

The Caucasus and Central Asia: Transitioning to Emerging Markets



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Preface

The countries of the Caucasus and Central Asia (CCA) have made significant strides in transitioning to market economies and laying the foundation for sustained growth since their independence in 1991. Almost all CCA countries now have functioning key macroeconomic institutions (central banks and ministries of finance) and have completed many reforms—such as the privatization of small and medium firms, price liberalization, and exchange rate unification—to enable the establishment of market economies. They have achieved stronger growth than countries in other regions, though this growth has been relatively volatile and gains in output have been driven mostly by commodity and labor exports, reflecting the highly undiversified economies of most CCA countries.

As they look forward, CCA countries can capitalize on the macroeconomic space afforded by current high commodity prices and still-comfortable remittance flows to pursue bold policy and structural reforms. These reforms—which are needed in both the public and private sectors—will help build macroeconomic institutions and policy frameworks that will allow these countries to manage volatility better and to sustain high growth, diversify their economies and strengthen job opportunities, and support market institutions through better governance. With the successful implementation of such reforms, many CCA countries will be well positioned to become dynamic emerging markets in the next decade. This emerging market vision will be bolstered if CCA countries strengthen their ties to each other and to the rest of the world.

This publication presents our analysis of the progress CCA countries have made in establishing macroeconomic policy frameworks and practices, and the priority actions they can pursue to strengthen those frameworks and practices in support of sustained, less volatile, and more inclusive growth. I hope that this publication will be of use for policymakers and others in CCA countries, and for the international community that supports them, to enable the completion of reforms to deepen and sustain markets and to allow these countries to achieve the vision of becoming dynamic emerging markets.

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Contents

1. Introduction	1
2. The CCA Growth Experience	5
Successes and Challenges	5
3. The Vision for the CCA and How to Realize It	13
Growth with Current Policies	13
The Vision	14
Policy Actions to Support the Vision	16
Potential Direct Payoff from Achieving the Vision	17
4. Monetary and Exchange Rate Policy in the CCA	18
Progress	18
Challenges	20
Transformation of Monetary Frameworks	22
5. The CCA Financial Sector	27
Achievements and Current Challenges	27
Key Obstacles	32
Transitioning to a Diversified, Modern, and Strengthened Financial System	35
Policy Requirements to Transform CCA Financial Systems	36
6. CCA Fiscal Policy and Fiscal Frameworks	39
Successes and Challenges Ahead	39
Sustainable and Accountable Delivery of Core Government Functions	44
Policy Requirements for Successful Delivery of Core Government Functions	44
7. Management of Energy Resource Wealth in the CCA	47
Successes and Challenges Ahead	47
Policy Requirements to Successfully Leverage Resource Wealth	52
8. Policies to Strengthen CCA External Linkages	56
Trade Linkages	56
Financial Linkages	60

Other Linkages—Remittances	62
Policies and Actions to Strengthen External Linkages	63
9. Structural Reforms and Political Economy	67
Structural Reforms and the Business Environment	67
Political Economy	71
Key Steps to Ease Structural and Political Economy Constraints	75
References	77

Chapter

1 Introduction

The countries in the Caucasus and Central Asia (CCA) have recorded significant macroeconomic achievements since independence. These countries have grown more rapidly—on average by 7 percent over 1996–2011—than those in many other regions of the world and poverty has declined. Inflation has come down sharply from high rates in the 1990s and interest rates have fallen. Financial sectors have deepened somewhat, as evidenced by higher deposits and lending. Fiscal policies were broadly successful in building buffers prior to the global crisis and those buffers were used effectively by many CCA countries to support growth and protect the most vulnerable as the crisis washed across the region. CCA oil and gas exporters have achieved significant improvements in living standards with the use of their energy wealth.¹

Table 1.1. CCA: Basic Economic Indicators 1/

	Population (millions)	GDP (millions of US\$)	GDP per capita (US\$)	Major components of GDP (shares in percent)
Oil and gas exporters				
Azerbaijan	9.1	64,819	7,114	Industry, incl. energy (52), construction (8)
Kazakhstan	16.7	188,049	11,278	Industry, incl. energy (31), retail & wholesale trade (14)
Turkmenistan	5.5	29,233	5,290	Industry, incl. energy (50), construction (16)
Uzbekistan	29.1	45,421	1,561	Industry, incl. energy (24), services (22), agriculture (18)
Oil and gas importers				
Armenia	3.3	10,138	3,096	Agriculture (20), construction (13), retail & wholesale trade (13)
Georgia	4.5	14,435	3,230	Retail & wholesale trade (15), public sector (10), industry (9)
Kyrgyz Republic	5.5	6,199	1,120	Industry (22), agriculture (17)
Tajikistan	7.8	6,523	836	Agriculture (24), retail & wholesale trade (17)

1/ All figures for 2011.

