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Opening Up in the Caucasus and Central Asia

Policy Frameworks to Support Regional and Global Integration

IMF staff team led by Peter Kunzel with Phil de Imus, Edward Gemayel, Risto Herrala, Alexei Kireyev, and Farid Talishli

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Executive Summary

The Caucasus and Central Asia (CCA) countries are at an important juncture in their economic transition.[1] Following significant economic progress during the 2000s, recent external shocks have revealed the underlying vulnerabilities of the current growth model. Lower commodity prices, weaker remittances, and slower growth in key trading partners reduced CCA growth, weakened external and fiscal balances, and raised public debt. The financial sector was also hit hard by large foreign exchange losses. While commodity prices have recovered somewhat since late 2014, to boost its economic potential, the region needs to find new growth drivers, diversify away from natural resources, remittances, and public spending, and generate much stronger private sector-led activity.

Greater regional and global economic integration would create favorable dynamics to transition to higher sustainable growth. Opening the region up to more trade and investment would increase access to goods and services at lower prices, spur competition, promote innovation and diversification, increase transparency, reduce rents, and ultimately increase productivity and growth.

Recognizing the benefits of greater economic integration, countries in the region are taking some steps in this direction. CCA countries have pursued various regional and bilateral economic integration initiatives and most are members of World Trade Organization (WTO). They have also made some progress in diversifying their economies and have adopted more flexible exchange rate regimes following recent bouts in global volatility.

However, greater efforts are needed to open the CCA economies up to international trade and investment. CCA countries should seize the opportunity afforded by the current global upswing and various economic cooperation initiatives to further develop their infrastructure and integrate into the global value chain. In this context, increased exports of non-commodity goods and services provide a clear opportunity for higher, sustainable, and inclusive growth, while intra-regional trade should also be exploited. Countries should reduce tariff and non-tariff barriers and strengthen participation in multilateral trade initiatives led by the WTO. Greater capital account liberalization would help with financial sector development and growth, but countries will need to ensure banks are well-equipped to deal with larger and potentially more volatile capital flows. The China-backed Belt-Road Initiative (BRI) may bring massive investment flows to the region over the next decade.

[1] The CCA countries are Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

For countries to reap the full economic benefits of integration and mitigate potential risks, economic frameworks and institutions will need to be strengthened. Robust economic frameworks and institutions will help countries manage larger trade and capital flows associated with greater economic integration and help ensure macroeconomic stability. This, in turn, will generate a more favorable investment climate and positive growth dynamics. The following areas deserve particular attention:

- ***Fiscal reforms.*** While CCA countries are aiming to improve fiscal balances following recent shocks, fiscal adjustment ought to be more ambitious to rebuild buffers and deal with future shocks while facilitating economic integration. This would send a clear signal of fiscal responsibility and strong macroeconomic management to foreign investors. Fiscal policies should also promote growth and equity and ensure that strong social safety nets are available to support the transition to greater economic openness. Immediate priorities include mobilizing revenues and rationalizing non-priority expenditures to free resources for pro-growth and pro-integration spending, improving the fairness of the tax system and efficiency of public spending, and safeguarding social spending. Fiscal frameworks will also need to be improved to help ensure public investment projects, such as those presented by the BRI, are implemented effectively and fiscal sustainability is maintained. This will require building more robust budgetary institutions, fiscal rules and risk management capacity.

- ***Monetary reforms.*** Monetary policy frameworks will need to be further strengthened to support economic integration. The move toward greater exchange rate flexibility in the region is a positive development which will help CCA countries weather future external shocks. While the choice of an alternative nominal anchor should reflect country-specific circumstances, inflation targeting has been gaining ground in the region. To successfully transition to inflation targeting, countries will need strong political commitment, greater institutional capacity, effective communications, and efforts to address lingering financial stability concerns, including restoring the health and viability of the banking sector. Actions to reduce dollarization should be stepped up to strengthen monetary policy transmission and ensure low and stable inflation.

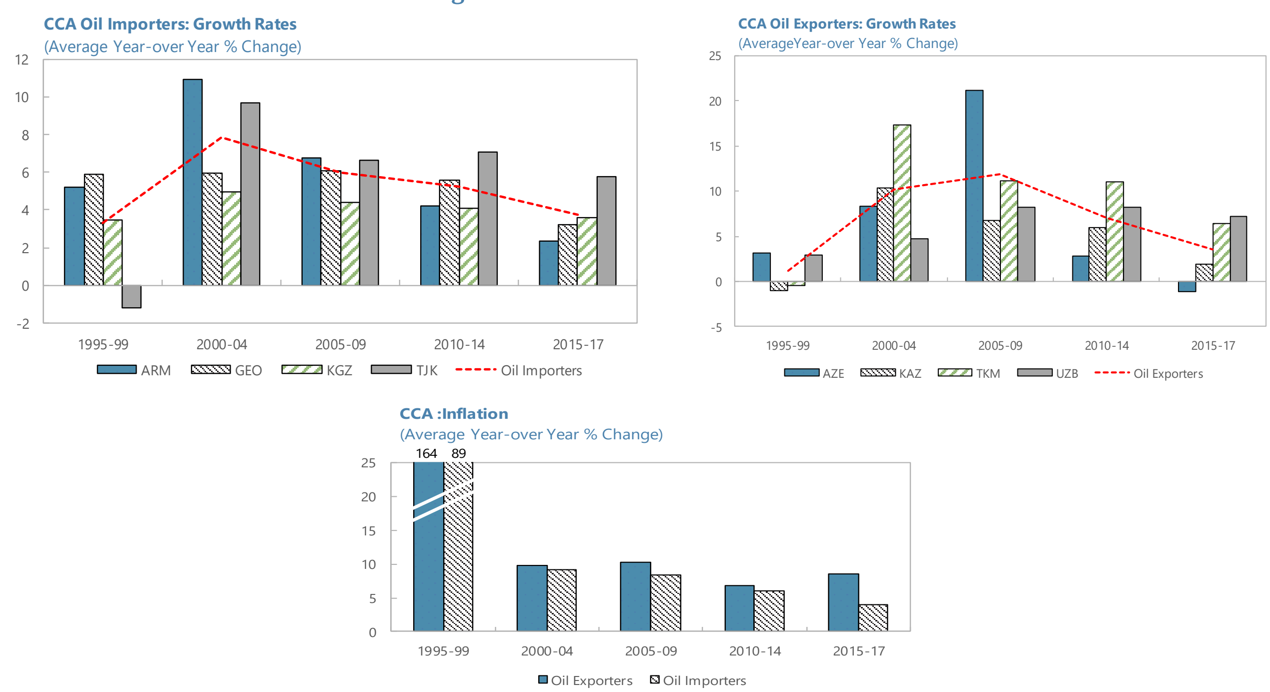
- ***Financial sector reforms.*** Effective financial intermediation is essential as CCA countries look to benefit from trade and investment opportunities. Banking sectors in the region have been hit hard by recent external shocks and have not fully recovered, hampering their intermediation role. While efforts have been made, more is needed to strengthen the banking sector including, in the first instance, proper identification and recognition of non-performing loans as well as timely intervention of troubled banks and stronger resolution frameworks. Improving prudential regulation and supervision and bank governance will be essential to avoid renewed losses, while more efforts are needed to improve correspondent banking relationships and bring the unbanked into the financial system to channel savings into investment. Capital markets also need to be modernized and deepened to diversify financing sources, facilitate project finance, and help conduct effective monetary policy.

- ***Structural reforms.*** Ambitious structural reforms should support successful economic integration. The CCA region has considerable potential to diversify, opening economies up to foreign trade and investment, which would boost growth. Reforms should focus on strengthening infrastructure, the business environment, governance, and labor skills, not only because gaps in the region remain considerable in these areas but also because progress on these fronts would make countries more competitive and attractive to outside investors, thereby supporting regional and global integration.

I. BACKGROUND

1. **The eight Caucasus and Central Asia (CCA) countries made significant economic progress during the 2000s.** Growth was robust, inflation declined, and gains were achieved in building institutions and policy buffers, and in reducing poverty. However, growth was not broad based. On the supply side, it was driven largely by oil and gas, mining, remittances, and construction, while on the demand side private consumption and public spending accounted for the bulk of growth.

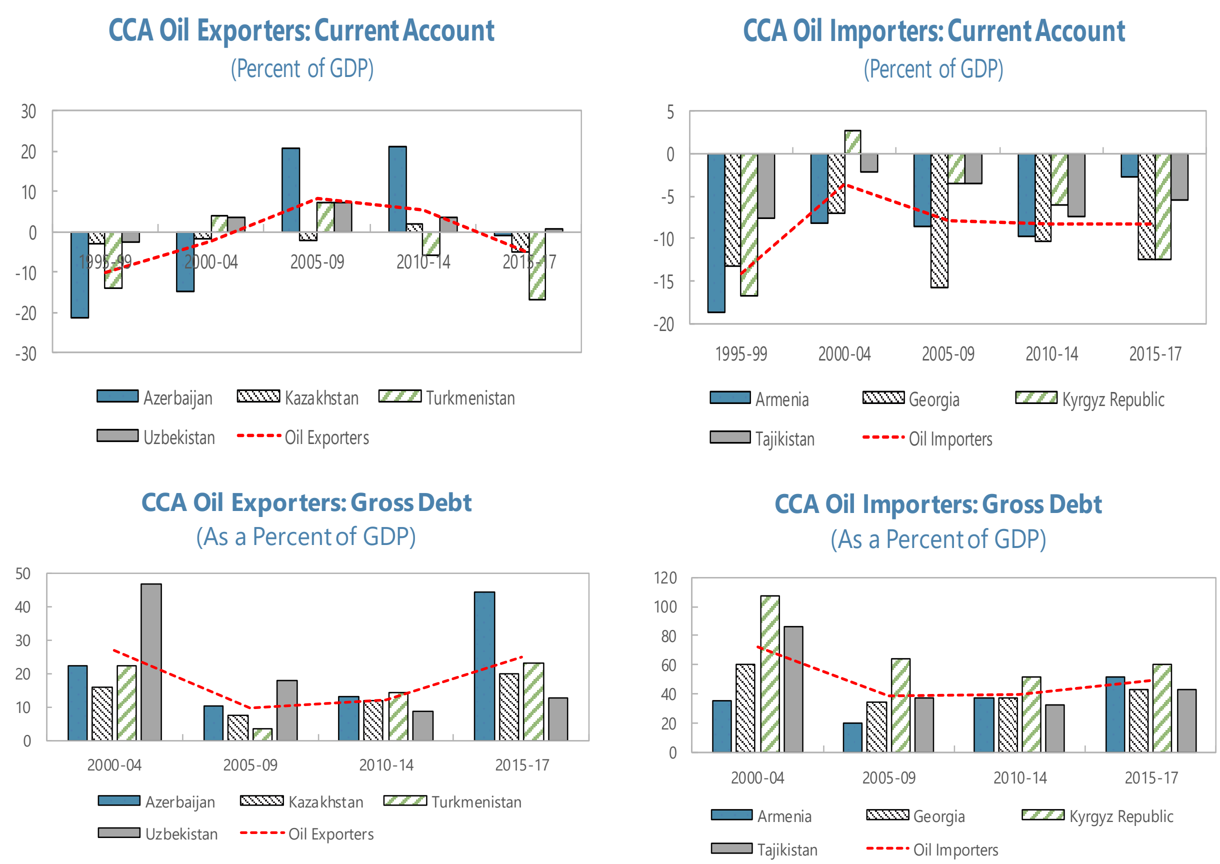
Figure 1. Growth Rates and Inflation



Source: IMF, World Economic Outlook.

2. **External shocks that have affected the CCA region since 2014 have placed pressure on macroeconomic balances and the current growth model.** As a result of lower commodity prices, weaker remittances, and slower growth in key trading partners (Russia and China), growth and current account balances weakened and public debt has risen. With these conditions and pressures likely to persist, growth will remain subdued unless the region can find new growth drivers, diversify away from natural resources, remittances, and public spending, and generate much stronger private sector-led activity. Increased exports of non-commodity goods and services are a clear area of opportunity. If well managed, the BRI could also considerably boost investment, trade, and economic prospects for the region.

Figure 2. Current Account Balances and Debt



Source: IMF, World Economic Outlook.

3. **Increasing trade and investment will require much greater regional and global cooperation and integration.** The CCA region remains fragmented and faces a common set of challenges, including intra-regional tensions, a largely landlocked and difficult terrain,

and an underdeveloped, outdated or outmoded infrastructure.[2] Several regional cooperation initiatives have been pursued—including the Eurasian Economic Union (EEU), the Central Asia Regional Economic Cooperation (CAREC) program, the Shanghai Cooperation Organization (SCO), and China's BRI—with varying degrees of success (see below). Most CCA countries are now also members of the WTO and some signed partnership and cooperation agreements with the European Union.

4. **As CCA countries pursue diversification and integration efforts, they will need to strengthen economic frameworks and institutions to fully reap the benefits and mitigate potential risks.** This will mean, for example, fiscal policy reforms that support efficient investment that can facilitate greater integration while ensuring public debt sustainability, monetary and financial sector frameworks that promote repair and recovery of banking systems, clear identification and management of vulnerabilities and risks, and structural reforms that promote better business and investment climates suited to greater cross-border cooperation.

5. **This paper looks at how the CCA countries can strengthen economic frameworks and institutions to maximize the benefits of greater openness for their economies.** Specifically, it will discuss the following issues:

- What the move toward greater integration implies for the scope, pace and sequencing of trade and capital account liberalization.
- What this more open trade environment means for public investment, debt sustainability, and fiscal risks, and how these risks can be managed.
- How monetary and exchange rate policy frameworks can be further modernized to mitigate potential risks from greater capital flows.
- How current financial sector weaknesses can be repaired and vulnerabilities addressed, and what more is needed to prepare the financial sector for greater integration, in terms of development, deepening and inclusion.
- The structural reforms needed to foster efficient trade and investment and ensure successful economic integration.

[2] The CCA has extremely varied geography, including vast mountain ranges, such as the Tian Shan, Hindu Kush, the Pamirs and the Caucasus Mountains. Central Asia is largely landlocked and is also home to the vast Kara Kum and Kyzyl Kum Deserts, which dominate the interior. These features hamper transportation and trade and raise infrastructure costs.

