prevail, offering little promise of job creation that could significantly support poverty alleviation.

Table 5. CIS-7: Geographical Composition of Merchandise Trade
(In percent)

	1988	1995	2001	2002
<i>Merchandise exports, fob</i>				
CIS	92.7	41.5	28.4	31.2
EU	...	18.0	37.0	34.0
Rest of the world	7.3	⁽¹⁾ 40.1	34.5	34.9
<i>Merchandise imports, cif</i>				
CIS	81.7	46.2	37.3	45.1
EU	...	15.8	17.3	24.2
Rest of the world	18.3	⁽¹⁾ 38.0	45.3	30.6

Note: In 1988, Rest of the world includes the EU.

Source: The IMF Directions of Trade Statistics for 1995, 2001 and 2002, "Vestnik Statistiki," No. 3, 1990, for 1988.

58. **Formal trade policy regimes, consisting of tariff and non-tariff barriers, are relatively open in the CIS-7, with the exception of Uzbekistan.** However, a statutory liberal trade regime is not sufficient for successful export performance. Nominally liberal

countries have in general many non-tariff and informal barriers to trade. A variety of substantial impediments to trade, mostly of a structural, institutional, and transport nature, have to be alleviated in order to sustain the recent outstanding export performance.

59. **Econometric studies suggest that the CIS-7 generally under-trade, although the magnitude of this phenomenon varies with the estimation methods.**²⁸ Only a few CIS-7 countries trade *on par* with their current potential. These studies support the view that comprehensive structural reform and stronger institutions would lead to increased trade and higher incomes.

60. **WTO accession has the potential to raise the level of CIS-7 trade by improving their access to external markets, but WTO membership is not sufficient for improved trade performance.** Four countries are WTO members (Armenia, Georgia, the Kyrgyz Republic, and Moldova) but their trade performance remains mediocre. Administrative capacity constraints and limited membership of neighboring countries prevent new member states from reaping the full benefits of WTO membership.²⁹ Similarly, an apparent lack of political will and administrative capacity in some of the other CIS-7 states has prevented them from joining the WTO, impeding the development of their trade potential.

Trade and transport facilitation

61. **The CIS-7 face excessive transport and transit costs.** The currently observed under-trading could be substantially mitigated by improving transport and trade facilitation infrastructure and procedures. While the CIS-7 participate in a large number of multilateral (WTO), regional, and bilateral agreements on transit and customs cooperation that provide for national treatment of transport companies in transit, these agreements have failed to bring about free transit for the region. All CIS-7 countries are members of the Transports Internationaux Routiers (TIR) convention, but high costs and complicated licensing and guarantee requirements limit its benefits. Transit countries often use their geographical advantage to restrict movement of goods of the transiting countries. For example, Ukraine creates restrictions on Moldovan transit to Russia; Kazakhstan on Kyrgyz transit to Russia; Uzbekistan on Tajik transit to Kazakhstan and to Russia; and Georgia on Armenian transit to the ports on the Black Sea. Transiting countries retaliate in-kind but with limited results, since the trade flows are geographically unbalanced. Transit countries, including some of the CIS-7 themselves and some neighbors, often violate customs and transit agreements by creating hurdles in customs clearance.

62. **Experience of the World Bank and other donors in the TTF area has shown that institutional issues are key to successful TTF projects.** Entrenched interests within TTF

²⁸ For more detailed discussion see Shiells (2003).

²⁹ These benefits include WTO mechanism for the resolution of trade disputes and negotiations with the new members on market access.

organizations and governments have created most obstacles encountered in the course of TTF projects in the CIS-7. The main institutional problems consist of weak government oversight, weak incentive frameworks, and poor staffing and performance evaluation systems. Occasionally, government bodies involved in TTF act like private firms rather than public agencies, and the extent of corruption in this sphere is significant. The CIS-7 can unlock substantial trade facilitation potential if they proceed more vigorously with customs modernization and reform—an area in which they can benefit from extensive experience of the World Bank and other IFIs.

