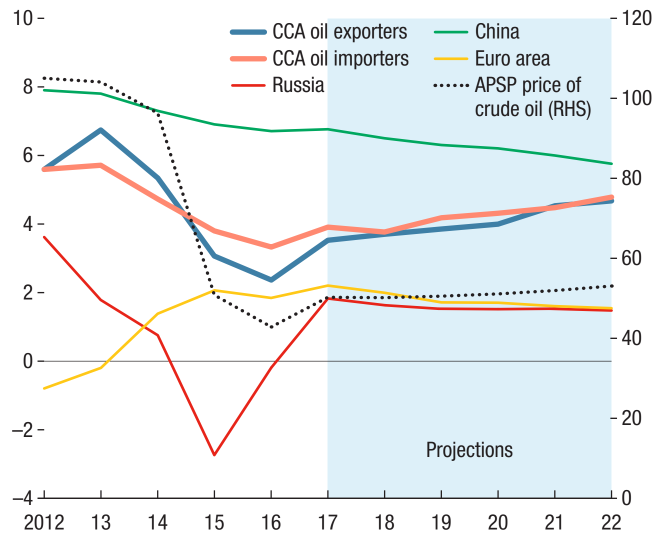
3. Caucasus and Central Asia: No Room for Complacency

Growth in the Caucasus and Central Asia (CCA) started to pick up during the second half of 2016, and is projected to accelerate further in 2017 and beyond. Improved economic conditions in the region's main trading partners and some firming of commodity prices, combined with continued implementation of structural reforms, are anticipated to support the recovery. However, medium-term growth is forecast to remain below historical norms. Reforms promoting diversification away from remittances and commodities should therefore be accelerated to secure strong, sustainable, and inclusive growth. To capitalize on opportunities for integration into the global economy—including through China's Belt and Road Initiative—institutional frameworks should be strengthened to facilitate productive investment and foster private sector development. Fiscal consolidation should continue to ensure that buffers are rebuilt, public expenditure channeled efficiently, tax collection improved, and social safety nets protected. Monetary policy frameworks should be strengthened further, including by establishing clear objectives, safeguarding central bank independence, and enhancing communication. Deep-rooted weaknesses in highly dollarized banking sectors—which are not in a position to support growth in some countries—should be addressed promptly.

Figure 3.1. Growth Expected to Recover Gradually

(Real GDP growth, percent, and US dollars a barrel)



Sources: National authorities; and IMF staff calculations.
Note: APSP = average petroleum spot price—average of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil prices; CCA = Caucasus and Central Asia; RHS = right scale.

Outlook Supported by Improving External Conditions

Economic activity in the CCA region bottomed out in 2016, as countries grappled with spillovers from the adverse external environment that emerged in mid-2014 (Figure 3.1). Regional growth declined to 2.5 percent last year, almost 3 percentage points below growth in 2014 when oil prices started to drop. Given some firming in the prices of key commodities—which nonetheless remain well below levels before 2014—and improved economic conditions in the region's main trading partners (Russia, China, and the euro area), growth in the CCA is projected to increase to 3.6 percent this year, and pick up to 3.7 percent in 2018. This baseline outlook is predicated on countries continuing to implement structural reforms, and, in some cases, promptly resolving financial sector weaknesses. Relative to the May 2017 *Regional Economic Outlook: Middle East and Central Asia Update*, the outlook is 0.4 percentage point stronger in 2017 and similarly weaker in 2018, largely reflecting developments in Kazakhstan, the largest economy in the region. Because external conditions are expected to remain relatively subdued in 2019 and beyond, and structural reforms are likely to proceed gradually, growth in the CCA is anticipated to average 4.3 percent in 2019–22, well below the 8.1 percent average in 2000–14.

Prepared by Sangyup Choi and Juan Treviño (lead author). Research assistance was provided by James Aylward, Jorge de León, and Sebastián Herrador.

In oil-exporting countries, growth is projected to pick up from a post-1998 low of 2.4 percent last year to 3.5 percent in 2017 and 3.7 percent in 2018. Oil exporters have shown signs of improvement since the second half of 2016, supported by some increase in oil prices and a gradual strengthening of external demand. In Kazakhstan, the construction, transportation, and agriculture sectors strengthened during the latter part of 2016, and growth is expected to further improve with advances in the operation of the Kashagan oil field and the continuation of structural reforms. In Azerbaijan, last year's economic contraction extended into the first quarter of 2017, albeit at a slower pace, due in part to lower oil production in the context of the agreement led by the Organization of the Petroleum Exporting Countries, exacerbated by ongoing financial vulnerabilities. Although the economy is projected to resume growing in 2018, this will be a gradual recovery, with activity limited by the implementation of much-needed fiscal consolidation. In Turkmenistan, growth was supported by strong agriculture and services activities last year, and is projected to remain stable in the short term, owing to rising exports of natural gas to China, expansionary credit policies, and industrial policies to promote exports and substitute imports. Growth among CCA oil exporters is anticipated to pick up slowly over the medium term given the relatively subdued external conditions, underscoring the need to reduce dependence on hydrocarbons.

In oil importers, last year's growth was 3.3 percent, some 0.5 percentage point below the 2015 outturn. This largely reflected the persistence of earlier adverse external shocks resulting in reduced remittances and commodity exports, but also weak domestic demand, especially in Armenia and Georgia. The slowdown in those countries was partially offset by strong growth in Tajikistan due to fiscal expansion that supported industrial and construction activities, and in the Kyrgyz Republic as a result of higher gold production and stronger industrial and services activities, especially during the second half of the year. As remittances pick up with the recovery in Russia and external demand improves, growth in oil importers is projected to strengthen to almost 4 percent this year and next. In Georgia, the projected acceleration in growth this year and next is expected to be stronger than anticipated in the May 2017 *Regional Economic Outlook: Middle East and Central Asia Update,* supported by solid domestic and external demand. In Armenia, economic activity is anticipated to pick up in 2017, reflecting higher projected copper prices and stronger remittances. Conversely, growth is expected to moderate in the Kyrgyz Republic as gold production stabilizes, and in Tajikistan, where the financial sector remains in significant distress and the outlook has deteriorated relative to May. Over the medium term, economic activity in oil importers is expected to remain on a path to recovery, assuming growth dividends from structural reforms gradually materialize.