II. Trade and Capital Account Liberalization

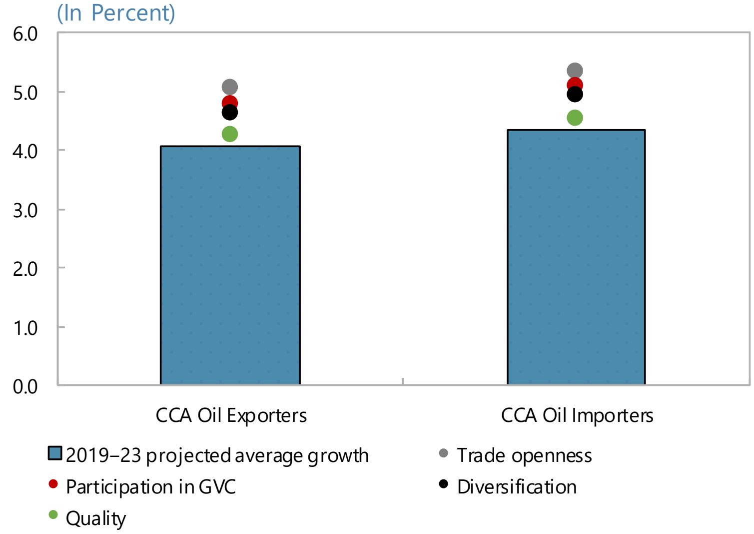
A. Trade

Increased trade openness would yield significant economic benefits to the region. Despite some recent progress toward trade diversification, CCA countries remain weakly integrated with the global economy, and intra-regional trade is low. The BRI offers opportunities to strengthen trade integration by utilizing new infrastructure networks and transitioning toward greater non-commodity and services exports. However, further trade liberalization—including in the context of various trade arrangements—and intra-regional trade is also needed.

The Benefits of Trade Integration

6. **Greater trade integration would yield significant benefits for CCA countries.** The benefits of open trade are well known: it offers consumers and businesses more choices at lower prices; promotes innovation and productivity; and supports growth and overall welfare. At the same time, countries need to adjust to greater competition as they liberalize trade, and may face disruptions in the short term, including a potential loss of jobs and revenues. Over the medium term, the benefits of enhanced trade integration are considerable for economies in the CCA region, and the global recovery provides an opportune time to boost exports and growth. Illustrative estimations suggest that greater trade integration measures—trade openness, global value chain (GVC) participation, export diversification, and product quality upgrade—could raise CCA countries' income levels by 5–10 percentage points within five to ten years (Kireyev et al, 2017). This estimation assumes that trade measures increase by the best year-on-year increase observed over the past 20 years. Thus, for example, growth rates could be 1 percentage point (ppt) higher on average in 2019-23, if countries take steps to improve openness, 0.7 ppt higher if they enhance their participation in GVCs, 0.6 ppt higher if they diversify their economies, and 0.2 ppt higher if they improve their product quality.

Figure 3. Estimated Contributions of Trade Measures to Growth
(In Percent)



Source: IMF staff calculations.
The growth increase is conditional on an increase in the given trade measure equal to the best historical period-over-period improvement observed in region in the last 20 years (7.7 percentage points for trade openness; 4 pp for global value chains; 2.4 pp for diversification; 1.5 pp for quality).

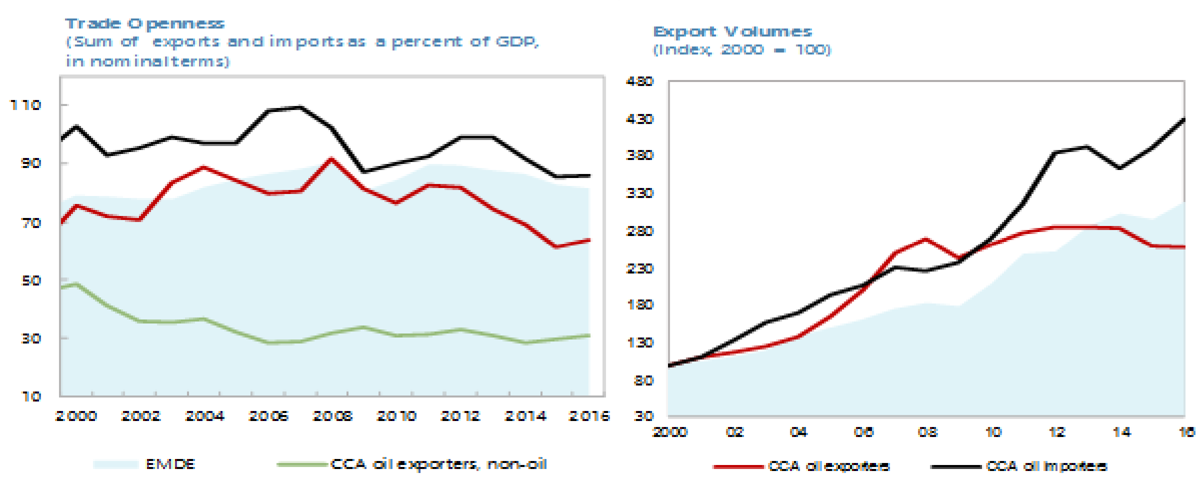
These effects would cumulate if the trade measures are taken in parallel but may not be the same for CCA oil exporters and importers given their different economic structures and degrees of trade openness.

Strengthening Trade Integration

7. **The CCA region faces challenges in deepening trade integration despite its considerable potential**. The region is at the crossroads between Asia, the Middle East, and Europe, and the BRI presents tremendous opportunities for deepening economic integration and joining GVCs. At the same time, trade openness has been declining and CCA's trade remains concentrated on few products. Regional trade initiatives have yet to yield significant results.

8. **Trade openness across the CCA has been declining since 2008**. This trend is in line with international developments, reflecting subdued international economic activity until 2017, including lower investment, slower trade liberalization, a decline in commodity prices, and slower growth of GVCs (IMF, 2016). CCA oil importers have been relatively more open than other Emerging Market and Developing Economies (EMDEs) and CCA commodity exporters, but lower remittances in recent years have compressed imports and contributed to an overall decline in openness (Figure 4). In CCA commodity exporters, lower oil prices have driven the decline in trade openness. Excluding oil, trade openness of CCA commodity exporters has remained broadly stable.

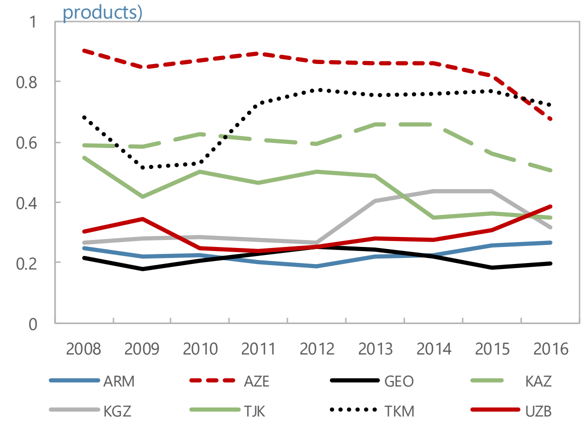
Figure 4. CCA: Trade Openness and Real Exports, 2000–16



Source: IMF October 2017 World Economic Outlook database and staff calculations.
Note: CCA = Caucasus and Central Asia; EMDE = Emerging and developing economies.

9. **Some progress toward economic diversification is being made.** While CCA exports are generally less diversified than EMDE exports, real export growth in CCA oil importers has been substantial and has outpaced that of CCA oil exporters and other EMDEs, suggesting some progress toward diversification. Recent data on the composition of trade seem to confirm that exports are becoming more diversified, notably in Kazakhstan, Azerbaijan, and Tajikistan. The UNCTAD concentration index was 0.57 for CCA oil exporters in 2016 (down from 0.62 in 2008) and 0.28 for oil importers in 2016 (down from 0.32 in 2008).[3] There is still, however, a considerable way to go to diversify exports in these economies.

Figure 5. Concentration Index
(1 = exports/imports highly concentrated on few products)



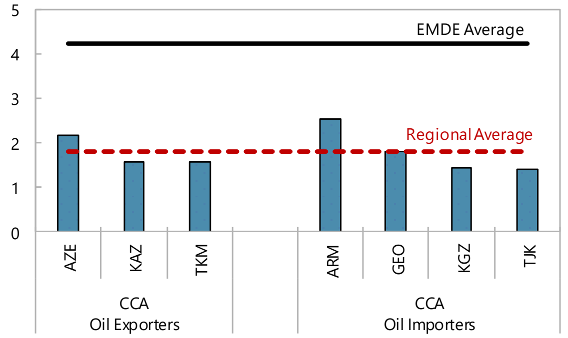
Source: UNCTAD.

10. **The CCA region remains weakly integrated into the global trade network.** The region has made some progress integrating with the rest of the world, including through the promotion of special economic zones, and its share in world trade, although still relatively low (0.5 percent of global trade), has grown. Still, non-oil exports by CCA countries were around $500 on a per capita basis in 2017, roughly half the average of EMDEs. Both oil exporters and importers export only to 50 percent of potential markets, suggesting considerable scope to increase the number of export markets. Trade penetration, measured on the basis of export value per trading partner, is also relatively weak (Figure 6).

[3] The concentration index, also named Herfindahl-Hirschmann Index, is a measure of the degree of product concentration. An index closer to 1 indicates a country's exports are highly concentrated on a few products. A value closer to 0 reflects exports that are more homogeneously distributed among a series of products. Middle-income developing economies had a concentration index of 0.07 and oil exporters an index of 0.46 in 2016.

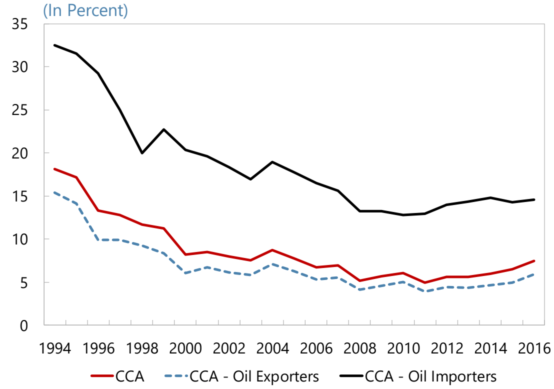
Figure 6. CCA: Trade Penetration and Intra-Regional Trade

CCA Export Penetration Index, 2015
(The higher the better)



Note: This indicator measures the extent to which a country's exports reach already proven markets, calculated as number of countries to which reporter exports a particular product divided by number of countries reporting importing the product that year. EMDE = Emerging and developing economies.

Share of Intra-Regional Trade in Total Trade
(In Percent)

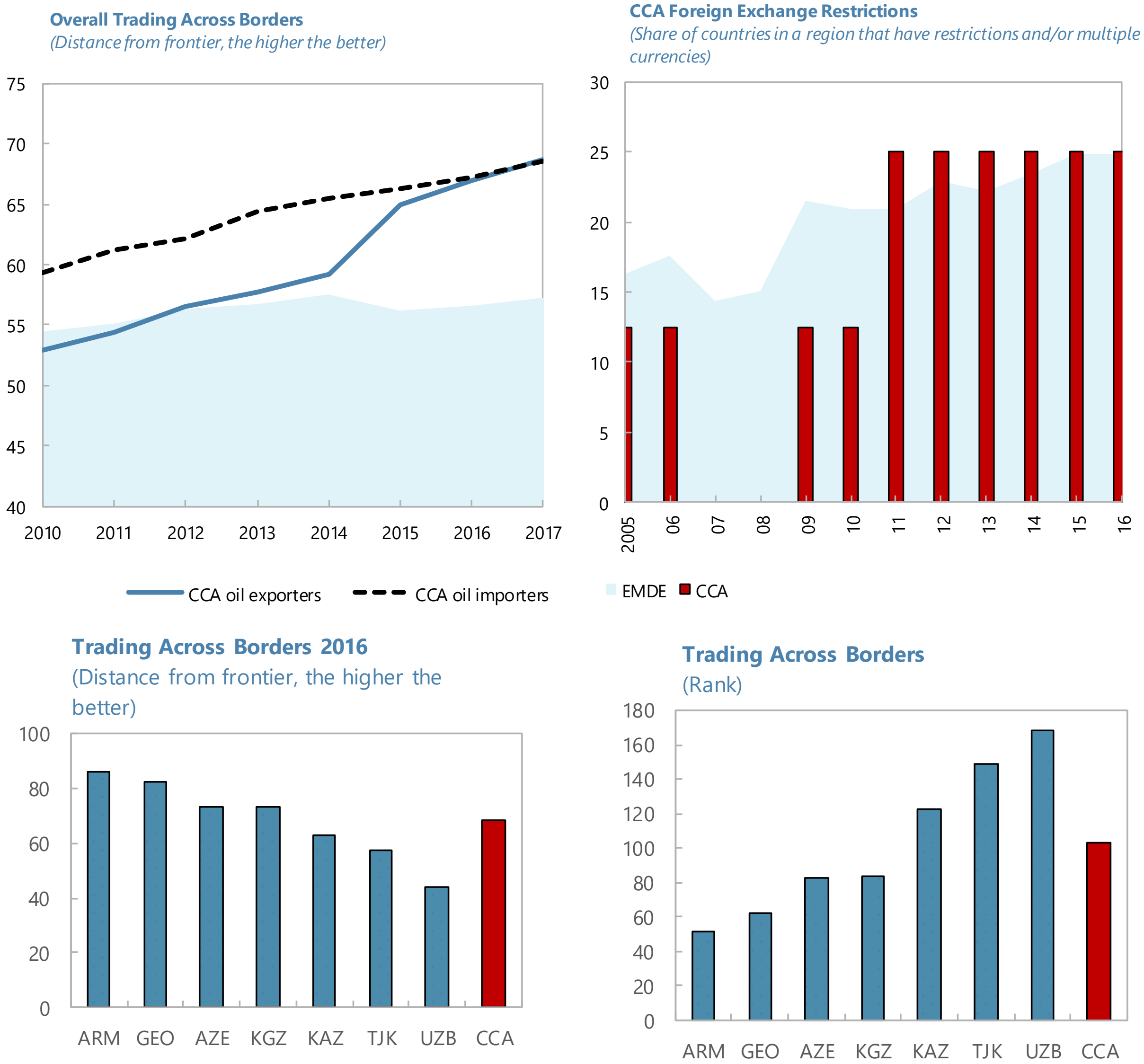


Sources: WITS database; and IMF staff calculations.