Management of shared public goods

63. The CIS-7 share abundant public goods, such as common water resources and power networks, and they can benefit from greater cooperation in managing them.

Although these potential gains are universally recognized, only limited progress has been achieved. Negative externalities, such as environmental degradation, can also be addressed effectively only on a sub-regional basis.

64. Regional cooperation is vitally needed in water and energy management in Central Asia. River water that originates in the Kyrgyz Republic and Tajikistan is used for the electricity generation in these countries, and for irrigation in Kazakhstan, Turkmenistan and Uzbekistan. Water use is regulated by bilateral agreements, which are not harmonized, and have failed to provide much-needed stability and efficiency in the utilization of water resources. These barter arrangements are rarely transparent, which breeds corruption. In addition, there is a problem of pollution of major rivers, such as Kura, Araks, Syr-Darya, Amu-Darya and Dniester. The lack of multilateral management of vulnerable water supplies resulted in the draining and pollution of the Aral Sea, destruction of its ecosystems, and serious threat to the health of the local population. To address these problems, five Aral Sea Basin republics have established the Inter-Disciplinary Coordinating Water Management Commission, which directly manages water resources with support from the World Bank, UNEP, and UNDP but improvements so far have been modest.³⁰

III. THE WAY FORWARD

65. The CIS-7 Initiative proposed a new partnership between the countries and the international community to address debt sustainability; improve donor coordination; provide knowledge services and reinforce capacity building; and foster regional cooperation. The Initiative has raised awareness of the difficulties faced by the countries and provided a forum to coordinate international efforts. Several countries sustained their reforms, thereby securing substantial support from the international community. The group also benefited from a return of growth and stability to Russia and other large neighbors, buoyed, among other things, by strong commodity prices. To a large degree, CIS-7 growth

³⁰ See Schiff and Winters, 2002.

has been driven by robust export performance. Debt sustainability indicators have improved, in some cases well beyond the levels expected at the time of the London conference.

66. **Nevertheless, reform progress and macroeconomic performance were uneven and increasingly divergent among the seven countries, though most of them have made significant advances in most fronts.** Some countries need to take further steps to secure the benefits extended by the international community, either by establishing reform track records to unlock official debt relief or addressing poor investment environments, trade barriers, and governance concerns so as to attract private foreign investment and spur export-led growth. Significant regional barriers to growth and prosperity remain to be addressed.

67. **The CIS-7 Initiative has enjoyed some success, notably in re-invigorating donor interest and fostering a better understanding of the development challenges facing these countries. However, several of the countries would like to move beyond the format of the Initiative.** The primary reason for this is the desire to focus donor and cross-country cooperation at the sub-regional level. The IFIs will continue to work with all the countries to define new modalities of cooperation on specific issues as necessary. Sub-regional efforts show recent signs of promise in Central Asia, while Moldova is being drawn into the EU's Wider Europe Initiative. Clearly, the South Caucasus region would benefit considerably from improved economic relations among the three countries, and the international community is expected to focus much more on fostering such relations.

A. Toward Effective Poverty Reduction Strategies

68. **The recent strong recovery in economic growth is encouraging as it led to significant reductions in poverty in most of the CIS-7.** However, economic activity in the CIS-7 is also vulnerable to several factors, including demand shocks from Russia and other large regional economies. The pace of growth may not be sustained without an increase in investment from very low levels, including from abroad. Reforms aimed at improving the business climate, reducing trade and transit barriers, promoting good governance and expanding property rights are essential to support sustained income and employment growth.

69. **To reduce poverty, growth must be broad-based and inclusive.** Pro-growth policies include steps to improve governance and reduce corruption; enhance the business environment and promote trade openness; and support SME and rural development. This needs to be complemented by measures that promote social inclusion, human resource development, and social protection, including protection of vulnerable groups such as children, the disabled, women, internally displaced persons, and migrant workers. Further efforts also are needed to identify and better target the poor and vulnerable.