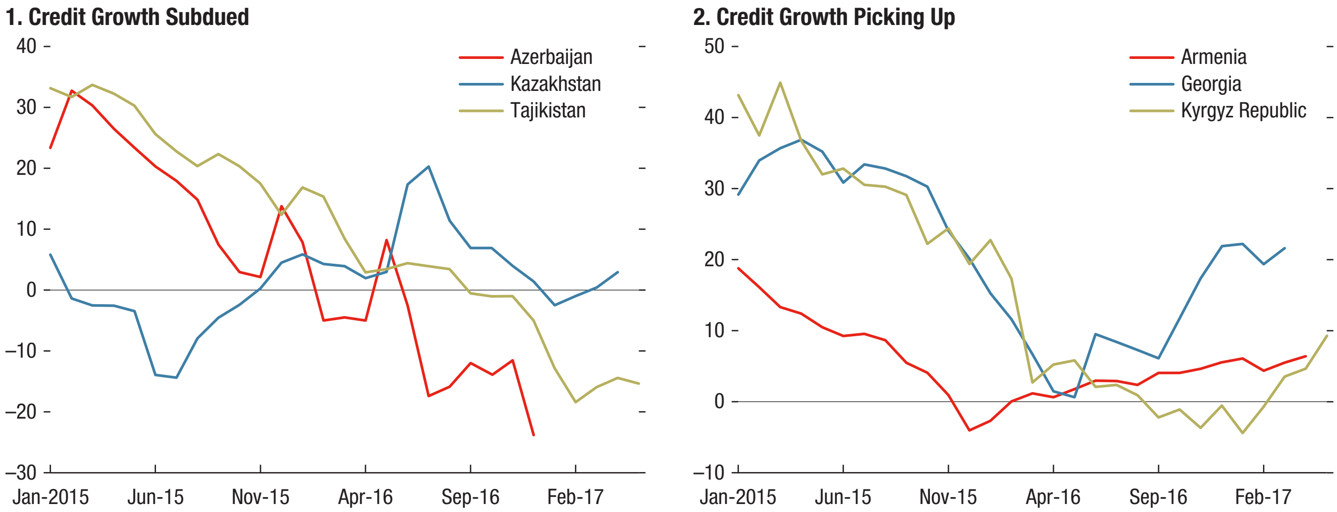
Financial Sector Weaknesses Restrain Growth

Financial sector vulnerabilities remain high in several CCA countries. In Azerbaijan, the largest state-owned bank is in the process of a voluntary debt restructuring worth some 9 percent of GDP, while several small banks are attempting to raise fresh capital. In Kazakhstan, the two largest banks have merged, and the authorities have provided support to the financial sector equivalent to about 4 percent of GDP this year. In Tajikistan, the authorities intervened in two major banks, providing support totaling some 6 percent of GDP. In these countries, the deterioration in asset quality and bank profitability, and the large share of underperforming loans, have adversely affected lending (Figure 3.2, panel 1).[1]

The financial systems of other CCA countries have proved somewhat more resilient, and credit growth has gained momentum (Figure 3.2, panel 2). In Armenia, for example, after the merger of three

[1]Underperforming loans comprise officially reported nonperforming loans (NPLs), adjustments made to make the NPL data more consistent with international definitions, plus estimates of restructured and exchanged loans.

Figure 3.2. Credit Growth Has Shown Diverging Trends across the Region
(Credit growth, percent, year over year)

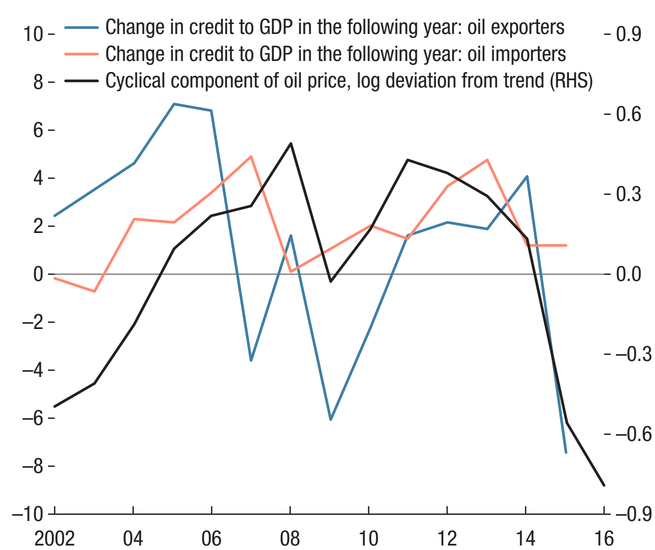


Sources: National authorities; and IMF staff calculations.
Note: These values are not adjusted for exchange rate effects.

banks in 2016 and injections of capital to meet new regulations, financial soundness indicators have improved, with better profitability and lower levels of nonperforming loans (NPLs). In Georgia, where the two largest banks acquired some smaller banks, NPLs have increased only marginally, and banks continue to report adequate capital and liquidity. In the Kyrgyz Republic, dollarization has declined, and capitalization of banks is adequate, although NPLs remain high. In Turkmenistan, credit growth has remained strong in support of the authorities' development efforts, although this rapid credit growth creates the risk of lower credit quality in the future.

While important steps have been taken, efforts that promote financial sector resilience should continue as, in some cases, vulnerabilities have raised concerns about the capacity of banking systems to support economic activity. Actions should focus on enabling an accurate assessment of banks' health, developing effective bank resolution frameworks, enhancing prudential regulation and supervision, and resolving governance issues (Box 3.1). Oil prices, which are anticipated to remain subdued, have historically been closely tied to the region's credit cycle (Figure 3.3) and

Figure 3.3. Credit Cycle Highly Correlated with Oil Prices
(Simple averages, percent of GDP)



Sources: IMF, *International Financial Statistics*; national authorities; and IMF staff calculations.
Note: RHS = right scale.

could therefore prove to be a persistent drag on economic activity in coming years. This underscores the need for resilient financial sectors that can effectively channel savings to productive investments, promoting much-needed economic diversification.