11. **Intra-CCA regional trade is also low**. The aggregate GDP of the eight CCA countries in 2017 was about US$350 billion (0.5 percent of world GDP). The common market of this size would rank the region among the largest 30 countries of the world and represents an opportunity for trade expansion. However, over the past few decades, intra-CCA trade has fallen considerably, reflecting regional tensions and the impact of the global financial crisis. Only in recent years has intra-regional trade started to recover, albeit slowly, reflecting trade arrangements (see below) as well as diversification efforts among some countries in the region. Yet, at 5 percent of total trade for oil exporters and 15 percent for oil importers, intra-regional trade remains low by international standards, clearly an underexploited potential for the region.

12. **Several factors explain the relatively low level of regional and global trade integration**. In addition to difficult terrain and product concentration, problems related to the business climate and foreign exchange restrictions have impeded trade. Although the overall trading environment for CCA countries has been improving in recent years, and CCA countries rank favorably in World Bank cross-country comparisons, on average, relative to EMDEs (Figure 7), individual components of trading efficiency across borders could be improved. For instance, cumbersome administrative procedures related to the processing of export and import documents lead to extended transit costs and delivery times in many countries. At the same time, there is considerable dispersion across CCA countries in the ease of trading across borders, with Armenia and Georgia ranking among the top-tier countries and Tajikistan and Uzbekistan ranking in the lower tier. Foreign exchange restrictions in some CCA countries have further hampered trade.

Figure 7. CCA: Trade Environment
(Percent)



Source: Doing Business, World Bank 2017.
Note: CCA = Caucasus and Central Asia; EMDE = Emerging and developing economies.

13. **Tariff and non-tariff barriers also constrain trade.** CCA countries have complex tariff schedules, apply tariffs on a range of different products—including machinery, chemical products, foodstuffs, energy and metals—and have different trade policies as reflected in their tariff rates, ranging from relatively liberal (especially Georgia) to more restrictive (Tajikistan and until recently Uzbekistan). The average tariff rate for the region was 4.5 percent in 2015, though the average has increased since Armenia and the Kyrgyz Republic joined the EEU, whose common tariffs are higher. By comparison, very open economies, like Japan and Germany, have an average tariff rate of 1.5 percent. CCA countries also retain considerable non-tariff barriers that impede trade. These include: regulations, quotas and bans on certain goods and raw materials (for example, carpets, chicken) in Kazakhstan, Turkmenistan and Uzbekistan; poor customs infrastructure and high logistics costs (Kazakhstan, Tajikistan); unpredictable changes in tariff schedules (Turkmenistan, Uzbekistan); and weak administration and legal regimes (Armenia and Azerbaijan) (Overland, 2017).

Table 1. Weighted Average Tariff Rate

	2012	2015
Armenia	2.4	2.5
Azerbaijan	4.1	5.3
Georgia	0.7	0.3
Kazakhstan	3.7	4.7
Kyrgyzstan	2.5	2.7
Tajikistan	5.2	7.2
Turkmenistan 1/	2.9	...
Uzbekistan	7.2	8.7
CCA 2/	3.7	4.5
China	3.6	3.4
Germany	1.0	1.6
Japan	1.2	1.4
Russia	6.3	2.8

Source: World Bank.

1/ Latest available data is for 2002.
2/ Excludes Turkmenistan.

14. **Strengthening trade integration will require a multi-pronged approach.** Priorities include:

- Using the BRI and other economic cooperation initiatives to develop infrastructure and facilitate trade integration. The BRI has already yielded over $10 billion in Chinese investments in the region (Box 1) and CCA countries should take advantage of its strategic position between Asia, Europe, and the Middle East to build and integrate infrastructure into the global network, while mitigating potential fiscal risks. For instance, the development of road and rail corridors in Kazakhstan under the very sizable 2014-17 “Nurly Zhol” stimulus initiative complement and extend international integration efforts.

- Increasing exports of non-commodity goods and services represent another area of opportunity. Greater specialization in manufactured goods and services would help diversify exports and boost competitiveness and growth. Again, the strategic position between East and West should be exploited. For example, trade between China and Europe that transits through the CCA could be tapped to integrate into GVCs. With China and Europe trade averaging over $1 billion a day there are important opportunities in industrial and consumer goods, textiles, and machinery and equipment.[4]

- There is scope for greater intra-regional trade. Revealed Comparative Advantage (RCA) analysis suggests that immediate potential for strengthening trade ties still lies in primary commodities, food, and metals (Box 2). In the long run, however, the CCA countries would benefit from greater specialization and integrating into GVCs.

- Countries in the region should also reduce tariff and non-tariff barriers, including high customs costs, and strengthen administrative procedures to facilitate trade.

Opportunities to Leverage Trade Initiatives

15. **CCA countries have pursued various economic integration initiatives usually involving larger regional economies.** Initiatives include the EEU, the CAREC, SCO, and China's BRI. While the number of initiatives with participation of CCA countries has expanded, most of them have met with limited success thus far (Box 3).

16. **CCA participation in multilateral trade agreements led by the WTO can stimulate more open trade and reforms.** WTO membership is important as members participate in the development of new trade rules in multilateral negotiations, have their interests defended against unlawful trade practices through the WTO dispute-settlement mechanism, and receive extensive trade-related technical assistance. WTO membership is therefore a powerful instrument for unlocking trade in a transparent, multilateral framework and stimulating domestic reform. Countries in the region should seek to take advantage of this opportunity, particularly given somewhat limited success with other regional initiatives.[5] While Armenia, Georgia, and the Kyrgyz Republic have been members

[4] Some countries in the region, especially the Kyrgyz Republic are already benefiting considerably from re-exports particularly in the manufacture of textile goods from China. In the case of the Kyrgyz Republic re-exports accounted for some 13 percent of GDP in 2010 (Mogilevski, 2012).

[5] A recent study finds that countries that recently joined the WTO and implemented the required trade reforms outperformed the original WTO members that did not have to undertake reforms (Kireyev, 2016).

for over a decade, Kazakhstan and Tajikistan joined the WTO more recently (in 2013 and 2015, respectively) and Azerbaijan, Uzbekistan and Turkmenistan are not yet members.[6]

17. **Recent WTO trade liberalization efforts could be particularly beneficial for CCA countries.** CCA countries should consider implementing the Trade Facilitation Agreement (TFA) established in early 2017. The WTO estimates that implementation of the FTA will cut customs-related costs of merchandise trade by 10-25 percent, and could lead to a $1 trillion annual increase in global trade (WTO, 2018). For the landlocked CCA countries the implementation of WTO's TFA can serve as a unique multilateral platform to address connectivity challenges and to improve trade flows within the region. CCA countries could also benefit from WTO's other initiatives. For instance, in December 2017, over 80 like-minded WTO members launched exploratory work on future WTO negotiations on electronic commerce, facilitating investment, and SME trade.

18. **Regional integration initiatives should be pursued as well to boost growth prospects.** For instance, the EEU has provided benefits to its membership, notably through a new customs code and a common labor market, boosting remittances, and expanding trade. More effort is needed, however, to achieve regional economic integration, including eliminating non-tariff barriers and exemptions, and moving ahead with EEU plans to forge other economic cooperation agreements, including with the European Union and China.

19. **CCA countries could better leverage bilateral trade agreements to gain broader access to markets.** While some CCA countries have negotiated bilateral trade agreements, their number is substantially lower than the EMDE average. Georgia concluded association agreements with the EU in 2014, which reduced or removed tariffs in bilateral trade. Armenia and Azerbaijan have signed cooperation and partnership agreements with the EU as well. Still, there is scope for countries to do more on a bilateral basis, even as the multilateral approach to trade liberalization is pursued.

B. Capital

While capital flows have been relatively low, and many CCA countries retain restrictions on capital account transactions, change is underway as countries seek to benefit from greater economic integration. When undertaking capital account liberalization, care should be taken to ensure that banks and government are able to manage risks associated with greater—and potentially more volatile—capital flows. Specific near-term actions should include

[6] Armenia, Georgia and the Kyrgyz Republic joined the WTO in 2003, 2000, and 1998, respectively. Azerbaijan has been negotiating WTO accession since 1997 and Uzbekistan since 1994, but they are not yet members. Turkmenistan has been weighing WTO accession since 2013 but has not yet applied for membership.

cleaning up bank balance sheets, improving the regulatory and supervisory framework, and addressing other risks, including those related to dollarization.

20. **CCA capital flows are relatively low and have not grown significantly since the global financial crisis.** Capital inflows to the region are primarily foreign direct investment (Figure 8). Kazakhstan is the largest beneficiary of these inflows, followed by Azerbaijan. Kazakhstan and Azerbaijan—the two largest oil exporters from the region—are also the primary source of CCA investment abroad, both foreign direct investment (FDI) and portfolio investment. Within the region, CCA oil importers invest primarily in Azerbaijan and Kazakhstan, whereas Georgia, and to a lesser extent the Kyrgyz Republic, have benefited most from FDI from CCA oil exporters.[7]

21. **The degree of capital account openness varies considerably across the region.** Armenia and Georgia have the most open financial systems as measured by the Chinn and Ito financial openness index (Figure 9).[8] Both countries maintain relatively few controls on cross-border capital flows. However, there are some restrictions, such as on the investment of insurance companies and pension funds abroad on prudential grounds and on land purchases by nonresidents. Most other CCA countries have intervened more in the financial system in the past (for example, interest rate caps and directed lending), and retain restrictions on cross-border flows as well as controls on the domestic financial system. Capital account restrictions include restrictions on FDI, domestic security purchases by non-residents and foreign securities by residents, real estate purchases by non-residents, repatriation requirements, and in some cases, foreign exchange surrender requirements (Turkmenistan and, until recently, Uzbekistan).

22. **There is no clear consensus on the pace and sequencing of capital account liberalization.** While capital account liberalization can provide benefits to an economy if well sequenced and executed—including by fostering financial sector development and growth—it can also prove disruptive if a country is not prepared to manage associated risks. In some cases, countries have opted to re-impose capital controls following capital account liberalization in the face of exchange rate pressures (such as in Belarus and Ukraine in 2014 and China in 2015). These reversals point to the need to be well prepared to deal with greater openness. Capital account liberalization should therefore be well planned, timed, and sequenced to ensure that benefits outweigh costs.

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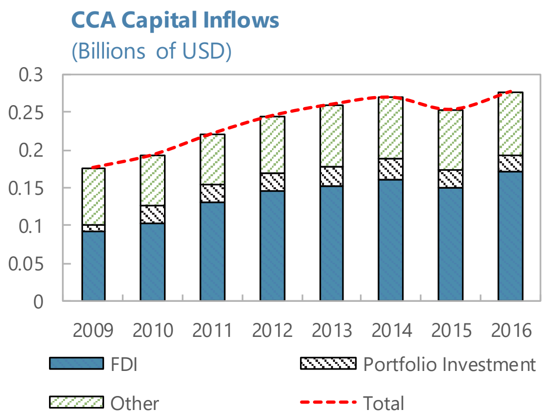
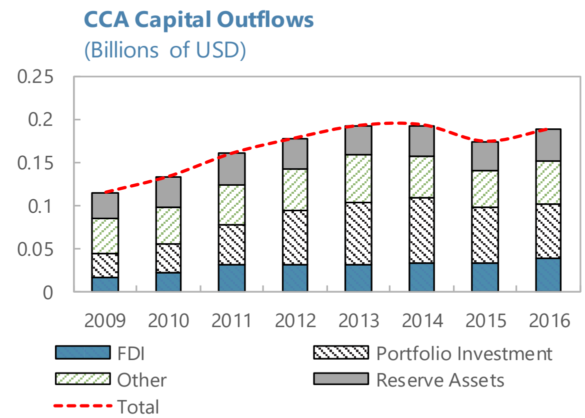
[7] Azerbaijan has been the largest single investor in Georgia in recent years, investing over $0.5 billion in 2015 in energy, infrastructure, and transportation. The two countries are connected by several important regional projects, including oil and gas pipelines, and the Baku-Tbilisi-Kars railway.

[8] The Chinn-Ito financial openness index measures a country's degree of capital account openness (Journal of Development Economics, 2006).

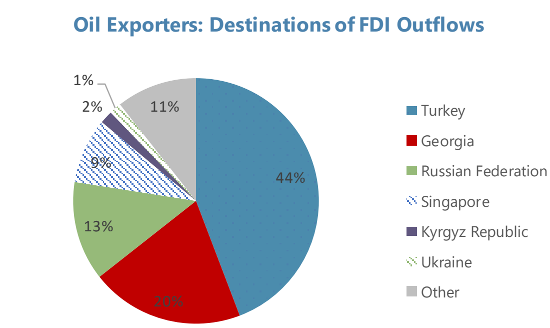
Figure 8. Capital Flows



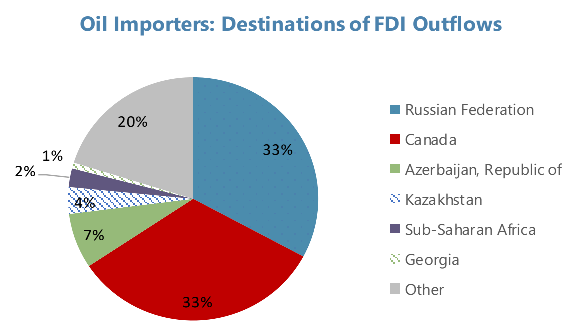
Source: IMF, WEO.
Note: Data excludes Azerbaijan, Turkmenistan, and Uzbekistan.



Source: IMF, WEO.
Note: Data excludes Azerbaijan, Turkmenistan, and Uzbekistan.