70. **The PRSP process, which has helped link poverty reduction objectives with public and donor policies, needs to become a more central part of the business of government.** This can be done by fully integrating poverty reduction strategies with decision-making at the central, line agency, and local government levels. Actively involving

parliaments, academics, civil society, professional associations, and the media is essential for effective formulation and implementation of poverty reduction strategies.

71. Success of the PRSPs also depends on strengthening ownership, better prioritization, sound fiscal policies, and improved public resource management.

Implementation capacity at all levels needs to be strengthened, and countries need to avoid unrealistic expenditure wish lists. Donors must make the PRSP the primary coordination instrument. The availability and quality of data needs to be improved to ensure that poverty trends are adequately forecasted, monitored and evaluated. Better account should be taken of the social impact of economic policies. This can only be achieved via continuous monitoring and evaluation.

B. Managing Public Finances and Debt

72. Fiscal discipline needs to be sustained, especially because of the already high debt levels and continued dependence on external inflows. Greater attention should be given to revenue mobilization and expenditure rationalization in order to secure fiscal viability.

Greater consistency and predictability of the fiscal stance is key to business confidence. Maintaining sustainable fiscal deficits is particularly important. In some countries, such as Georgia, progress in revenue reforms has been slow or insufficient. Improved revenue performance should be a result of broad-based governance reforms, such as improvements in business climate, strengthening the rule of law, dealing with corruption, and strengthening the revenue collection service.

73. Maintaining the institutional reform drive is vital for satisfactory fiscal outcomes and poverty reduction strategies.

Good public expenditure management should provide the framework to guide preparation and implementation of poverty reduction strategies. There is a need to ensure that budgets capture actual spending intentions and link medium-term budgetary resource allocation with sectoral policies and expenditure programs. Spending cuts are still feasible in low-priority areas, and efficiency gains can be made where funds are spread thin and service provision is inefficient. Spending on items with a high impact on growth and poverty may need to rise considerably. Targeting of social welfare expenditures should be improved, which will also facilitate the reduction of pervasive quasi-fiscal subsidies.

74. A review of donor support for public finance reforms is warranted, to refine priorities and modalities of cooperation.

Donors need to enhance their support of strategic budget formulation, while maintaining support to the ongoing treasury projects and the transfer of best practices in budget execution and audit.

75. Most CIS-7 countries have limited or no access to international capital markets, and will continue to rely on concessional official external financing.

There is a need for prudent borrowing policies and reforms to increase effectiveness of external financing. For creditors and donors, adequate financing consistent with repayment capacity, including increasingly on grant terms for some (such as Tajikistan), will be necessary for debt

sustainability, while providing the financing needed to meet the MDGs. Even so, vulnerabilities to external shocks that could quickly lead to deteriorations in debt indicators needs to be lessened.

76. **Highly concessional stock-of-debt operations in the Kyrgyz Republic, Tajikistan, and Georgia and Moldova (once performance has been reestablished in the latter two countries) are key to attaining debt sustainability.** Paris Club creditors have granted nonconcessional flow reschedulings to Georgia and the Kyrgyz Republic, with the possibility of a stock-of-debt treatment following a period of sound policy and reform implementation. However, only the Kyrgyz Republic has established a sufficient record to benefit from a possible stock of debt operation. Georgia and Moldova need greater efforts to reestablish a track record of reform implementation, though agreement reached on a new Fund-supported program for Georgia is a welcome step in that direction. The Evian Approach, announced by the Paris Club creditors in October 2003, holds significant promise for achieving durable debt sustainability in the CIS-7.