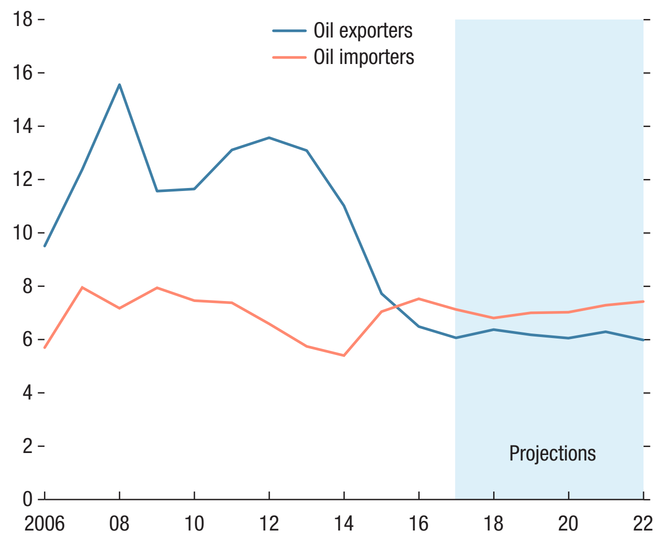
Fiscal Consolidation Efforts Should Continue

Fiscal balances in many CCA countries deteriorated in recent years as policymakers accommodated lower budget revenues in the context of falling commodity prices and remittances. With the notable exceptions of Azerbaijan and Kazakhstan, overall fiscal balances worsened in 2016 relative to 2015. However, overall balances are projected to improve in many countries this year and next, reflecting a combination of higher revenues in some, and lower public expenditures in others, helped by the continued unwinding of previous public investment booms (Figure 3.4).[2] With few exceptions, fiscal balances are anticipated to continue this trend gradually over the medium term. This partly reflects the expectation that previous fiscal stimulus will dissipate and revenues will improve with economic activity, but it is also predicated on the assumption that countries proactively identify and address—or at least contain—fiscal risks in the context of a new growth paradigm less reliant on commodity revenues.

Among oil exporters, overall fiscal deficits are anticipated to widen by some 1.6 percentage points of GDP on average this year relative to 2016, but this reflects, for the most part, one-time fiscal transfers to the financial sectors in Azerbaijan and Kazakhstan. Over the medium term, oil exporters' fiscal deficits are projected to decline further to 0.4 percent of GDP on average.[3] This reflects a gradual pickup in both oil and non-oil revenues, and large cuts in public investment. Deficit financing has relied on a combination of asset drawdowns (Kazakhstan, Turkmenistan) and foreign debt issuance (Azerbaijan, Kazakhstan).

Figure 3.4. Projected Fiscal Consolidation from Reduced Public Investment

(Weighted average, percent of GDP for oil importers, percent of non-oil GDP for oil exporters)



Sources: National authorities; and IMF staff calculations.
Note: Country-specific weights correspond to purchasing-power-parity-adjusted GDP.

For oil importers, higher deficits arising from fiscal accommodation—and financial sector support in Tajikistan—were mostly financed through foreign debt issuance and other foreign financing (except for Tajikistan, which issued debt domestically). Overall deficits for this group are projected to decline to 4.2 percent in 2017 and 3.7 percent in 2018, backed by revenue mobilization and strengthened expenditure management in Armenia, and implementation of wage bill reform in the Kyrgyz Republic. Fiscal deficits for these countries are projected to gradually decline to 1.9 percent of GDP on average by 2022, supported by revenue mobilization efforts

[2]These booms resulted in substantial increases in the share of public investment to GDP in some CCA countries. Fiscal accounts do not necessarily reflect them since many projects were implemented through state-owned enterprises.

[3]Non-oil fiscal deficits are projected to increase to 17.6 percent of non-oil GDP this year from 13.9 percent in 2016, but decline to 10.9 percent of non-oil GDP in 2022.

in Armenia (the 2016 tax code is expected to raise revenues by about 2 percentage points of GDP over the medium term) and improved tax administration and expenditure restraint in Tajikistan.

Fiscal consolidation efforts continue, but more might be needed to reduce debt and bring buffers back to preshock levels. Moreover, the pace and composition of fiscal consolidation should be carefully calibrated so as to not undermine medium-term growth. This calls for strengthening the efficiency of public spending by carefully selecting projects with the highest impact on productivity and potential growth, as well as by streamlining public sector wage bills—including in some countries by limiting staff numbers and bonusesand implementing civil service reforms (Tamirisa and others, forthcoming)—while ensuring preservation of critical social expenditure that protects the poor and vulnerable. These actions should be coupled with additional efforts to mobilize revenues, including through reducing tax exemptions and strengthening collections (Box 3.2). As countries adjust to the new reality of low commodity prices and move toward more flexible exchange rate regimes (see below), anchoring fiscal consolidation in strong and credible multiyear frameworks will become instrumental for maintaining macroeconomic stability and, ultimately, achieving strong, sustainable, and inclusive growth. To this end, it is essential that CCA countries promote transparency and accountability in the use of public funds.

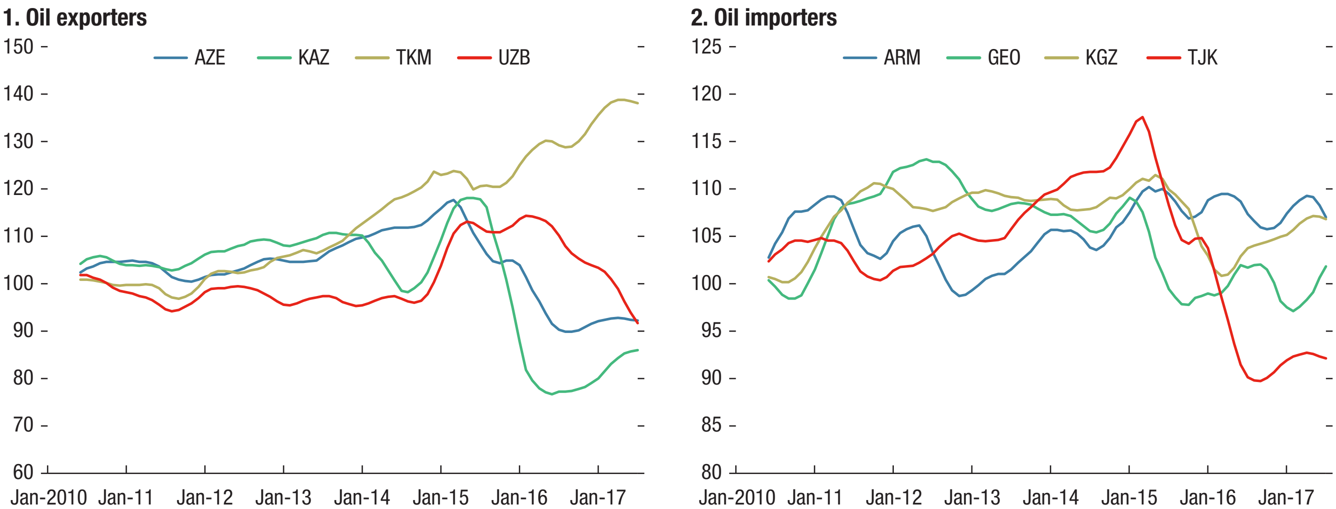
External Balances Projected to Improve Gradually