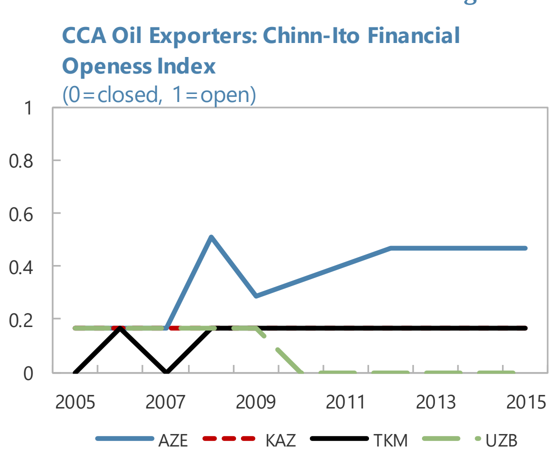


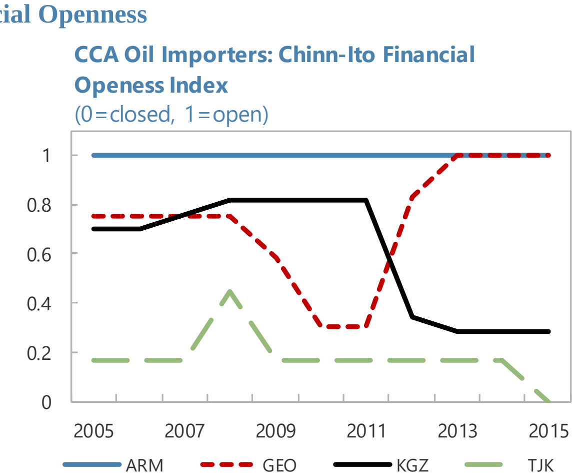
Source: IMF, Coordinated Direct Investment Survey.



Source: IMF, Coordinated Direct Investment Survey.

Figure 9. Financial Openness





Source: Chinn and Ito (2015).

23. **The pace and sequencing of capital account liberalization for CCA countries should take into account their ability to manage associated risks**. Armenia, for example, achieved financial opening in a relatively short time in the 1990s, completing the process well before it lifted the FX anchor and moved to inflation targeting. Georgia, in contrast, started financial opening at around the same time as Armenia but arrived at its present high level of openness only in 2013, after it had already moved to inflation targeting in 2009. Since many other CCA countries retain fairly closed financial systems and are in need of bank balance sheet repair, they may not be well equipped to remove capital controls quickly. Rather, capital account liberalization should focus in the short term on strengthening the health of the banking sector, improving the regulatory and supervisory framework, and addressing other risks, including those related to dollarization (see below).

III. ECONOMIC FRAMEWORKS AND INSTITUTIONS

Robust economic frameworks and institutions will be essential to help CCA countries integrate regionally and globally. Strong frameworks and institutions will be needed to manage larger trade and capital flows associated with greater economic integration and help ensure macroeconomic stability. This, in turn, will generate a more favorable investment climate and positive growth dynamics.

A. Fiscal Policy and Frameworks[9]

While CCA countries are aiming to improve fiscal balances following recent shocks, more ambitious fiscal adjustment would be preferable to rebuild buffers and deal with possible future shocks and greater economic integration. Policy efforts should focus on revenue mobilization, rationalizing non-priority expenditures, strong social safety nets, and improving public spending, as investment opportunities—including public-private partnerships (PPPs)—are expected to grow in the context of various integration initiatives. Such efforts would support fiscal consolidation while allowing for more pro-growth spending. A close eye will also need to be kept on fiscal risks as more public investment and infrastructure projects get underway. This will require building more robust budgetary institutions, fiscal rules, and risk management capacity.

Current Fiscal Situation and Plans

24. **Fiscal deficits and public debt levels in both oil exporters and importers have increased considerably as a result of the 2014-15 external shocks.** In oil importers, weaker revenues and higher public spending to support economic activity increased fiscal deficits by about 4 percentage points of GDP on average between 2013 to 2016 to 6.1 percent of GDP, and public debt increased to 49 percent of GDP. In oil exporters (Azerbaijan and

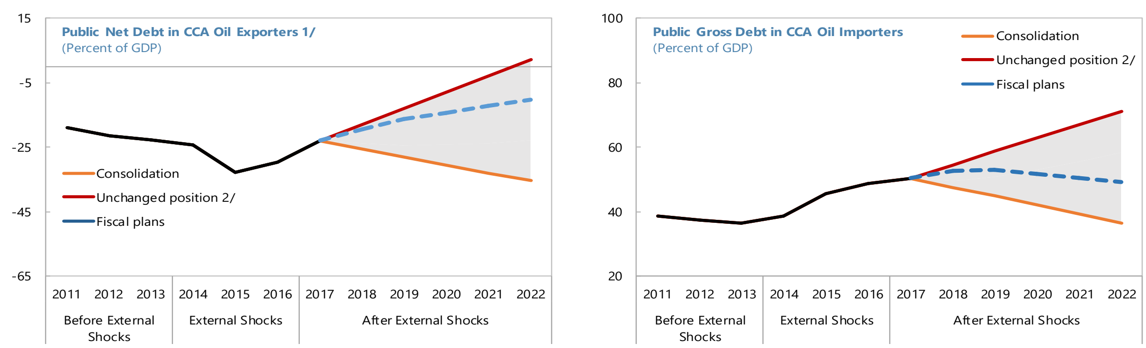
[9] This section draws on Gemayel et al (2018).

Kazakhstan), fiscal balances deteriorated by about 7 percentage points of GDP on average over the same period, and fiscal deficits reached 3.3 percent of GDP by 2016. Net foreign assets—the difference between the government's gross assets and debt—in oil exporters actually improved by about 7 percent of GDP over this period, reflecting the positive impact of exchange rate depreciation on net foreign assets.[10]

25. **Countries in the region are planning to undertake fiscal adjustment over the medium-term.** Adjustment plans for 2017-22 vary by country. Those with higher deficits—like Azerbaijan, Kazakhstan, and Tajikistan—have generally initiated larger adjustment plans, reflecting the magnitude of the shock they faced and the completion of the counter-cyclical policies they pursued. Others, like Armenia, Georgia, and the Kyrgyz Republic have more moderate adjustment plans.

- For CCA oil exporters, overall fiscal deficits are projected to improve by over 2 percentage points of GDP from 2016 to an average of about 1.1 percent of GDP in 2022. Despite the improvement in the fiscal position, the overall deficit and lower projected oil prices over the medium term will cause net financial assets to fall from 26 percent of GDP in 2016 to around 10 percent of GDP by 2022, which will reduce fiscal buffers (Figure 10, blue dashed lines).
- CCA oil importers' fiscal adjustment will stabilize public debt above pre-crisis levels. The fiscal deficit is expected to improve on average by over 4 percentage points of GDP from 2016 to about 1.9 percent of GDP in 2022. Under these adjustment plans, public debt is projected to stabilize at around 50 percent of GDP by 2022, a level comparable to 2016, but considerably higher than the 37 percent of GDP average at end-2013.

Figure 10. Public Debt Options for the CCA



Source: IMF REO October 2017, IMF staff calculations
Note: Turkmenistan and Uzbekistan omitted for lack of data
1/ Public debt for oil exporters is measured on a net debt basis, taking into account foreign assets of country oil funds.
2/ Unchanged position refers to a scenario in which the end-2017 fiscal balance is added to the stock of debt in each forecast year.

[10] The positive exchange rate effect on net foreign assets reflects the higher dollar denominated share of assets compared to liabilities. In addition, the conversion of net foreign assets into local currency has contributed to the increase of net foreign assets relative to GDP.

Suggested Fiscal Adjustment

26. **Given the persistent nature of the shocks and to facilitate greater economic integration, CCA countries should pursue more ambitious consolidation efforts**. This would allow fiscal buffers to be rebuilt, and create room for countercyclical policies in case further shocks arise.[11] It would also send a clear signal of fiscal responsibility and strong macroeconomic management to domestic and foreign investors, which is needed if the region aims to increase investment and integrate successfully into the global economy. The adjustment should be done in a growth-friendly manner by preserving much-needed infrastructure investments, while aiming to reduce expenditure inefficiencies and increasing revenues. To be successful, policymakers will need to ensure that the needed reforms are well designed and effectively communicated to the population, including on their distributional consequences.

27. **More ambitious consolidation could aim to bring debt to pre-shocks levels (orange line).** This would provide policy buffers in the event of renewed external shocks, including through counter-cyclical policies. Oil importers could target a pre-shock level of gross public debt--37 percent of GDP on average, which would require a reduction in gross debt (on average) of about 12 percentage points of GDP from end-2016 levels. Oil exporters would target a pre-crisis net asset-to-GDP ratio–26 percent on average, which would require a consolidation effort of about 11 percentage points of GDP, on average, from end-2016 levels. This would help preserve the stock of sovereign assets for future generations.

28. **The size, timing, and speed of consolidation should be country-specific.** While CCA debt levels may appear relatively low on average, their sensitivity to shocks (for example, growth and/or commodity price shock) reinforces the need for rebuilding fiscal buffers beyond current adjustment plans. Countries with higher debt levels, limited buffers, and weaker debt dynamics should front-load consolidation. Countries with more manageable debt levels could follow more gradual consolidation.

Fiscal Adjustment Composition

29. **To support pro-growth fiscal policies, CCA countries should enhance revenue mobilization and increase productive spending and efficiency.** Higher tax revenues—for

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[11] Shocks could include a decline in remittances and a contraction of economic activity in key trading partners in the case of oil importers, and lower commodity prices and a decline in sovereign wealth funds' assets in the case of oil exporters. A more open economy also argues for greater fiscal buffers to deal with larger and potentially more volatile capital flows, particularly as the region transitions to greater openness, and given the sensitivity of debt dynamics to exchange rate volatility.

instance, by broadening the tax base and strengthening tax administration—would support consolidation efforts while allowing for more pro-growth expenditures. Efforts are also needed to make income taxes more progressive, through adjustments in income tax rates and value-added taxes, and to promote equity, by reducing regressive and distortive exemptions and closing tax loopholes. On the spending side, current expenditure needs to be prioritized, capital spending made more efficient, and social spending improved, including through better targeted programs. Consideration should also be given to rationalizing government wage bills, especially where public sector wages and employment are high relative to the private sector (see Tamirisa et al, 2018), and reducing generalized energy subsidies using mechanisms to protect the most vulnerable segments of the population, and efforts to improve public services (for example, improved access to electricity). Such reforms would help generate savings, raise income equality, and improve productivity and growth. They would also facilitate economic integration and diversification as the CCA economies become more competitive and attractive to domestic and foreign investors.

30. **The efficiency and productivity of public investment needs to be improved.** This is particularly important in the context of the BRI, where considerable opportunities for investment, including through public-private partnerships (PPPs) are expected. The average efficiency of investment in the CCA region, measured using a frontier approach, is below that of the EMDE average.[12] In relatively high efficiency countries—such as Azerbaijan, Armenia, and Georgia—an increase in public investment represents an opportunity to close infrastructure gaps and to boost short- and medium-term growth. In lower-efficiency countries—for example, the Kyrgyz Republic, Kazakhstan, and Tajikistan—structural reforms that strengthen public management should be considered before embarking on large public investment projects that may cause fiscal sustainability concerns (see IMF, 2015c and 2016b).

Table 2. Public Investment Efficiency, Distance to Frontier

CCA Commodity Exporters	**0.79**
Azerbaijan	0.94
Kazakhstan	0.65
Turkmenistan	..
Uzbekistan	..
CCA Commodity Importers	**0.71**
Armenia	0.79
Georgia	0.86
Kyrgyz Republic	0.57
Tajikistan	0.61
Emerging Market Economies	0.78
Low Income Developing Economies	0.77
Advanced Economies	0.89

Source: "Making Public Investment More Efficient", IMF Fiscal Affairs Dept. Board Paper June 2015

[12] The score ranges between 0 and 1, where 1 represents perfect efficiency and 0 perfect inefficiency. The frontier is made up of efficient combinations of infrastructure quality as measured in the World Economic Forum's Global Competitiveness Index and public capital stock per capita in 2014. See IMF (2015) for a detailed explanation of the methodology.

Strengthening Fiscal Policy Frameworks

31. **Stronger fiscal frameworks will be required as CCA countries seek to benefit from greater economic integration.** This will help ensure investment projects, such as those presented by the BRI, are implemented effectively, while maintaining sustainable fiscal positions. Robust fiscal frameworks would also improve transparency and governance and contribute to a better investment climate. Three elements are particularly important:

Robust budgetary institutions and medium-term budgeting

32. **Many CCA countries do not have comprehensive and unified medium-term budgeting.** For instance, capital and recurrent budgets may be prepared by separate ministries without using program classification, or accounts do not adequately distinguish between recurrent and capital spending, leading to possible underestimation of costs. At the same time, capital spending is often not projected beyond the budget year, making it difficult to assess whether investment projects are sustainable. Even when projections are available, they are not necessarily published or integrated into a medium-term budget framework. As a result, many CCA countries exhibit large deviations between budgets and outturns.

33. **Stronger budgetary institutions and medium-term budgeting would foster credibility and efficiency of public spending, and promote fiscal sustainability.** Governments should have a holistic view of their expenditures, meaning that all expenditure decisions (including public investment) are considered together, leading to better prioritization among competing items. All public investments, including PPPs, should be fully integrated into spending plans, authorized by the legislature and disclosed in budget documentation to ensure adequate oversight and transparency. In addition, public investment should take into account immediate capital outlays and future operating and maintenance costs, and be set in a multi-year budgeting framework, so that overall expenditures are fully aligned and compatible with projected resource envelopes over the medium-term.

Fiscal Rules

34. **CCA countries typically do not have robust fiscal rules.** Countries either do not have specific rules, the rules are not well calibrated to achieve their objectives, or do not take into account macroeconomic shocks. Furthermore, practices on budget amendments have reduced compliance with fiscal rules. Without credible fiscal rules, countries are more vulnerable to overspend in good times (with the risk that spending quality suffers), or to cut spending abruptly when times are bad.

35. **Credible fiscal rules would anchor sustainability and facilitate public investment.** Credible rules impose durable constraints on fiscal policy, ensure transparent budget processes, and create space for sustainable investment (Schaechter et al, 2012) by limiting discretion and anchoring expectations. If properly calibrated and implemented, fiscal rules can help correct the deficit bias prevailing in many CCA countries and ensure fiscal sustainability. Nevertheless, fiscal rules are not a panacea—especially for oil exporters where revenue volatility can be large or when there are significant Public Financial Management (PFM) weaknesses. Best practices in designing and implementing fiscal rules include: (i) clearly defined objectives linked to numerical targets; (ii) incentives to build buffers in good times and allow for adequate fiscal support in downturns; (iii) calibration that ensures fiscal sustainability in the face of shocks; (iv) escape clauses to deal with tail events; (v) effective monitoring; and (vi) broad institutional and economic coverage, including at the subnational level (IMF, 2018b).