C. Fostering Efficient Private Sector Development

77. **Sustained and consistent efforts are needed to improve the business environment through regulatory reforms and removal of administrative barriers.** A heavy burden on business persists, especially on SMEs, from obsolete regulations and heavy-handed administration. In some areas, such as anti-monopoly and competition policy, consumer protection, and the environment, regulations are inadequate, and need to be brought into compliance with WTO requirements and other international norms. Institutional infrastructure for product testing and certification, quality assurance, product development, export promotion and marketing services are still widely deficient. Increased transparency in regulatory processes, strengthened public-private consultation mechanisms, and greater use of cost-benefit analysis and market impact assessment of new regulations are needed. Donors should support these actions.

78. **Tackling corruption in a systematic and sustained manner is key to improving investor confidence and leveling the playing field for SMEs to flourish.** Governance and corruption problems go beyond the business environment and include pervasive unofficial payments to receive health care, education, social benefits, and driver's licenses. They reach much deeper (e.g., corruption in pharmaceuticals procurement), compromising public health and safety. Corruption and weak governance in public services delivery affect more heavily the poor and those least able to defend themselves.

79. **To improve businesses' access to finance, countries need to promote financial deepening and develop financial lending infrastructure.** This should foster diversification of financial products and services, mitigate credit risks, and support faster growth. In addition to bolstering financial sector supervision, technical assistance is needed to create credit information and collateral registry systems, and to generalize cash flow-based lending. Special tailored efforts are needed to enable financial institutions to deal profitably with SME

clients. In some instances, regulatory impediments for the development of non-bank institutions—leasing companies and microfinance institutions—need to be removed.

80. **Urgent judiciary reforms are generally needed to strengthen firms' belief in the ability and willingness of the state to defend property rights and adjudicate impartially in business disputes.** The priority is to reduce corruption in the courts. Developing civil society by promoting social networks based on professional and business associations, trade organizations, and non-economic groups would be complementary actions.

D. Placing an Emphasis on Regional Cooperation

81. **Significant potential benefits in the CIS-7 can be gained from regional cooperation.** Technical assistance and collaboration among agencies in addressing drug trafficking, human trafficking and communicable diseases need to be strengthened. Countries should strive to harmonize regional trade and transport arrangements. Regional and bilateral free trade agreements in Central Asia need to be made compatible with, and foster, multilateral trade negotiations under the WTO. Tariffs and trade restrictions outside the region need to be reduced to ensure that distorting trade diversion does not outweigh the benefits of freer regional trade. Regional trade agreements would benefit from a removal of exemptions and contingent protection clauses. It would also be desirable for the CIS-7 to form coordinating committees on trade policy (most likely on a sub-regional basis), to address issues of intra-regional trade liberalization and facilitation and to forge a common stance on common extra-regional trade problems. Agreement on a competition (anti-monopoly) framework, harmonization of national standards, and creation of an effective dispute resolution mechanism are areas where progress would also be beneficial. For Moldova and the South Caucasus, a solution to long-standing conflicts (Transnistria, Nagorno-Karabakh, and Georgia's breakaway provinces) could bring significant benefits. The EU, Russia, Turkey, and the U.S. have key roles to play in supporting resolutions of these conflicts.

82. **There is a clear need to build non-discriminatory regional transit systems, which rely on modernized and more efficient customs.** The multiplicity of transit agreements should be replaced by straightforward and clear arrangements comprising mutual recognition of customs control procedures and documentation, standardized transit documentation, and vehicle certification requirements. Improved transparency in procedures and accessibility for users should be fostered. Transport and trade facilitation projects should stress the maintenance and rationalization of infrastructure, and the upgrading of information and communications technology. Customs reform projects should upgrade the other key facet of trade facilitation in the CIS-7. Transport system inter-operability must be prioritized, and arrangements for sharing regional public goods should be streamlined.