The current account deficit in the region reached 6.4 percent of GDP in 2016, some 2.8 percentage points more than in 2015. Within this overall trend, current account balances deteriorated in almost all oil exporters, reflecting lower oil prices. In contrast, the current account balance improved in most oil importers. In Armenia, the current account deficit marginally improved to 2.3 percent of GDP, partly due to a new copper mine and a rebound in exports to Russia. In the Kyrgyz Republic, the current account deficit narrowed by about 6 percentage points of GDP, benefiting from strong exports of gold, low fuel import prices, and a pickup in remittances. In Tajikistan, where the current account deficit narrowed by some 2 percentage points of GDP, exports somewhat recovered, while imports contracted only moderately despite a substantial decline in remittances.

Exchange rate movements have facilitated adjustment to the adverse external environment in many CCA countries (Figure 3.5), as discussed in Chapter 3 of the October 2016 *Regional Economic Outlook: Middle East and Central Asia*. Among oil exporters, Azerbaijan and Kazakhstan have allowed their currencies to move more freely, while Uzbekistan recently announced the unification of the official and parallel exchange rates—with the som losing about half of its value against the US dollar at the official exchange rate—and liberalized some transactions in foreign currency to allow for fuller use of market mechanisms to determine the exchange rate. All three currencies have depreciated in real effective terms relative to the period before the oil price drop. In contrast, the Turkmen manat has significantly appreciated in real effective terms over the past several years, despite a step devaluation in 2015. Among oil importers, currency adjustment has also played a role as shock absorber. In real effective terms, exchange rates have, on average, moved laterally since 2015 in Armenia, following a clear trend toward appreciation in 2013–15, and in Georgia, where the real effective exchange rate has remained below preshock levels. Similarly, the significant depreciation of Tajikistan's somoni over the past few years has brought the real effective exchange rate below historical averages. Conversely, the depreciation in the Kyrgyz Republic in 2015–16 has been largely reversed.

The current account balances of most CCA countries are projected to improve gradually in 2017 and beyond. These projections reflect a gradual improvement in external conditions,

Figure 3.5. Real Effective Exchange Rates Show Diverging Trends
(Six-month moving average, 2010 = 100)



Sources: Information Notice System database; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

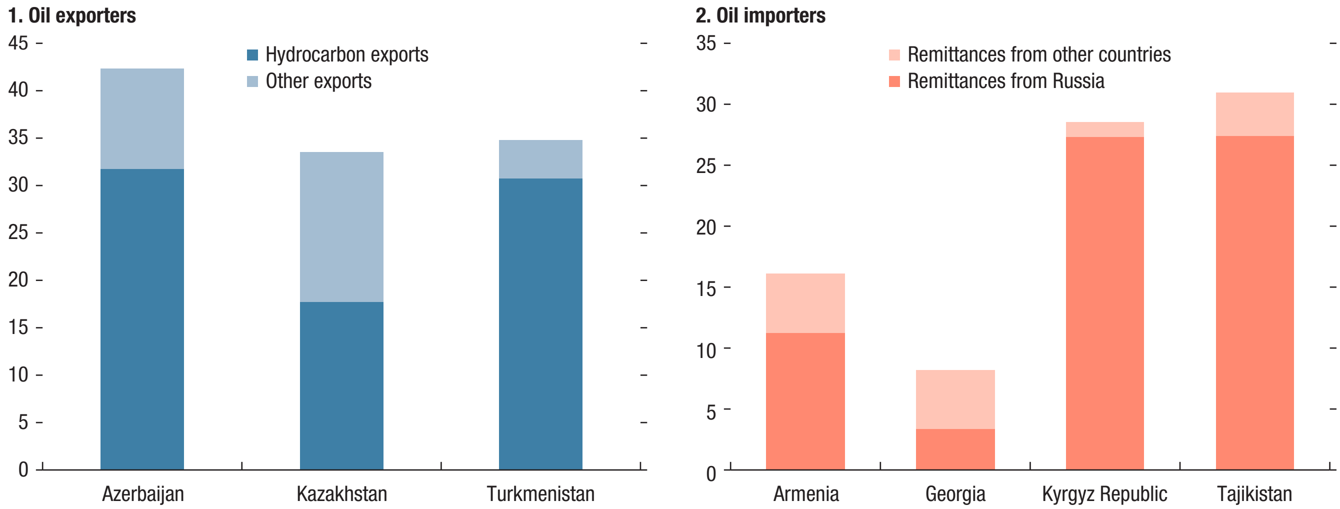
but also several country-specific factors. In Kazakhstan, oil exports are projected to increase as the Kashagan oil field becomes fully operational, although a return to current account surplus is not expected in the near future. In Turkmenistan, external deficits are projected to remain sizable over the medium term—amid significant public investment projects, low hydrocarbon prices, and a large import content of domestic spending—despite growing hydrocarbon exports and export-promotion and import-substitution policies. In oil importers, current account deficits will increase in 2017 and decline gradually throughout 2022. This gradual improvement reflects a pickup in imports that partially offsets the continued recovery in remittances observed since mid-2016. The high reliance on commodity exports and remittances again underscores the need for continued diversification across the region (Figure 3.6).

Monetary Policy Frameworks Should Be Enhanced Further

After peaking at double digits during 2016, CCA regional inflation is projected to moderate to 8.9 percent in 2017 (Figure 3.7), driven by Kazakhstan, where price pressures are easing, including from some exchange rate appreciation. In most other countries, inflation is anticipated to pick up this year, but remain subdued, especially among oil importers. In Georgia, for example, inflation is projected to accelerate from excise tax increases, the lagged effects of exchange rate depreciation, and higher commodity prices, before converging in 2018 to the central bank's target of 3 percent. In Armenia, where inflation has been persistently low, higher food prices are projected to exert some upward pressures, but inflation will remain in line with the official medium-term target range of 4±1.5 percent. Among oil exporters, higher import prices, combined with rapid growth in public sector wages and expansionary credit policies, have put upward pressure on inflation in Turkmenistan. In Uzbekistan, inflation is projected to accelerate into double digits given recent high money growth and rapid depreciation of the som. Regional inflation is projected to decline gradually to 5.9 percent by 2022.