Fiscal Risk Management

36. **Sound risk management practices can reduce fiscal risks associated with investments or broader shocks, helping to safeguard macroeconomic stability.** Better understanding risks allows governments to reduce exposures and take mitigating measures. Moreover, greater transparency and effective risk management practices can help underpin credibility and market confidence, which in turn could attract more trade and investment.

37. **CCA countries have room to improve fiscal risk management.** While there is some analysis of fiscal risks in CCA countries, this tends to focus on static sensitivity of main fiscal aggregates to macroeconomic shocks (for example, commodity prices and exchange rates), without looking at correlation of shocks, impacts on asset and liability values, or within a macroeconomic modeling framework. Analysis also does not generally capture the impact of spending of the broader public sector—such as subnational governments or state-owned enterprises—which could give rise to contingent liabilities. Capturing such potential risks is particularly important in the context of the BRI as foreign investments may involve a ramping up of PPPs, including at the subnational level. Countries should therefore aim to improve the coverage and timeliness of data for the sovereign balance sheet and the analytical framework for assessing fiscal risks. Expanding the capacity to manage and mitigate risk, either through direct controls over exposures or through risk provisions, will also be needed.

B. Monetary Frameworks[13]

Monetary policy frameworks across the CCA need to be further strengthened to support economic integration. The move towards greater exchange rate flexibility in the region is a positive development and will help CCA countries weather future external shocks. While the choice of an alternative nominal anchor should reflect country-specific circumstances, inflation targeting has been gaining ground in the region. By promoting price stability, inflation targeting can play a role in financial sector reforms and market development, as well as stimulate investment, economic integration and growth. To successfully transition to inflation targeting, countries will need strong political commitment, continued development of institutional capacity, and efforts to address lingering financial stability concerns, including restoring the health of bank balance sheets. Adopting similar inflation targets in CCA countries would promote greater exchange rate stability and trade and financial linkages.

Towards More Flexible Exchange Rates

38. **Countries in the CCA region are moving away from managed exchange rates**. Many abandoned FX anchors and other managed monetary policy regimes over the past decade.

Table 3: Monetary and Exchange Rate Policies, and Financial Openness in CCA

	Monetary policy regime		Exchange rate arrangement		Financial openness (0=closed: 1=open)	
	2005	2015	2005	2015	2005	2015
Armenia	Other	Inflation target	independent float	float	1	1
Azerbaijan	Other	Other	conventional peg	other managed	0.2	0.5
Georgia	Other	Inflation target	managed float	float	0.75	1
Kazakhstan	Other	Inflation target	managed float	float	0.2	0.2
Kyrgyz Republic	Other	Other	managed float	other managed	0.7	0.3
Tajikistan	Monetary target	Monetary target	conventional peg	other managed	0.2	0
Turkmenistan	FX anchor	FX anchor	managed float	conventional peg	0	0.2
Uzbekistan	Other	Monetary target	managed float	crawl	0.2	0

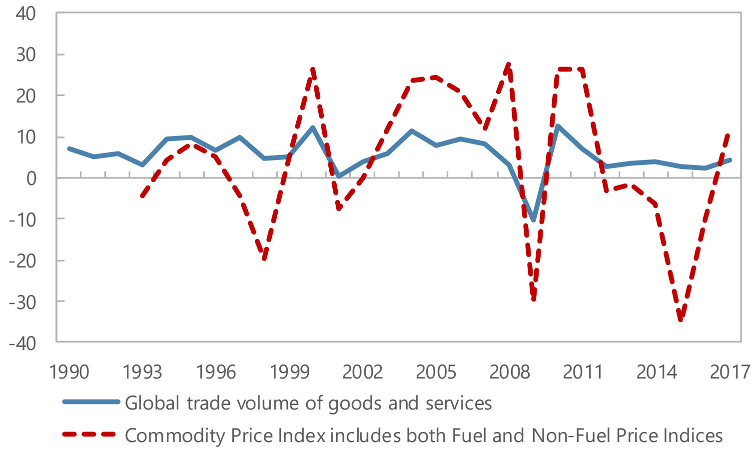
Source: AREAER database, M Chinn and H Ito (7/20/2017).

39. **Inflation targeting coupled with more flexible exchange rates has been gaining ground.** While no country in the region targeted inflation in 2005, Armenia, Georgia, and Kazakhstan have all transitioned to inflation targeting since. This shift mirrors global trends and is set to continue: the Kyrgyz Republic recently announced an inflation target, and Azerbaijan, Tajikistan, and Uzbekistan have announced their intention to move to inflation targeting over the medium term. Turkmenistan continues to peg its currency to the U.S. dollar.

[13] See Horton et al (2016) for a comprehensive treatment of monetary and exchange rate policies in the CCA.

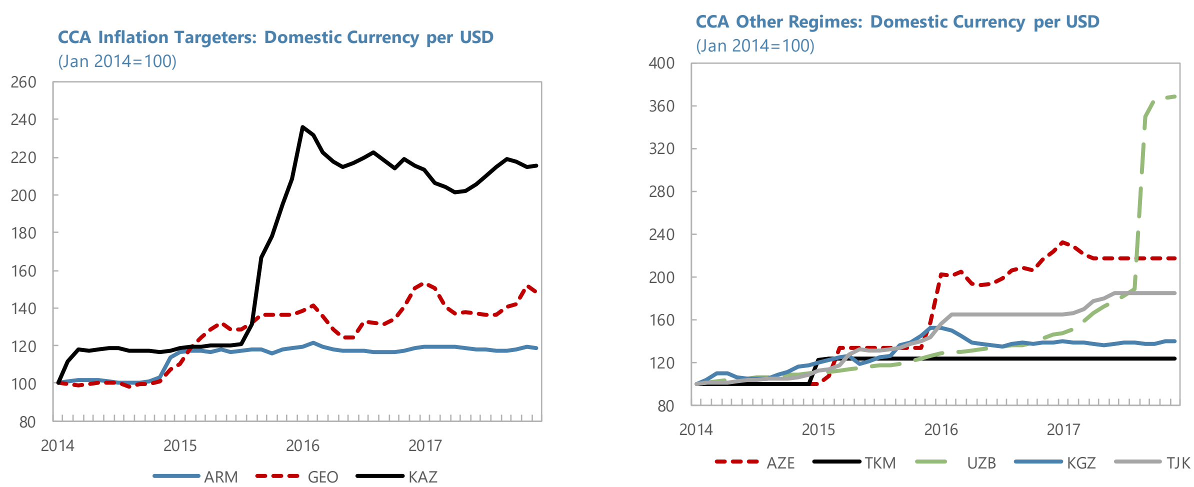
40. **Greater exchange rate flexibility is playing an important stabilizing role.** The move from pegged or managed toward more flexible exchange rates in the region was driven by volatility in the global economy. In late, 2014 CCA currencies came under pressure and foreign exchange reserves were drawn down. CCA countries recognized the need to adjust to the new environment and the useful shock-absorbing role greater exchange rate flexibility can play (Horton et al, 2016). Accordingly, all countries in the region allowed for some degree of exchange rate flexibility, with some (for example, Azerbaijan and Turkmenistan) pursuing step devaluations. Uzbekistan has recently made the sum fully convertible, as part of a broader economic liberalization strategy (Box 4). The move towards greater exchange rate flexibility helped countries weather the external shock and was a welcome development for CCA countries to integrate further into the global economy.

Figure 11. Global Shocks



Source: IMF, World Economic Outlook.

Figure 12. Exchange Rates

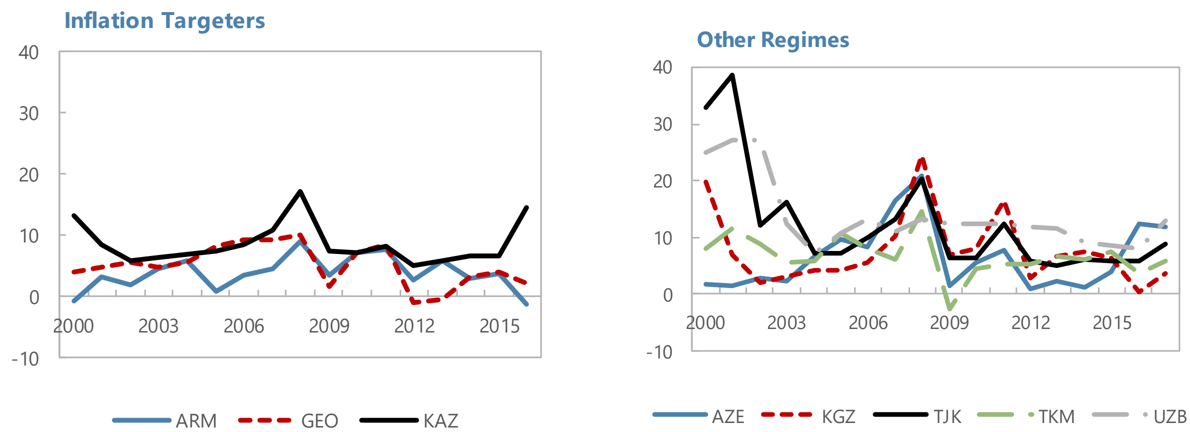


Source: IMF, International Financial Statistics.

Ensuring a Credible Nominal Anchor to Support Macroeconomic Stability and Openness

41. **Inflation targeting can bring significant economic benefits and support global integration.** While the choice of the nominal anchor should reflect country-specific circumstances, empirical evidence for emerging economies suggests that inflation targeting regimes outperform others as measured by inflation, inflation expectations, volatility of the output gap, interest rates, exchange rates, and international reserves (Batini and Laxton, 2005).[14] The recent experience of CCA countries corroborates these findings: the countries in the region with the longest experience with inflation-targeting—Armenia and Georgia—have also enjoyed lower inflation and exchange rate volatility over the past decade. By fostering greater macroeconomic stability, an effective inflation targeting regime provides an environment conducive to domestic and foreign investment and growth, thereby facilitating greater integration into the global economy.

Figure 13. Inflation, 2000-17



Source: IMF, World Economic Outlook.

42. **Under inflation targeting, the standard approach is to set the monetary policy stance so that inflation reaches the target in the medium term.** The time horizon is typically left purposefully vague to leave room for monetary policy to address other objectives, such as smoothing temporary disturbances in GDP growth and exchange rates. Inflation-targeting countries in the CCA region have employed annual inflation targets which have also shifted in time. While this practice may aim to demonstrate commitment to control inflation, it also potentially exposes the economies to greater output volatility, and risks loss of credibility if the target is missed. For inflation targeting central banks, managing the path of inflation too narrowly is, in general, not optimal.

[14] Monetary aggregate targeting may be simpler to implement than inflation targeting, and has met with some success, though the link between monetary aggregates and inflation can be weak. The growth of money in circulation may also be hard to predict and control with traditional monetary policy instruments.

43. **The choice of the inflation target is important for exchange rate stability and can promote greater openness.** Economies at similar levels of development and openness can promote exchange rate stability by selecting similar inflation targets. In developed countries, inflation targets tend to cluster around 2 percent, and in emerging economies around 4 percent. In Armenia, Georgia, and Kazakhstan the target levels for inflation are 4, 3, and 5-7 percent, respectively, in 2018. By selecting similar inflation targets, CCA countries would reduce the cost of hedging against FX risks and promote trade and financial links, including within the region, without imposing the more arduous constraints on policy, such as fiscal policy, that are typical of trade and monetary unions.

44. **Strong political commitment is needed to successfully transition to inflation targeting.** To successfully anchor expectations, the central bank needs to be assigned a clear inflation targeting mandate and granted strong de facto operational independence. Government interference in the central bank's operations, for instance through fiscal dominance or directed lending, needs to be discontinued. This is a tall order in some emerging and developing countries that are used to tightly controlling financial systems and allocating financial flows based on other policy objectives. While CCA central banks appear to be relatively independent and transparent based on the letter of the law (Dincer and Eichengreen, 2014), this does not always ensure adequate independence in practice.

45. **Modern monetary policy frameworks and strong institutional capacity support inflation targeting.** CCA countries should continue to build their monetary policy frameworks and institutional capacity given the time it takes to set up modern IT frameworks. Key elements of a modern IT framework include declaring a medium-term inflation objective; selecting a suitable operational target; building up analytical capacity, particularly as regards inflation forecasting; deep and liquid money and foreign exchange markets; and, clear, open, and timely communications (Horton et al, 2016).

46. **Addressing financial stability concerns arising from flexible exchange rates is essential, especially in the transition phase.** Efforts to improve the health of bank balance sheets is key for banks to effectively manage large capital inflows and exchange rate swings. The high level of dollarization in the balance sheets of CCA banks, non-financial corporations, and households represents a considerable risk, particularly given the large net open FX positions (see below), and can impede monetary policy effectiveness. Incentives to reduce dollarization—including by achieving low and stable inflation, removing regulations that discourage local currency use, and prudential measures to encourage more local currency use (for example, lower local currency reserve requirements and higher provisions on FX lending)–can be helpful to reduce dollarization and mitigate FX risks. Some CCA countries are already undertaking de-dollarization strategies, including Armenia, Georgia, and the Kyrgyz Republic which have put in place a wide range of actions from restrictions on some FX transactions to prudential, supervisory, and crisis management measures.

C. Financial Sector Policies[15]

Healthier banking systems and deeper capital markets in CCA countries would support regional and global integration by promoting more efficient intermediation, financial inclusion, larger capital flows, infrastructure investment, and economic diversification. To facilitate this transformation, bank balance sheets need to be strengthened, intermediation enhanced, transparency improved, financial inclusion encouraged, and correspondent banking relationships (CBRs) promoted. Developing capital markets would help companies diversify their financing sources and promote investment opportunities.