83. **Donor coordination would be further enhanced if one of the IFIs assumed a lead role in the formulation and delivery of each sub-regional cooperation program.** Such programs could be designed for each of the three sub-regions and should involve the CIS-7 and their neighbors. Significant externalities from developments in Afghanistan and

neighboring countries (for the Central Asian sub-region) and in the Middle East (for the Southern Caucasus) also call for more effective coordination between donors operating in different sub-regions. Sub-regional frameworks would help in managing shared public goods. Given the three sub-regions' geographical features and traditional intra-regional links, infrastructure services and public utilities should be optimally planned at the sub-regional level.

84. Regional cooperation initiatives are more likely to be beneficial if early successes can be secured and made visible to the public, and if popular and business constituencies for regional cooperation are built up. Furthermore, the pay-offs from regional cooperation would be substantially enhanced if its scope were extended to larger neighbors like the EU, China, Iran, Russia, Turkey, Ukraine, and South Asia. Such an expansion could yield significant benefits by linking natural resources to their potential markets within regional cooperation frameworks. Broader regional cooperation may also enhance the “policy lock-in” effect and result in more efficient cooperation in the areas of regional security and the environment.

IV. Concluding Remarks

85. During 2001-03, the CIS-7 countries experienced annual real GDP growth averaging over 7 percent, which has erased some of the income losses sustained in the first decade of transition and helped reduce poverty. Many of them now demonstrate stronger overall fiscal discipline and better debt-carrying capacity. Donor awareness and coordination for the benefit of the countries are demonstrably stronger now than they had been before the CIS-7 Initiative was launched, and donors have responded with debt relief. Knowledge creation, cross-country dissemination, and enhanced capacity building have been supported by a growing range of donor-assisted activities. Developments in many structural areas (e.g., business climate, governance, core public service delivery and trade facilitation) have been mixed, and most countries still face serious challenges. Regional cooperation received an initial boost from the global war on terror, but has progressed more slowly than expected due to lukewarm political commitment in the countries and larger neighbors. This is a particularly acute problem for the smaller countries. Financial and physical indicators of living standards in the CIS-7 remain well below regional norms.

86. The CIS-7 Initiative has enjoyed some success, notably in re-invigorating donor interest and fostering a better understanding of the development challenges facing these countries. However, several of the countries would like to move beyond the format of the Initiative. The primary reason for this is the desire to focus donor and cross-country cooperation at the sub-regional level. Sub-regional efforts show recent signs of promise in Central Asia, while Moldova is being drawn into the EU's Wider Europe Initiative. Clearly, the South Caucasus region would benefit considerably from improved economic relations among the three countries, and the international community is expected to focus much more on fostering such relations. The IFIs will continue to work with all the countries to define new modalities of cooperation on specific issues as necessary. There is also considerable potential for enhancing the development prospects in the region through the PRSP process.

For the countries, better progress is needed to define priorities within PRSPs and to link them closely with their budgets. For their part, donors can be expected to insist that their assistance be framed within the context of country PRSPs. External assistance should be largely grant-based, and consistent with commitments made with respect to attainment of the Millennium Development Goals in these countries.

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ASSUMPTIONS USED IN DEBT SUSTAINABILITY SCENARIOS

Annex Table 1. Central Government Revenue (excluding grants)

	2001	2002	2003		2004	2005	2008	2010
			London	Latest				
<i>(In percent of GDP)</i>								
Armenia	14.7	15.4	16.7	14.8	15.1	15.6	16.8	17.6
Georgia	8.5	8.7	11.9	9.5	9.9	10.4	12.2	13.4
Kyrgyz Republic	16.1	18.0	16.5	17.7	18.1	18.6	19.3	19.9
Moldova	14.6	14.6	16.5	16.2	17.0	17.0	17.0	17.0
Tajikistan 1/	15.5	16.8	15.0	16.4	17.8	18.6	19.5	19.9
Average	13.9	14.7	15.3	14.9	15.6	16.0	17.0	17.6
<i>(Growth rates in percent)</i>								
Armenia	12.5	7.0		8.4	11.7	12.2	11.3	10.1
Georgia	14.3	-8.1		21.9	10.4	8.9	10.9	10.4
Kyrgyz Republic	26.4	17.6		16.7	8.3	11.6	9.5	9.5
Moldova	-9.1	11.0		30.6	24.5	6.1	5.1	5.1
Tajikistan 1/	14.7	24.5		13.6	25.2	11.1	8.0	7.9
Average	11.8	7.4		18.2	16.0	10.0	9.0	8.6