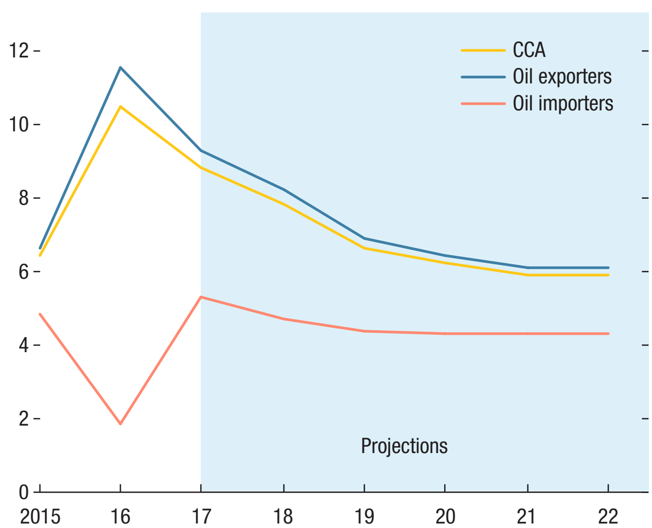
With inflation prospects generally subdued as exchange rates stabilize, and with the expected

Figure 3.6. High External Dependence
(Percent of GDP, 2014–16 average)



Sources: National authorities; and IMF staff calculations.

Figure 3.7. Inflationary Pressures Subsiding
(Weighted averages, CPI, percent change, year over year)

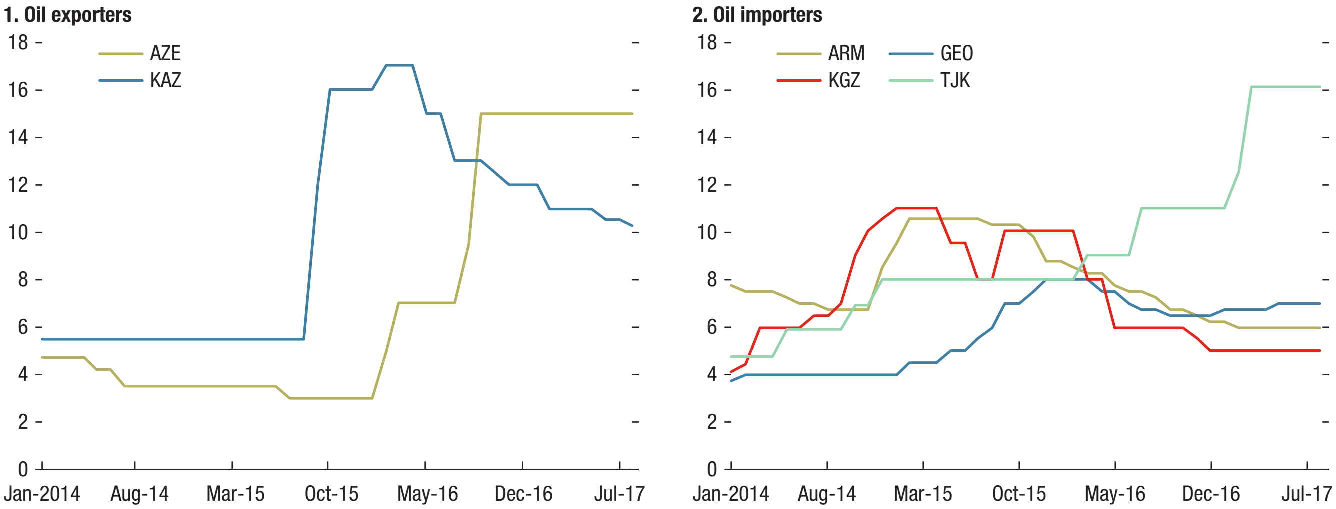


Sources: National authorities; and IMF staff calculations.
Note: Country-specific weights correspond to purchasing-power-parity-adjusted GDP. CCA = Caucasus and Central Asia, CPI = consumer price index.

pickup in economic activity being slow relative to historical standards, restrictive monetary policies have started to unwind in many countries (Figure 3.8). Exceptions include Azerbaijan, Georgia, and Tajikistan, where central banks have increased their policy rates in response to rising inflation. In 2017, the National Bank of Tajikistan raised its policy rate twice to reach 16 percent, significantly increased sales of National Bank of Tajikistan bills, and raised reserve requirements. In Azerbaijan, the central bank sharply raised its policy rate in late 2016 from 7 percent to 15 percent, where it has remained. At the other end of the spectrum, rapid policy rate cuts have taken place in Kazakhstan among oil exporters, and in Armenia and the Kyrgyz Republic among oil importers. These actions, however, have in some cases had a limited impact on bank lending and deposit rates, indicating weaknesses in the monetary transmission mechanism.

Since the exchange rate no longer serves as an anchor for domestic prices in most CCA countries, policymakers should redouble efforts toward developing strong and credible monetary policy frameworks. Priorities include establishing clear monetary policy objectives, enhancing central bank communication, and improving the transmission mechanism for monetary policy and the analytical toolkit for central banks. Moreover, the exchange rate should continue to act as a shock absorber. Given the exposure to external shocks and widespread dollarization, foreign exchange

Figure 3.8. Diverging Monetary Policy Actions
(Monetary policy rates)