The State of Play

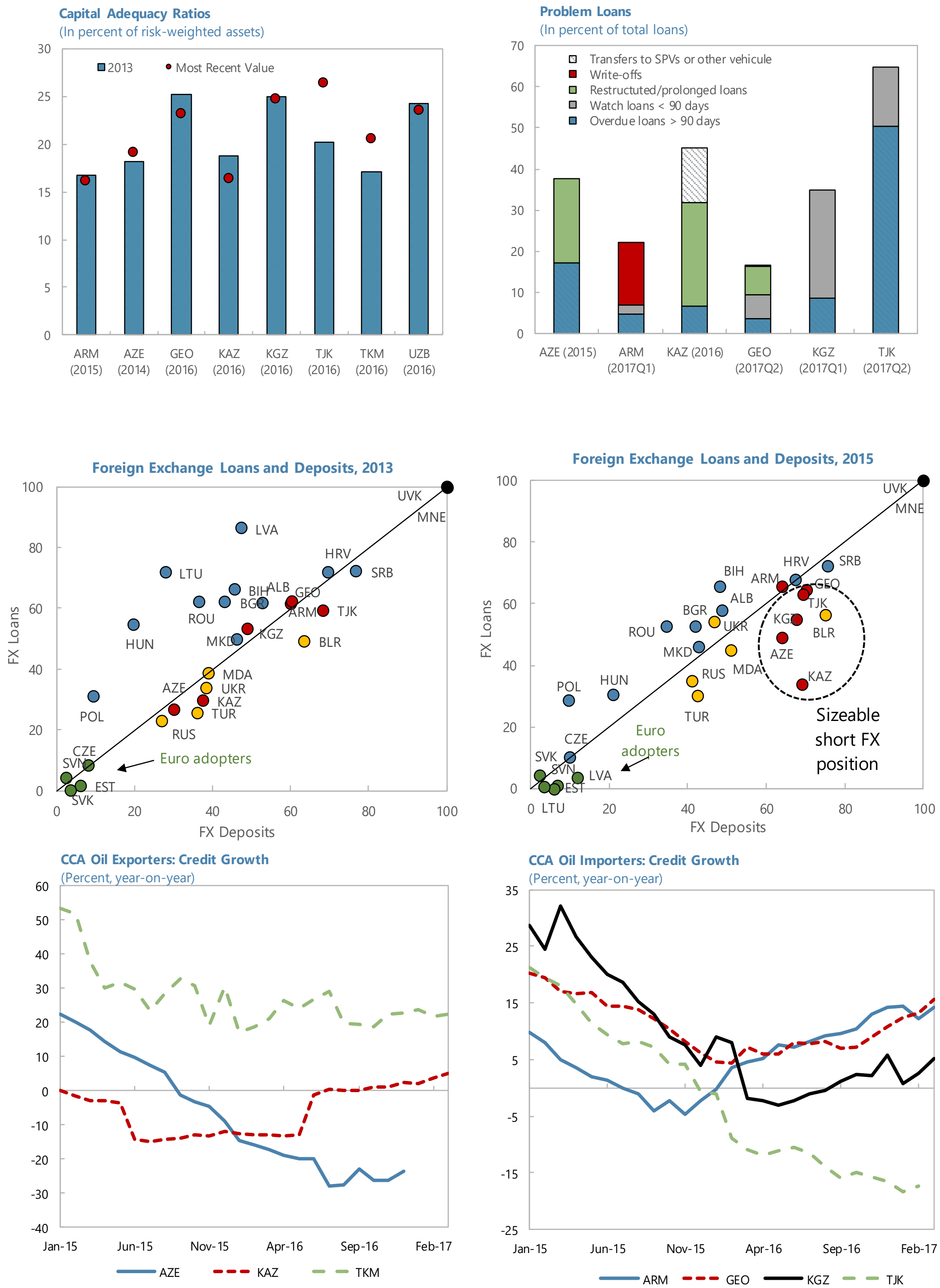
47. **Since 2014, CCA financial systems have been affected by external shocks, with the impact differing across the region.** Reflecting the low global interest rate environment, banks in the region had borrowed heavily in foreign currency on an unhedged basis to finance lending. With significant net open FX positions, banks suffered large losses when domestic currencies depreciated from late 2014. Banking sectors in Armenia, Georgia, and the Kyrgyz Republic have proven more resilient, reflecting a lower initial level of non-performing loans (NPLs) and improved regulation and supervision. In contrast, the impact of shocks in CCA countries that are more dependent on oil (Azerbaijan and Kazakhstan) and remittances (Tajikistan) was more pronounced. Strains in CCA banking sectors intensified as liquidity tightened, asset quality deteriorated, and banks became undercapitalized.

48. **Even before the latest shock, CCA banking sectors were not at full strength.** Asset quality was generally weak, due in part to shortcomings in regulation, supervision, and governance (Figure 11). The sector lacked competition, and in most countries, related-party lending was part of regular business practices. These issues translated into excessive risk taking, which was exacerbated in highly dollarized economies.

49. **Efforts have been made to strengthen bank balance sheets.** These include liquidity support, capital injections, bank restructurings, mergers, and liquidations. For example, in Azerbaijan, the largest state-owned bank is in the process of a voluntary debt restructuring worth some 9 percent of GDP, and in Kazakhstan, the two largest banks have merged, with the authorities providing about 4 percent of GDP in capital support in 2017. In Tajikistan, the government also intervened, providing assistance equivalent to some 6 percent of GDP to the two largest banks. Some countries have also taken measures to strengthen prudential requirements related to foreign exchange rate risk and to reduce dollarization.

[15] This section draws from the forthcoming IMF Departmental Paper "Building Resilient Banking Sectors in the Caucasus and Central Asia".

Figure 14. CCA Countries: Selected Financial Indicators



Sources: National Authorities; and IMF staff calculations.

50. **Still, financial sector vulnerabilities remain high.** While the asset quality of CCA commercial banks has deteriorated, the overall magnitude is difficult to assess, and bank balance sheets remain exposed to FX risk. Official data show significant NPLs, ranging from 4-5 percent in Georgia and Armenia to 50 percent in Tajikistan. However, a broader definition of problem loans, including watch loans, restructured loans, write-offs, and transfers to special purpose vehicles, suggests weaker asset quality. Regulatory shortcomings may have created incentives to mask deteriorating asset quality.[16]

51. **Financial inclusion is limited.** While the level differs among CCA countries, financial inclusion is, on average, lower than the EMDE average. For example, outstanding deposits with CCA commercial banks averaged about 30 percent of GDP in 2016 compared to about 62 percent for the average of non-CCA EMDEs. Within the CCA, this figure ranges from 40 percent in Georgia to 22 percent in Uzbekistan. According to surveys, households cite insufficient savings, expenses associated with holding a bank account, inadequate documentation, distance, and lack of trust in banks as some of the reasons for the low use of financial services. Firms responded that they do not apply for loans because of unfavorable interest rates, complex application procedures, insufficient collateral requirements, or because they do not need financing (IMF, 2015).

52. **Under these conditions, CCA banking sectors are not in strong shape to support integration, diversification, and more inclusive and sustainable growth.** Credit growth (at constant exchange rates) declined by 30-40 percentage points in Azerbaijan and Tajikistan during 2015-16. The fall was less pronounced in Armenia, Georgia, Kazakhstan, and Kyrgyz Republic. While there has been some recovery in credit growth in Armenia and Georgia, weakened balance sheets and legacy impairments have impacted confidence in general and weakened banks' lending ability.

Correspondent Banking Relationships (CBRs)

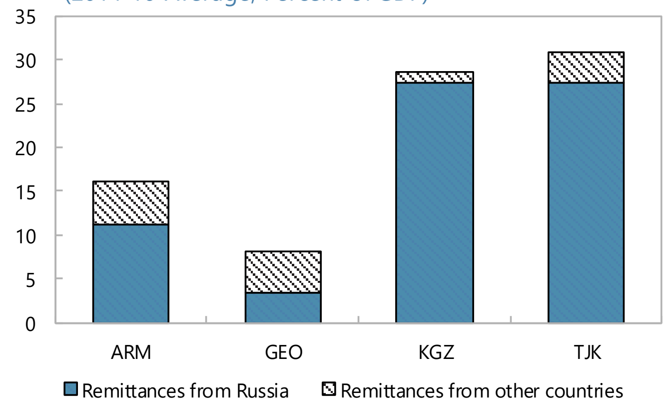
53. **Greater access to CBRs would stimulate greater economic ties and opportunities for the region**. Banks that can maintain or increase their CBRs—related to trade finance, remittances, and any transactions that require settlement in foreign currency—are able to process higher dollar-volume amounts and stimulate cross-border financial flows (IFC, 2017a). By the same token, a decline in the number of CBRs is a concern because it may affect the ability to send and receive international payments or drive payments underground with potentially adverse impacts for trade, financial stability, and growth.

[16] For example, official regulatory ceilings on NPLs (for example, in Kazakhstan NPL ratios were to be kept below 10 percent) have likely encouraged banks to under-report NPLs, leading to under-provisioning.

54. **Unfortunately, CBRs are under pressure in several CCA countries**. A recent IMF survey on CBRs in the region found that 39 percent banks experienced a slight decline in the number of CBR accounts, while 13 percent experienced a significant decline over the past three years (IMF 2018c). For example, one of the last major U.S. domiciled banks has recently withdrawn from the Kyrgyz banking system, compelling banks to carry out dollar-denominated transactions—such as those related to remittances—with a small number of Russian and Kazakh banks. Transactions in dollars is becoming increasingly difficult and costly, impeding the efficacy and profitability of the banking sector. The main reasons provided by survey respondents for the decline in CBR accounts included changes in the business strategy and insufficient business to justify the cost of customer due diligence. Other factors—such as reorganization of business portfolios and enforcement actions by the domestic authority on relevant foreign financial institutions—were reported to play a smaller, but still significant, role.

Figure 15. CCA Oil Importers: Remittances

(2014-16 Average, Percent of GDP)



Source: Bloomberg.

Capital Markets

55. **CCA capital markets are relatively underdeveloped, impeding regional integration.** While there are differences within the region, the non-bank share of financial system assets is generally small, private equity markets are underdeveloped, and the insurance business is picking up very slowly (IMF, 2014). Local debt markets remain small to non-existent. Some corporates have been able to issue domestically, but trading is thin. There are interbank markets for bank liquidity, such as a repurchase market in Kazakhstan, and foreign exchange swap markets are becoming more active.

56. **Kazakhstan has ambitions to develop a regional financial center in Astana.** The Astana International Financial Centre (AIFC) was opened in 2018 with the aim of establishing a financial hub to attract investments from Central Asia, China, and the Middle East. The Astana International Exchange (AIX) has partnered with the Shanghai Stock Exchange, which is a part owner, and NASDAQ. The AIFC is in a special economic zone offering tax incentives, easier procedures for foreigners to acquire work permits, use of English as its official language, and is regulated by a court and international arbitration center based on English law. AIFC's development will require further developing capital markets and addressing governance issues in Kazakhstan and the region (see below). The

AIFC will also need to compete with other regional financial hubs in China and the Middle East. International investors will be watching progress related to Kazakhstan's privatization program and Sukuk issuance in the period ahead.

Towards a New Business Model

57. **A new business model for the financial system is needed in the region**. This model should provide a more transparent environment for domestic finance, promote and efficiently channel savings to productive investment, and increase foreign participation. Reforms start with fostering a stronger and more competitive banking system. This would enhance trust in the system and give it the ability to adopt products and services to the changing environment for investment and economic diversification. Without change, the region risks missing out on considerable opportunities for economic growth and prosperity.

58. **No single strategy can be applied to strengthen financial resilience and efficiency—decisive action is needed on different fronts simultaneously**. The required actions also depend on country-specific circumstances. Country strategies should have the broad goals of (i) strengthening financial stability, bank lending, and financial inclusion; (ii) developing CBRs; and (iii) capital market development.

59. **Reforms are needed to enhance financial stability and facilitate bank intermediation to support economic activity and regional integration**. Some comprehensive programs for enhancing financial stability have been announced recently, including through improved regulatory and supervisory frameworks in Armenia, Georgia Kazakhstan, and the Kyrgyz Republic. The immediate priorities to enhance financial stability and intermediation for countries in the region include the following:

a. *Accurately assessing banking health in CCA countries.* Uncertainty about the size of problems on banks' balance sheets is hindering timely intervention. Early intervention would limit potential fiscal costs and support a speedier recovery. NPL reporting, including off-balance-sheet items, should be brought in line with international best practice, and independent asset quality reviews undertaken to accurately assess the viability of banks.

b. *Further strengthening prudential regulation and supervision.* Strengthening consolidated supervision and macro-prudential frameworks is essential. For instance, stricter rules on banks' open positions in foreign currency and foreign-currency-denominated lending would reduce dollarization, strengthen monetary policy transmission, and facilitate economic integration. Financial supervision should also move toward a risk-based approach and CCA banks encouraged to strengthen credit risk assessment to prevent further accumulation of impaired assets.

c. *Improving bank governance.* In many CCA countries, weak bank governance—exacerbated by political interference and corruption—have encouraged related-party lending and excessive risk taking. Governance problems can seriously undermine credit support to the economy and growth, and efforts should be taken to strengthen transparency, including establishing clear responsibility at the executive and board levels, limit public sector influence on banks, and establish independent risk management, compliance, and internal control units.

d. *Strengthening bank resolution frameworks.* CCA countries need to enhance the effectiveness of their resolution frameworks, including strengthening the independence and governance of the resolution authority. State support should only be provided for viable banks under strict conditions—such as time-bound recapitalizations with clear restructuring plans. For insolvent institutions, liquidation options should provide for orderly closure while protecting retail customers through deposit insurance.

e. *Promoting savings and financial inclusion.* This means, inter alia, developing and marketing savings products, and undertaking a financial literacy campaign. Modern mobile banking products and payment systems should be promoted to reach the large unbanked segments of the population. Bringing the unbanked into the financial system will help channel savings into investments and contribute to a more vibrant and inclusive economy.

60. **Efforts should be devoted to addressing CBRs, given their importance for the banking sector and the potential to improve integration and economic prospects for the region more broadly.** Measures should be taken to enhance respondent banks' capacity to manage risks, improve communications between correspondent and respondent banks, strengthen and effectively implement regulatory and supervisory frameworks in line with international standards—particularly for AML/CFT—and remove impediments to information sharing.