Annex Table 2. Exports of Goods and Services

	2001	2002	2003		2004	2005	2008	2010
			London	Latest				
<i>(percent of GDP)</i>								
Armenia	23.3	29.1	25.3	35.5	37.1	37.9	36.7	35.7
Georgia	30.4	28.9	38.2	28.1	28.3	29.0	30.1	30.3
Kyrgyz Republic	36.7	39.6	39.5	36.6	35.2	34.5	30.0	28.3
Moldova	49.7	52.4	47.1	53.3	47.9	48.8	51.7	52.9
Tajikistan 1/	45.3	41.4	44.7	41.2	38.7	38.9	36.7	35.4
Average	37.1	38.3	39.0	38.9	37.4	37.8	37.0	36.5
<i>(Growth rates in percent)</i>								
Armenia	20.8	28.0	9.8	37.4	14.7	10.2	6.6	6.2
Georgia	-6.8	0.0	7.0	9.1	6.4	6.6	6.6	5.5
Kyrgyz Republic	-2.1	13.5	14.1	9.4	2.3	6.3	0.5	6.6
Moldova	14.7	18.3	11.9	21.1	9.1	8.0	6.9	6.1
Tajikistan 1/	3.5	5.7	9.1	15.3	8.1	7.4	4.5	4.8
Average	6.0	13.1	10.4	18.5	8.1	7.7	5.0	5.8

1/ Net of alumina and electricity imports, on account of barter operations

Annex Table 3. External Current Account Balance

	2001	2002	2003		2004	2005	2008	2010
			London	Latest				
			<i>(percent of GDP)</i>					
Armenia	-9.0	-6.6	-9.5	-7.7	-6.9	-6.2	-5.0	-4.4
Georgia	-5.6	-6.0	-5.2	-11.1	-10.8	-10.4	-3.5	-3.3
Kyrgyz Republic	-3.3	-3.9	-6.5	-3.5	-4.2	-5.1	-5.1	-4.8
Moldova	-4.4	-2.9	-7.8	-9.0	-7.2	-7.4	-6.3	-4.9
Tajikistan ^{1/}	-6.7	-2.7	-5.1	-2.9	-3.0	-3.7	-3.0	-3.5
Average	-5.8	-4.4	-6.8	-6.8	-6.4	-6.6	-4.6	-4.2

(1) Net of alumina and electricity imports on account of barter operations

Annex Table 4. External Environment Assumptions

	2003	2004	2005	2008
	Estimates	Projections		
World Growth				
Latest 1/	3.1	4.0	4.4	4.2
London conference 2/	4.4	4.6	4.6	4.5
Russian Growth				
Latest 1/	6.0	5.0	4.0	4.0
London conference 2/	4.4	0.0	5.1	5.3
Petroleum Price				
Latest 1/	28.5	25.5	23.5	21.5
London conference 2/	22.5	21.5	21.0	21.0
Cross Exchange rates				
US\$/Euro				
Latest 1/	1.119	1.117	1.105	1.081
London conference 2/	0.904	0.908	0.912	0.92
US\$/SDR				
Latest 1/	1.3892	1.3879	1.384	1.3768
London conference 2/	1.2752	1.2777	1.2805	1.283

Sources: WEO and OECD (CIRR) data; and Fund staff estimates and projections.

1/ Summer 2003 WEO forecast.

2/ Summer 2001 WEO forecast.