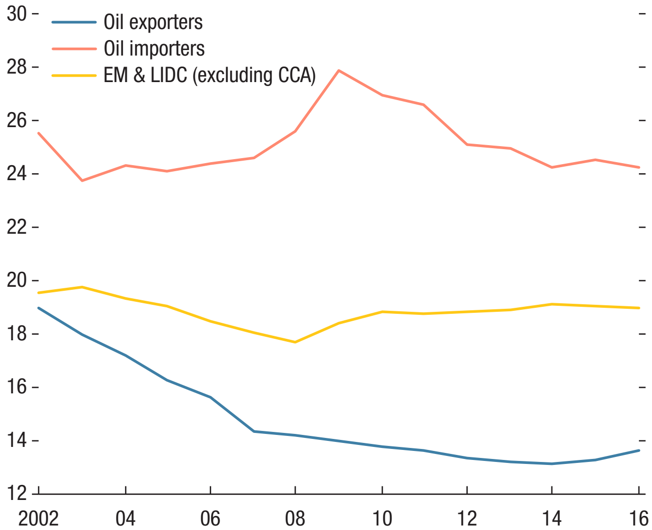
Sources: IMF, *International Financial Statistics*; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

reserve buffers should be maintained, with direct market interventions limited to dealing with disorderly conditions. The pace of monetary easing should be consistent with inflation developments, not only to avoid undermining the price stability mandate, but also to support financial development and contribute to dedollarization efforts. Policies toward improving liquidity management and developing a local currency yield curve should continue. For example, the Central Bank of Armenia continues to improve liquidity forecasting and management and to enhance its instruments and analytical toolkit. The National Bank of Georgia now publishes its forecast for the policy rate path in its monetary policy report. In the Kyrgyz Republic, efforts to gradually narrow the corridor around the policy rate and make it more symmetric are ongoing, with the goal of gradually making the transition to an inflation-targeting framework.

Structural Reforms Needed for Strong, Sustainable, and Inclusive Growth

Despite the nascent recovery, implementation of structural reforms to promote strong, sustainable, and inclusive growth through economic diversification and private sector job creation is urgently needed. Although the region had been catching up quickly to the living standards in other emerging markets (see Chapter 3 of the October 2016 *Regional Economic Outlook: Middle East and Central Asia*), the growth slowdown over the past couple of years, combined with the subdued outlook, suggests that further significant income and employment gains could be elusive. For example, the decline in youth unemployment in oil exporters since 2002 has stalled recently—with youth unemployment even picking up in some countries—while the reductions secured by oil importers following the global financial crisis have also come to a halt (Figure 3.9). These developments highlight the urgency of following through on structural reforms, not least because external conditions are projected to remain relatively subdued in coming years.

Figure 3.9. Persistent Labor Market Deficiencies
(Average, percent of youth unemployment rate)



Source: International Labour Organization estimates.
Note: CCA = Caucasus and Central Asia; EM = emerging market economy; LIDC = low-income developing country.

Some previously announced reforms have started to be implemented. In Kazakhstan, the authorities have launched the *100 Concrete Steps* and *3rd Modernization Initiative*. These comprehensive initiatives, which aim to address gaps in public administration, the business environment, competitiveness, and commodity dependence, require strong commitment from stakeholders, as they need consensus for their implementation. A key element is the planned reduction of the role of the state through privatizations, the first wave of which is expected in 2018. In Armenia, a new entity, the *Center for Strategic Initiatives*, was established in January 2017 to foster public-private partnerships and attract foreign direct investment. Reforms in the energy sector and the tax system have proceeded successfully in that country, and others are underway, seeking to tackle corruption, improve competition and the business climate, and attract foreign direct investment. Given the limited fiscal space across the region and the projected reduction in public investment, it is also crucial for the CCA to proceed with the reform and privatization of state-owned enterprises. For example, Georgia is planning to introduce a public-private partnership law, and strengthen monitoring of contingent liabilities arising from these partnerships and from state-owned enterprises. In Tajikistan, structural fiscal reforms should aim to improve service delivery, enhance the business climate, and reduce fiscal risks. In Turkmenistan, the new seven-year development plan is creating an opportunity to broaden and deepen market-oriented reforms. Uzbekistan has announced a comprehensive economic and social reform package, including a reform of the foreign exchange system. These reforms, if implemented appropriately, hold the promise of significantly improving the business climate, with positive implications for the Uzbek economy and the rest of the CCA region.

Accelerating the implementation of structural reforms in support of private sector development is critical to achieving the greater diversification needed to boost growth by attracting productive investments and creating jobs. Reforms that further strengthen governance, transparency and accountability, and property rights are also necessary for CCA countries to benefit fully from the opportunities created by China's Belt and Road Initiative (Box 2.1, Chapter 2), and from the strengthening global economy more broadly (Chapter 4).

Risks Balanced in the Short Term, but Tilted to the Downside over the Medium Term

Continued strengthening of the global economy, trade, and some commodity prices, as well as several upside risks at the regional level, imply a balanced risk outlook for the CCA region. For example, in Georgia, growth could surprise on the upside given the possibility of stronger-than-expected returns from trade integration—including through deeper economic ties with China. In the Kyrgyz Republic, upside risks include deeper economic ties with China, whose Belt and Road Initiative provides the region with a gateway into the global economy; projects financed by the Russian-Kyrgyz

Development Fund; and a greater-than-expected impact from the country's membership in the Eurasian Economic Union. Among oil exporters, despite vulnerability to lower commodity prices, Kazakhstan's upside risks include benefits from structural reforms, enhanced regional cooperation, deeper economic relations with Uzbekistan, and a stronger recovery in Russia.

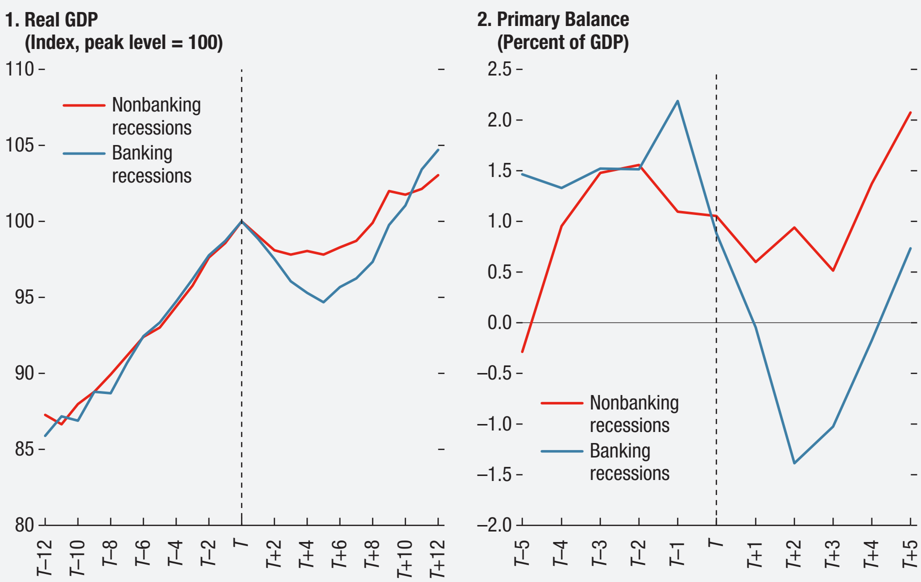
The downside risks are salient mostly over the medium term, stemming from the possibility of inward-looking policies in advanced economies that would adversely affect global trade and commodity prices. Also, monetary policy normalization in advanced economies, notably in the United States, could trigger a rapid tightening in global financial conditions. This tightening would lead to exchange rate volatility and depreciation, which could further increase public debt across the CCA and exacerbate the region's financial sector vulnerabilities. Internally, the fact that economic activity in the region is expected to pick up could delay the implementation of structural reforms, increasing the risk that the window of opportunity provided by the strengthening global economy and the various integration initiatives will be missed. This could be exacerbated by not committing to resolve financial sector vulnerabilities promptly, especially where banks are not in a position to support growth, much less the needed diversification. Ultimately mediocre economic performance could result, which would harm the living standards of the population.