61. **Capital market development should be a part of broader financial reforms and economic integration.** Efficient foreign exchange and money markets, as well as hedging instruments, are needed. The development of the corporate bond and equity markets can also be useful to channel savings for project finance and infrastructure investment, and strengthen partnerships with foreign investors. The potential increase in trade, investment, and infrastructure projects with the BRI also has the potential to develop ancillary products and services, such as insurance. Efforts to develop capital markets should be pursued on several fronts:

a. *Modernizing infrastructure:* Modernizing financial sector infrastructure can expand and deepen capital markets. Modernization programs should include reviewing and updating securities/capital markets laws to ensure transparent rules for issuers and investor protection, appropriate regulations and robust supervisory arrangements, and upgrading settlement, clearing, and payments infrastructure and operations to international standards (IFC, 2017b).

b. *Money and foreign exchange markets:* In the money and foreign exchange markets, the central bank can play a role in monitoring market developments and behavior, and act as safety valve in emergency situations. Developing the Treasury bill market would help to support money market development and cash management.

c. *Equities:* The NASDAQ exchange in Armenia, and cooperation between Kazakhstan and Euroclear to open the domestic bond market are good examples of regional initiatives to develop markets and infrastructure, and to adopt international standards. Additionally, countries should ensure the regulations and taxes do not unduly constrain market development.

d. *Debt markets:* Governments should develop medium-term debt management strategies that integrate market development objectives. As part of such a strategy, it is important to establish a sovereign benchmark yield curve for the pricing of corporate debt; an issuance strategy; an effective auction and primary dealer system; market support mechanisms, including buy-back operations to establish benchmarks and trading; and incentives to grow the investor base. Governments could also consider using capital markets to support the finance of infrastructure projects.

D. Structural Reforms

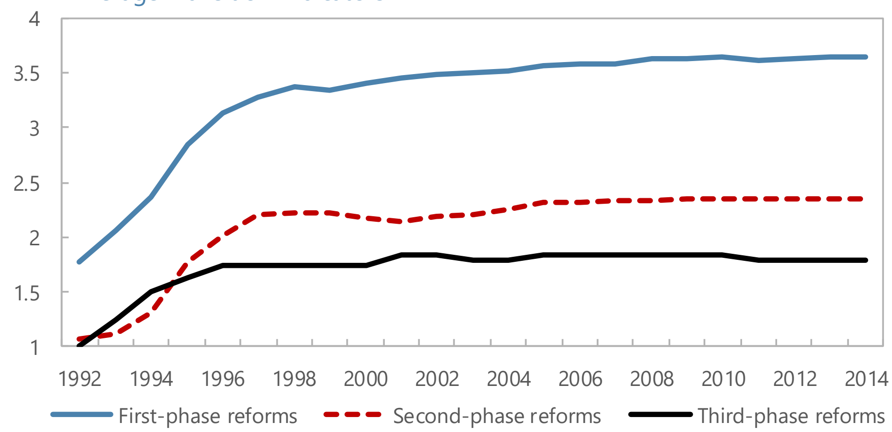
Ambitious structural reforms will be needed to support successful economic integration. The current growth model—heavily reliant on commodities, remittances and public spending—is susceptible to shocks and will not generate sufficient growth and jobs needed to reduce poverty. The region has considerable potential and opportunities to diversify, open economies up to foreign trade and investment, and boost growth. To support these objectives, reforms will need to address impediments to private sector activity, productivity and growth. Efforts to strengthen infrastructure, the business environment, governance and labor skills will be particularly important—both because gaps in the region remain considerable in these areas, and because progress on these fronts would make countries more attractive to outside investors and support regional and global integration.

Opportunities for Greater Integration and Private Sector Activity

62. **Reforms in the region should aim to raise productivity growth and facilitate deeper economic integration.** Empirical analysis (Dabla-Norris et al, 2016) suggests that the effectiveness of structural reforms to raise productivity depends on a country's income level

and its distance to the technology frontier. Thus, for instance, to maximize productivity gains low-income countries may benefit more from removing price controls and trade liberalization, whereas emerging markets can benefit more from enhancing the efficiency of banking systems, developing capital markets, and strengthening the business environment. CCA countries have already completed many of the so-called first-stage or "market enabling" reforms consisting of price liberalization, privatization of small firms, and exchange rate unification as defined by the EBRD's framework for transition economies. Progress on market-deepening and market-sustaining reforms (stages 2 and 3)—which include governance reforms, financial deepening, privatization of larger firms, commercialization of infrastructure, and other elements to strengthen the business environment (for example, contract enforcement and property rights)—are not as well advanced. A recent study by Funke et at (2017) suggests that improvements to strengthen institutions, develop infrastructure, enhance financial market development, and improve labor market efficiency could have high payoffs for growth in the region.

Figure 16. Three Stages of Reform in the CCA:
Average Transition Indicators



Source: European Bank for Reconstruction and Development.

63. **Inadequate infrastructure remains a key impediment to growth and integration.** EBRD transition indicators show that Kazakhstan and countries in the Caucasus have made more inroads in developing infrastructure—including roads, railways, water, electric grids, and information and communications technology—than other CCA economies. Infrastructure investments in countries like Kazakhstan and Georgia are central to their development plans, and have gathered support from international partners.[17] Reforms in Tajikistan, Turkmenistan, and Uzbekistan are less advanced.

[17] Georgia's ambitious public investment plans includes the development of an East-West highway and North-South corridor by 2020 with support from international partners. In Kazakhstan, the development of road and rail corridors complement international integration via the BRI.

Table 4. Transition Indicators[1]

	Corporate Sector				Energy		Infrastructure				Financial Sector			
	Agribusiness	Industry	Real Estate	ICT	Natural Resources	Electric Power	Water	Urban Transport	Roads	Railways	Banking	Insurance	Private Equity	Capital Markets
Armenia	3-	3	3-	3	2+	3+	3-	2+	3-	2+	2+	2	1	2
Azerbaijan	2+	2	2	2-	2+	2+	2-	2	2+	2+	2	2	1	2-
Georgia	3-	3-	3-	3-	2	3+	2	2+	2+	3	3-	2	1	2-
Kazakhstan	3-	2	3	3	2-	3	2+	2+	3-	3	2+	2+	2-	2
Kyrgyz Republic	2+	2	2+	3	2-	2+	2	2	2-	1	2	2-	1	2-
Tajikistan	2	2-	2-	2+	1	2	2	2	2-	1	2	2-	1	1
Turkmenistan	1	1	1	2-	1	1	1	1	1	1	1	2-	1	1
Uzbekistan	2	1	2	2	1	2+	2-	2	1	3-	1	2	1	1
CCA	2+	2	2+	2+	2-	2+	2	2	2	2	2	2	1	2-

Source: EBRD Transtion Report 2016-17.

[1] Transition Indicators range from 1 to 4+, with 1 representing little or no change relative to a rigid centrally planned economy and 4+ representing the standards of an industrialized market economy.

64. **A strong business environment is key to fostering innovation, productivity, and growth.** The World Bank's Doing Business Indicators—which measure the quality and effectiveness of business regulation—show considerable dispersion across CCA countries. Georgia, with an overall ranking of 9 out of 190 countries, has implemented the highest number of business regulation reforms (47) since the launch of the report in 2003. Other countries in the region—with the exception of Tajikistan and Turkmenistan (not ranked)—rank in the top half of countries overall, but there is scope for improvements, notably to improve access to electricity, obtain construction permits, pay taxes, strengthen insolvency procedures, and enhance customs procedures.

Table 5. Doing Business Indicators[1]

	DTF	Ranking								
	Distance to Frontier	Overall Rank	Starting a Business	Construction Permit	Get Electricity	Property Registr.	Paying Taxes	Border Trading	Contract enforce	Resolve Insolvency
Armenia	72.5	47	15	89	66	13	87	52	47	97
Azerbaijan	70.2	57	18	161	102	21	35	83	38	47
Georgia	82.1	9	4	29	30	4	22	62	7	57
Kazakhstan	75.4	36	41	52	70	17	50	123	6	39
Kyrgyz Republic	65.7	77	29	31	164	8	151	84	139	119
Tajikistan	58.8	123	57	136	171	90	132	149	54	148
Turkmenistan	…	…	…	…	…	…	…	…	…	…
Uzbekistan	66.3	74	11	135	27	73	78	168	39	87
CCA	70.1	60.4	25.0	90.4	90.0	32.3	79.3	103.0	47.1	84.9

Source: World Bank Doing Business Report 2018.

65. **Governance needs to be improved.** The CCA region continues to lag behind others on most governance indicators (Box 5). Tackling corruption, strengthening voice and accountability, and the rule of law, would encourage investment and strengthen the region's growth potential. While specific measures differ from country to country, efforts to strengthen governance and weed out corruption will require political leadership and greater voice, efforts to improve AML/CFT, and improved procurement and fiscal transparency. More effort is also needed to strengthen the rule of law, including the judicial framework, property rights, and contract enforcement.

66. **Strengthening labor markets and skills would yield significant benefits as the region opens up.** The region needs to prepare its labor force, and particularly its youth, for the business and labor market opportunities that will present themselves with the opening up of markets to foreign trade and investment. The unemployment rate remains relatively high in Armenia, Georgia, and Tajikistan and youth unemployment throughout the region is typically twice as high as overall unemployment. While the education system is generally strong, school-to-work transition is weak, and vocational education and job-related training are not adequate. This is reflected in large labor market and business skill gap indicators. With youth and rural unemployment high and employment allocated to the low-productivity agricultural sector, it will also be important to develop the skills that are increasingly in demand in the global labor market (for example, skills in information technology, and critical thinking; Fasih 2008) and that would facilitate integration into GVCs. Furthermore, labor market regulation—including hiring and redundancy rules, employee protection and wage regulations—could be improved in a number of countries in the region to ensure adequate flexibility and protection. For example, more flexible employment

contracts in countries like Armenia, Kyrgyz Republic, Tajikistan, and Uzbekistan would generate employment while facilitating labor market flexibility.[18]

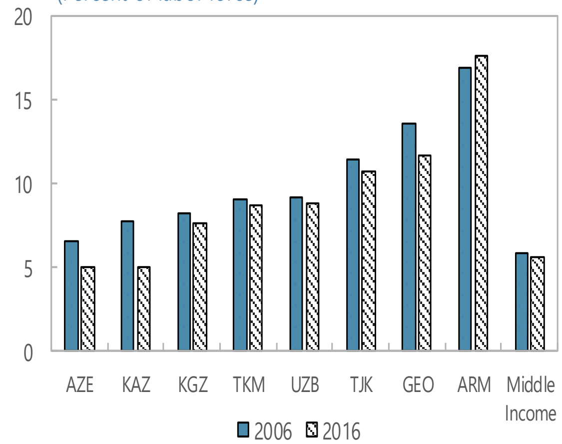
Table 6. Development and Inclusion Gaps[1]

	Ranking		
	Education	Labor Markets	Buisness Skills
Armenia	Medium	Medium	Large
Azerbaijan	Small	Large	Large
Georgia	Small	Medium	Large
Kazakhstan	Medium	Small	Large
Kyrgyz Republic	Small	Large	Large
Tajikistan	Small	Large	Large
Turkmenistan	N/A	N/A	Large
Uzbekistan	Medium	Small	Large

Source: EBRD Transtion Report 2016-17.

Figure 17. Unemployment Rate

(Percent of labor force)



Source: World Development Indicators.

[18] These countries, for instance, do not allow fixed-term contracts for permanent tasks, which is practice in most countries.

Box 1. The CCA and the BRI

China's Belt-and-Road Initiative (BRI) unveiled by President Xi Jinping in 2013 involves all CCA countries. The initiative focuses on strengthening economic ties and cooperation along the Silk Road connecting China to Europe via Central Asia (Silk Road Economic Belt) and the Indian Ocean (Maritime Silk Road). While the focus has been on infrastructure investment—including roads, railways, and power grids—the initiative covers broader cooperation including trade facilitation and technical assistance. The BRI is one of the largest and most complex investment projects in history—covering more than 65 countries, equivalent to 65 percent of the world's population and 40 percent of global GDP as of 2017.

The BRI presents considerable investment and trade opportunities for the CCA. China's outward direct investment (ODI) to the region through the end of 2016 amounted to nearly $10 billion. Kazakhstan has been the primary beneficiary, with over $5 billion in investment (4 percent of GDP). For the Kyrgyz Republic and Tajikistan, investments have been significant (in excess of $1 billion each), representing nearly 17 and 19 percent of their countries' GDP, respectively.

While economic opportunities under the BRI are considerable and expected to grow, it also entails risks that need to be managed. Specifically, fiscal risks associated with public investment and infrastructure spending need to be mitigated and public debt sustainability maintained (see section on fiscal policy and frameworks). In addition, higher investment and growth could lead to a deterioration in the current account, which could be only partially offset by higher capital inflows. Greater exchange rate flexibility should help mitigate such risks (see section on monetary frameworks).

Figure 1.1. China's ODI Stock in CCA, 2016
(USD billion)

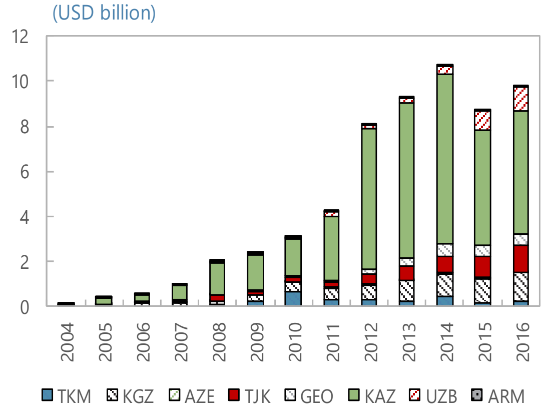
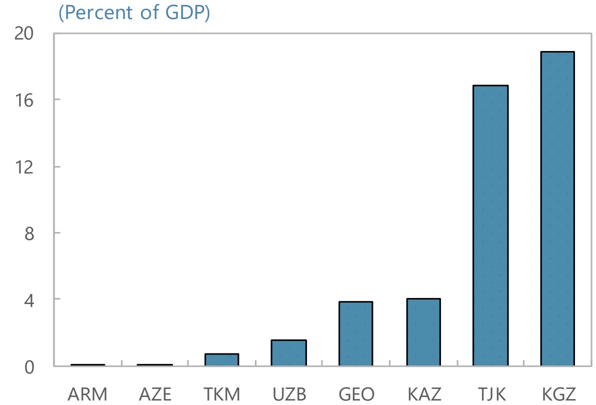


Figure 1.2. China's ODI Stock in CCA, 2016
(Percent of GDP)



Source: CEIC.

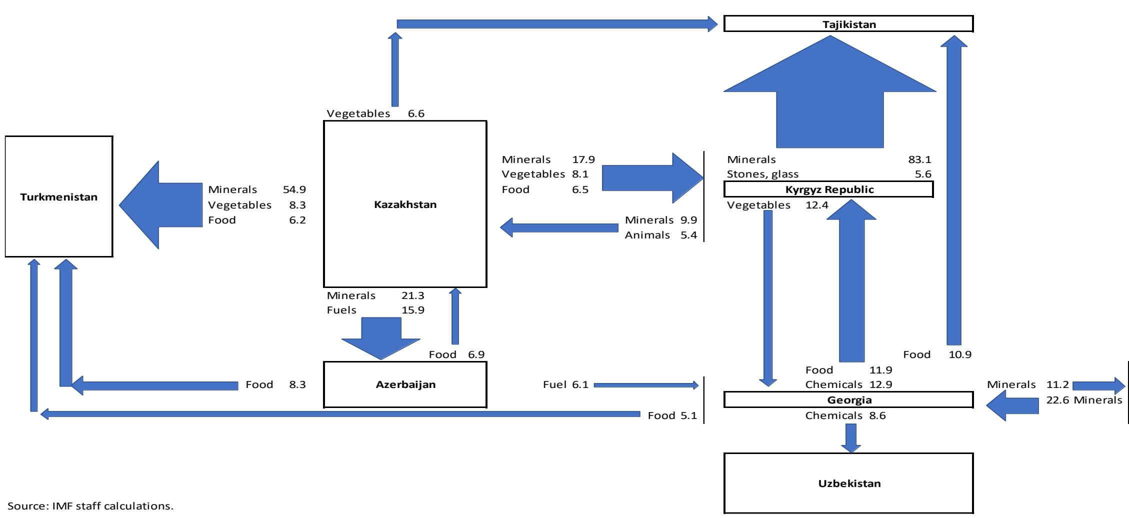
Box 2. Potential to Enhance Regional Trade

The potential to increase regional trade among CCA countries can be assessed by the revealed comparative advantage (RCA) index.[1] The RCA index has been estimated for each CCA country relative to each of its regional trading partners in 16 broad sectors. Data limitation precluded the calculation of the RCA for Tajikistan, Turkmenistan, and Uzbekistan relative to other CCA countries. However, bilateral export flows of Armenia, Azerbaijan, Georgia, Kazakhstan, and the Kyrgyz Republic allow the identification of some underused potential for regional integration within these CCA countries (Figure 1). Given their level of development, the largest potential to enhance trade integration among CCA countries in the near term exists mainly in the trade in primary commodities, foods, and metals. While there is no visible RCA for CCA countries relative to each other in machinery, transportation equipment, and other manufactured products, opportunities should be explored, also in the context of global integration, as greater specialization would provide opportunities for entering GVCs and boost competitiveness and growth.

Kazakhstan has the largest potential for additional exports, though RCA exists for most countries in the region. The largest potential to deepen regional integration seems to exist between Kazakhstan, which has RCA in minerals compared to Turkmenistan, the Kyrgyz Republic and Azerbaijan. Substantial additional exports of vegetables and foods are also possible from Kazakhstan to Tajikistan, Turkmenistan and the Kyrgyz Republic. Additional large trade potential seems to exist between the Kyrgyz Republic, which has a RCA over Tajikistan in minerals' exports, and between Georgia and Armenia in different types of minerals. Georgia, could sell more chemicals to the Kyrgyz Republic and Uzbekistan.

Figure 2.1. Revealed Comparative Advantage

(Pairwise indices)



Source: IMF staff calculations.

[1] RCA is a measure of a country's relative advantage in a specific sector as evidenced by trade flows. If the index is higher than 1 in a sector, a country's share of exports in that sector exceeds the global export share of the same sector. In this case, the country has a relative advantage in that sector. The RCA index can also be interpreted as an indicator of direction and broad sectors for potential additional export flows between two countries.

Box 3. Why Have Integration Initiatives in the CCA Had Limited Success in the Past?

Greater economic integration has been a consideration for the CCA countries practically since the break-up of the Soviet Union in 1991. As early as December 1991 the Commonwealth of Independent States (CIS) was founded among the eight CCA countries plus Belarus, Moldova, Russia and Ukraine. In 1994, eleven CIS countries (all but Turkmenistan) agreed to create a CIS-wide free-trade area (FTA), but agreements were not signed or ratified by the full group. A customs union among Belarus, Kazakhstan, and Russia was established in 1996 and was extended as the Eurasian Economic Community (EAEC) in 2000 to Kyrgyz Republic and Tajikistan. The Eurasian Economic Union (EEU) succeeded the EAEC in 2014-15, comprising Belarus, Kazakhstan, and Russia and later, Armenia and Kyrgyz Republic. Other groupings and affiliations have included the following:

- Membership of seven CCA countries (excluding Armenia) in the **Central Asia Regional Economic Cooperation** (CAREC) program, which has focused on transportation, trade, and energy/utility projects, which have totaled $31.5 billion in investments since 2001.
- Membership in the **Shanghai Cooperation Organization**, formed in 2001-03 to foster policy dialogue by Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan, along with China and Russia, and later, India and Pakistan. Armenia and Azerbaijan are SCO "dialogue partners."
- China's **BRI** covering over 65 countries including all CCA countries (Box 1).
- Partnership or free trade agreements of the Caucasus countries with the **European Union**.
- Membership of several CCA countries in the **World Trade Organization**.

While progress has been made in building capacity and institutions and upgrading infrastructure and connectivity, integration has not proceeded as strongly as suggested by these initiatives. Slow progress reflects a range of factors:

- **Structural**—the importance of primary commodity production and export in most CCA countries, including hydrocarbons, minerals, metals, grain, cotton.
- **Macroeconomic**—volatility of growth and inflation in the CCA is among the world's highest, in part reflecting the importance of natural resources and volatile prices. Recessions in 1998 (Russian crisis), 2008-09 (global financial crisis), and 2014-15 (oil price shocks) were setbacks.
- **Institutional and policy variation**. The period since independence has been marked by an extended period of building national institutions and policy frameworks, including related to fiscal policy, business environments, and rule of law. Convergence of policy frameworks (tax bases and rates, regulations) has not been a central objective.
- **Political-economy and governance challenges**—have limited domestic and foreign investor interest in many CCA countries, including investors from other CCA countries. Business openings appear to have often gone to nationals, especially political elites.
- **Geopolitical challenges**—have included tensions in the Caucasus and Central Asia, and dislocations linked to sanctions against Iran and Russia.

It will be important to overcome these challenges going forward, including with a strong spirit of openness and commitment to ensuring that integration extends beyond membership in regional groupings to meaningful support from the highest levels for real integration—at borders, at grass-roots levels, and among national institutions and agencies that are critical for facilitating trade and exchange, coordination, monitoring, and enforcement. The change in policy direction in Uzbekistan and opening of trade, transport, energy, and visa links and other contacts with regional neighbors is encouraging, and should be followed by the rest of the CCA.

Box 4. Uzbekistan's Liberalization Strategy

In February 2017, the government of Uzbekistan introduced a broad-based program to develop the Uzbek economy, which is being rapidly put into action. The program has the potential to markedly strengthen Uzbekistan's growth prospects and improve living standards. It also presents an opportunity for enhanced economic co-operation among CCA countries, with significant positive economic benefits for the region. Some of the principal elements of the program include:

- **Foreign exchange liberalization:** The Uzbek sum has been floated and restrictions on the purchase and sale of foreign exchange (including repatriation requirements) have been lifted. Preparations are underway to move to inflation targeting in the medium term.

- **Trade liberalization:** Licensing requirements for foreign trade are being simplified, and previous monopolies (such as those related to the import and export of agricultural products) are being opened to competition. Customs procedures for transit of goods through Uzbekistan are being simplified.

- **Strengthening transportation and utility networks.** Rail and road connections are being actively promoted, including the recent openings of the Angren-Pap railway line, linking China and Central Asia, and the Turkmenabad-Farab road and railway bridge. Significant efforts are also placed on boosting energy production and exports, with support from the World Bank and Asian Development Bank.

- **Travel:** Visa requirements are being lifted for a growing number of countries, and the exit visa system is being abolished. Regulations and processes for border crossing have been simplified, and new crossing points opened with Tajikistan, the Kyrgyz Republic, and Kazakhstan.

- **Migration:** the framework regulating Uzbek labor in Russia has been improved to provide workers better rights and security.

Box 5. Governance

Governance is a broad concept covering all aspects of how a country is governed, including its economic policies, regulatory framework, and adherence to rule of law. Poor governance offers incentives and opportunities for corruption—the abuse of public office for private gains—which undermines public trust, threatens market integrity, distorts competition, and endangers economic development.

Good governance thus matters for economic development and growth. Well-functioning political institutions secure good policies even through changes in governments, and protect investors from arbitrary government decisions and expropriation.[1] Political stability, robust and business-friendly regulations, and legal certainty also improve the investment climate which is conducive to growth.

Governance challenges vary across the CCA. The Worldwide Governance Indicators suggest that CCA countries lag behind other regions, particularly in controlling corruption, enforcing the rule of law, and strengthening voice and accountability.[2] Among the CCA countries, Georgia stands out as having better scorecards in most dimensions of governance, particularly in government effectiveness, regulatory quality, and controlling corruption.

Figure 5.1. Governance Indicators
(2016)

Source: World Bank, *Worldwide Governance Indicators*.
Note: CCA - Caucasus and Central Asia, SSA - Sub-Saharan Africa, MENA - Middle East and North Africa LAC - Latin American Countries, ECA - Eastern Europe, EAP - East Asia and Pacific.

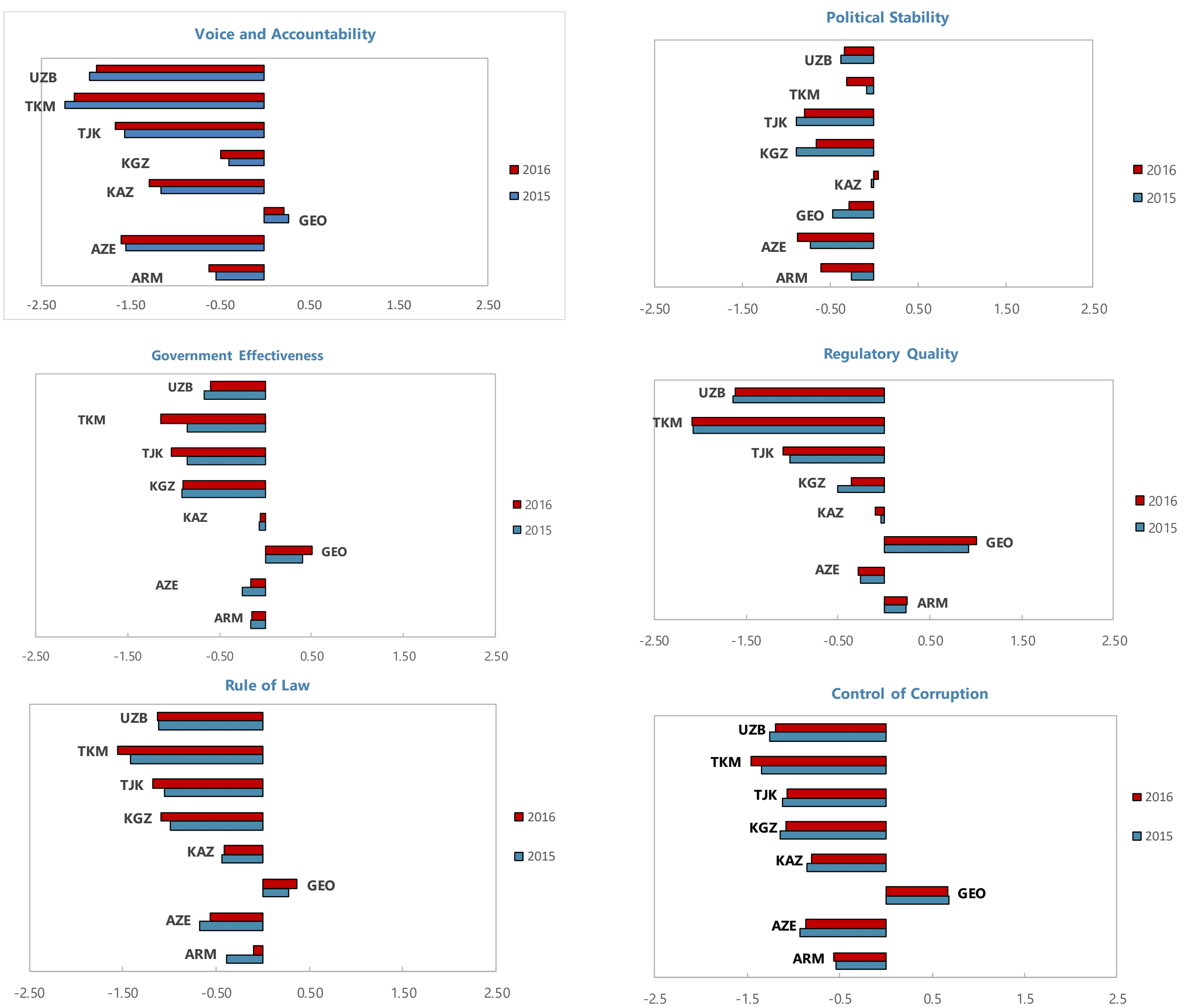
CCA countries need to tackle governance issues more forcefully. Weeding out corruption will be key to improving the investment climate. While specific anti-corruption measures differ from country to country, strong vested interests and ties make monopolistic economic structures, rent seeking, and corruption difficult to overcome. Change will need to come from government leadership. Strengthening AML/CFT in line with the FATF standards, procurement laws and fiscal reporting are specific areas where more could be done to enhance transparency and boost anticorruption efforts.

Efforts are also needed to strengthen the rule of law, including the judicial framework to improve property rights, contract enforcement, and insolvency procedures. Improving the quality of the judiciary—both in terms of its technical capacity and its independence from private influence and public interference—is key to ensure enforcement of economic rights, predictability and to promote investment.

[1] Acemoglu (2008), IMF (2015), IMF (2018).

[2] The World Bank's Worldwide Governance Indicators (WGI) combine the views of a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. While useful as a tool for broad cross-country comparisons and for evaluating broad trends over time, they are often too blunt for formulating specific governance reforms and do not represent the IMF's assessment of the level of governance in a particular country.

Figure 5.2. Governance Indicators in CCA Countries



Source: The Worldwide Governance Indicator.
Note: ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance.

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