Box 3.1. Addressing Financial Sector Vulnerabilities in the Caucasus and Central Asia to Support Growth

Recent external shocks have exposed continued financial vulnerabilities in Caucasus and Central Asia (CCA) countries. Despite some progress, fully addressing these vulnerabilities will require a stronger commitment to enhance regulation and supervision, improve bank resolution frameworks, and strengthen governance. This will limit short-term fiscal risks and enhance long-term growth.

Sound financial sectors provide many benefits—channeling savings to productive investments, reducing economic volatility and uncertainty, and cushioning the impact of adverse external shocks. But effective regulation and supervision are needed to mitigate the risk that banking sector vulnerabilities amplify the depth of downturns (Figure 3.1.1, panel 1), and generate strong fiscal pressures (Figure 3.1.1, panel 2). In extreme cases, these vulnerabilities can trigger crises with severe and long-lasting consequences and a loss of confidence in financial intermediaries.

Figure 3.1.1. Implications of Banking Recessions in Emerging Markets



Source: IMF 2015.
Note: A "banking recession" is defined as a recession preceded by rapid banking sector expansion. *T* (years) corresponds to the onset of a recession episode.

Recent external shocks have exposed ongoing shortcomings in regulation and supervision, loan loss recognition, and governance across the CCA. Some countries, notably Armenia, Georgia, and the Kyrgyz Republic, have already acted to strengthen regulation and supervision, significantly increasing the resilience of their financial sectors. However, progress has been slower in Azerbaijan, Kazakhstan, and Tajikistan, where policy responses have focused on helping financial sectors remain operational, and comprehensive programs for enhancing financial stability have only recently been announced.

This box was prepared by Juan Treviño. Research assistance was provided by Jorge de León Miranda.

Box 3.1 *(continued)*

While financial stability risks vary across the CCA, they could trigger potentially disruptive macroeconomic and social effects in some countries. Policymakers should focus immediate attention on those policies that are most critical or can be achieved quickly. Key priorities include the following:

- *Assessing banking sector health:* Although not a pressing issue in all CCA countries, uncertainty about the magnitude of problems on banks' balance sheets emerging from imperfect assessment of the health of banks is hindering an appropriate policy response. Reporting of nonperforming loans (NPLs), including off-balance-sheet items, should be brought in line with international best practice, and independent asset quality reviews should be undertaken to more accurately assess the viability of banks. This need is especially acute in Azerbaijan and Kazakhstan, where NPL measurements do not include assets transferred to special purpose vehicles, and where asset quality reviews have not yet been implemented. Performing these reviews would enable formulation of a strategy to proactively address NPLs, and assess provisioning and capitalization needs. This would, in turn, facilitate the timely intervention of banks if shareholders and managers fail to achieve a turn-around (for example, if they are unable to raise capital), limiting potential fiscal costs and supporting a speedier recovery in financial intermediation and, consequently, growth.

- *Improving bank resolution frameworks:* Although Armenia, Georgia, and Tajikistan have been working on improving their resolution frameworks following the lessons from the global financial crisis, all CCA countries need to do more to develop effective resolution frameworks. These frameworks should ensure that state support is provided only for viable banks and under strict conditions—such as time-bound recapitalizations with close oversight and corrective actions that avoid forbearance, and with clear restructuring plans where management is replaced and shareholder participation reduced or eliminated if necessary. Effective frameworks are especially urgent in Azerbaijan, Kazakhstan, and Tajikistan where fiscal pressures arising from discretionary support to financial institutions have increased significantly. For insolvent institutions, liquidation options should provide for orderly closure while protecting retail customers through deposit insurance programs. The resolution authority should have political and operational independence, sound governance structures and adequate resources, and should follow transparent processes. It should be subject to rigorous evaluation and accountability and be protected against liability for actions and omissions taken in good faith.

- *Enhancing prudential regulation and supervision:* CCA countries should continue strengthening regulatory and supervisory frameworks so that financial institutions remain resilient during periods of stress. Strengthening consolidated supervision and macroprudential frameworks is essential, and steps toward reducing dollarization risks must continue. For instance, the experience of countries such as Georgia and Armenia shows that the risk of large exchange rate depreciations can be mitigated by stricter rules on banks' open positions in foreign currency, more restrictive liquidity requirements on foreign currency, and higher risk weights and stricter limits on foreign-currency-denominated loans.

- *Strengthening corporate governance:* In many CCA countries, weak governance and opaque bank ownership—exacerbated by weak management, political interference, and corruption—have facilitated related-party lending, excessive risk taking, and discretionary support from regulators. Failure to address governance problems can lead to credit misallocation, which threatens economic diversification and, ultimately, growth. A strong governance structure should emphasize transparency and include clear responsibility at the executive and board levels, limit public sector influence in the administration and operation of the bank, and establish independent risk management, compliance, and internal control units. These actions would facilitate the development of a well-functioning financial system and promote confidence in the economy.

Box 3.2. Setting the Course for Growth-Friendly Fiscal Policy in the Caucasus and Central Asia

Growth-friendly fiscal consolidation is needed in the Caucasus and Central Asia (CCA). Options include enhancing tax revenue and improving the fairness of the tax system, curtailing public sector wage bills, reforming subsidies, improving the targeting of social safety nets, and supporting more efficient public investment. Well-designed fiscal rules and other steps to strengthen public financial management would also help.

Faced with large and persistent external shocks in 2014–15, most CCA countries allowed fiscal deficits to increase. This helped contain the impact of the shocks on output and job creation, but led in some instances to a rapid increase in public debt. At the same time, sizable risks built up in the banking sector, and support provided to the financial sector added significantly to deficits and debt in some countries (see Box 3.1).

Fiscal policymakers now face the challenge of restoring sound public finances and rebuilding buffers over the medium term in a growth-friendly way, including by maintaining scope for productive public investment. Meeting this challenge requires not only setting and achieving appropriately ambitious medium-term deficit targets, but also proactively identifying and addressing fiscal risks. With commodity prices unlikely to revert to preshock levels, thereby limiting future remittance flows, fiscal consolidation needs to be framed in the context of a transition to a new inclusive growth model based on greater diversification and job creation. Therefore, it is imperative that structural reforms be pursued in parallel.

Key considerations for fiscal policymakers include the following:

- *Enhancing revenue:* Tax revenue could provide a key lever for designing a growth-friendly consolidation package and improving its fairness. Broadening both the direct and indirect tax bases, and reducing widespread tax exemptions, would provide additional revenues and improve the distribution of the tax burden—an important concern affecting the investment climate in some countries. Although many CCA countries (including Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, and Tajikistan) are already pursuing policies to increase tax revenues, more ambitious fiscal targets and corresponding fiscal reforms are needed. Finally, improving revenue administration to ensure better enforcement of tax collection, including by taxing higher-net-worth individuals more effectively, would improve the fairness of the tax system.
- *Strengthening expenditure policy:* Consolidation efforts should focus on creating space for growth-enhancing investment, and on implementing fairer and more targeted social safety nets by curtailing government wage bills, inefficient and regressive subsidies, and poorly targeted social benefits. Most countries (except Tajikistan and Uzbekistan) are already planning some curtailment of current expenditures, with Georgia and the Kyrgyz Republic planning sizable cuts in the public sector wage bill. Although several CCA countries have already undertaken subsidy reform, energy subsidies remain large, especially in the Kyrgyz Republic, Turkmenistan, and Uzbekistan. Further reform would create additional space for better-targeted social spending. Finally, before any large increases are considered, reforms to boost the efficiency and productivity of public investment should be implemented.
- *Anchoring fiscal consolidation:* Experiences in other regions suggest that well-designed fiscal rules can play a valuable role in supporting fiscal consolidation. However, fiscal rules need to be tailored to countries' political economy settings to ensure they are not circumvented, for example by shifting spending to public sector units outside the government perimeter. Further improvements in public financial management, including medium-term budgeting, would also help anchor fiscal consolidation plans.

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CCA: Selected Economic Indicators

	Average 2000–13	2014	2015	2016	Projections 2017	Projections 2018
Real GDP Growth	**8.3**	**5.3**	**3.1**	**2.5**	**3.6**	**3.7**
(Annual change, percent)						
Armenia	7.6	3.6	3.3	0.2	3.5	2.9
Azerbaijan	11.3	2.7	0.6	–3.1	–1.0	1.3
Georgia	5.9	4.6	2.9	2.7	4.0	4.2
Kazakhstan	8.0	4.3	1.2	1.1	3.3	2.8
Kyrgyz Republic	4.5	4.0	3.5	3.8	3.5	3.8
Tajikistan	7.9	6.7	6.0	6.9	4.5	4.0
Turkmenistan	11.3	10.3	6.5	6.2	6.5	6.3
Uzbekistan	7.0	8.1	8.0	7.8	6.0	6.0
Consumer Price Inflation	**9.2**	**5.9**	**6.4**	**10.5**	**8.9**	**7.8**
(Year average, percent)						
Armenia	4.2	3.0	3.7	–1.4	1.9	3.5
Azerbaijan	6.4	1.4	4.0	12.4	12.0	8.0
Georgia	5.5	3.1	4.0	2.1	6.0	3.0
Kazakhstan	8.5	6.7	6.7	14.6	7.3	6.5
Kyrgyz Republic	8.7	7.5	6.5	0.4	3.8	5.1
Tajikistan	13.9	6.1	5.8	5.9	8.9	8.0
Turkmenistan	5.5	6.0	7.4	3.6	6.0	6.2
Uzbekistan	14.9	9.1	8.5	8.0	13.0	12.7
General Gov. Overall Fiscal Balance	**3.1**	**2.3**	**–3.5**	**–2.2**	**–3.4**	**–1.0**
(Percent of GDP)						
Armenia[1]	–3.2	–1.9	–4.8	–5.6	–3.3	–2.7
Azerbaijan[1]	7.5	2.7	–4.8	–1.1	–0.3	0.7
Georgia	–2.9	–2.9	–3.8	–4.1	–3.8	–3.8
Kazakhstan	3.2	2.4	–6.3	–4.1	–6.6	–2.0
Kyrgyz Republic	–4.5	1.0	–1.2	–4.5	–3.0	–2.4
Tajikistan	–2.7	0.0	–1.9	–10.6	–6.5	–5.4
Turkmenistan[2]	4.3	0.9	–0.7	–1.3	–1.1	–0.1
Uzbekistan	3.4	4.3	2.8	2.7	0.3	0.7
Current Account Balance	**0.8**	**2.3**	**–3.6**	**–6.4**	**–4.9**	**–4.2**
(Percent of GDP)						
Armenia	–8.9	–7.6	–2.6	–2.3	–3.6	–3.2
Azerbaijan	8.8	13.3	–0.4	–3.6	1.9	2.5
Georgia	–11.0	–10.7	–12.0	–13.3	–11.9	–10.7
Kazakhstan	–0.9	2.8	–2.8	–6.4	–5.3	–3.8
Kyrgyz Republic	–1.3	–16.0	–16.0	–9.7	–11.6	–12.0
Tajikistan	–4.5	–2.8	–6.0	–3.8	–6.3	–6.2
Turkmenistan	–7.7	–6.4	–14.0	–21.0	–15.4	–14.3
Uzbekistan	4.9	1.7	0.7	0.7	0.9	0.3

Sources: National authorities; and IMF staff estimates and projections.

[1]Central government.

[2]State government.