¹ CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan. CCA oil and gas importers: Armenia, Georgia, Kyrgyz Republic, and Tajikistan.

While macroeconomic achievements have been notable, there remains ample room to strengthen macroeconomic outcomes in CCA countries. Growth in CCA countries has been volatile, and has relied heavily on energy resources, other commodities, and remittances. Like growth, inflation has been volatile, and real interest rates generally remain high. Central banks in the region often lack independence, monetary policy has been pro-cyclical, and high rates of dollarization reflect continued weak confidence in many CCA countries. Progress has been uneven in restoring post-crisis fiscal positions and rebuilding fiscal buffers. Non-oil revenue remains low in resource-rich CCA countries and these economies have infrastructure gaps despite large capital outlays. Social and capital spending needs are generally high in the CCA, and quasi-fiscal activities—supported by directed lending and investment—are widespread and direct resources away from important priority areas such as health and education.

CCA countries face other common challenges arising from still weak regional cooperation, low global integration, and the relatively slow pace of structural reforms. Regional integration is lacking across a range of important dimensions, including trade, financial markets, and infrastructure. These are all critical to strengthen CCA countries' ties to each other and the rest of the world, which would help drive diversification and growth. Many CCA countries moved rapidly after independence to implement first-generation structural reforms such as privatization and exchange rate unification. Few countries in the CCA have, however, pursued more difficult structural reforms—such as improvements in the governance of financial institutions and firms, and public private partnerships—that will deepen institutions and create appropriate capital stocks to sustain the development of markets and support job-creating investment and growth. In addition, some CCA countries face challenges arising from unresolved conflicts with their neighbors.

Over the coming decade, CCA countries have the opportunity to boost their economic development and to strive to become dynamic emerging markets.² This opportunity rests on strong commodity prices and healthy remittance flows, which help create the macroeconomic space to pursue ambitious policy and structural reforms. The payoff to the citizens and governments in the CCA from the successful pursuit of ambitious reforms will be large and will come through the key strengths of emerging

² The challenges and opportunities of CCA countries were discussed and debated at the high-level conference, May 2013, “The Caucasus and Central Asia: The Transition Journey and the Road Ahead,” in Bishkek, Kyrgyz Republic (<http://www.imf.org/external/np/seminars/eng/2013/cca/>). The dynamics and challenges of the CCA are also covered in “Central Asia and the Caucasus: At the Crossroads of Eurasia in the 21st Century” (Hermann and Linn, 2011).

markets.³ These strengths lie in high and sustainable growth that rests on robust institutions, strong capital stocks, integration into regional and global production networks, and sustained investor interest backed by capital flows that help support the development of diverse economic activity and job creation.

As they look forward, CCA countries can take policy actions to realize their vision of becoming dynamic emerging markets:

- Emulate the best practice in monetary policy frameworks of emerging market countries. Consolidating the decline in inflation and reducing its volatility, strengthening monetary transmission, fostering an environment that promotes lower dollarization and interest rates, and dealing with “fear of floating” concerns will be important steps in attaining this goal.
- Aspire to develop competitive banking sectors and create nonbank financial institutions that support private-sector-led growth. The financial system should follow international standards of regulation and supervision to deepen and broaden financial intermediation, ensure the financial soundness of banks and other financial institutions, and increase the financial sector’s contribution to economic growth.
- Fiscal policy over the coming decade should aim to provide increasingly effective core governmental functions, in a non-distortive, transparent, and accountable way. In addition to their security, justice, and regulatory functions, governments should notably aim at fostering long-term growth prospects and protecting the most vulnerable groups, through efficient spending on health, education, and infrastructure. To meet these objectives, governments will need to develop fiscal frameworks that anchor policies on clear fiscal paths; undertake revenue and spending measures to consolidate further their fiscal positions; and advance public financial management reforms aimed at promoting transparency and accountability and better fiscal policy outcomes.
- CCA oil and gas exporters should leverage their resource wealth to ensure sustained improvements in living standards, achieve economic and asset diversification, and reduce reliance on natural resources. To meet these objectives, governments will need to establish fiscal anchors and sound resource fund management, and support macro policies through decisive improvements in governance and business climates.

³ It must be acknowledged that reform implementation has slowed across CCA countries in the past decade due to the combination of powerful vested interests, state capture—in some instances, and narrow political space.

- Enhance economic and financial cooperation with the rest of world and within the CCA to create opportunities for economic diversification and structural transformation that will support sustainable growth.
- Pursue forceful structural reform efforts and major improvements in governance frameworks and institutions to underpin better macro policy frameworks and ensure sustainable growth in the CCA.

This paper starts by discussing the growth experience in CCA countries and the vision of how the CCA economies can transform their economies. This is followed by chapters that, for each policy area noted just above, cover progress so far during the transition, the remaining challenges faced by CCA countries, and the priority actions they can pursue to overcome their challenges and achieve their emerging market vision.

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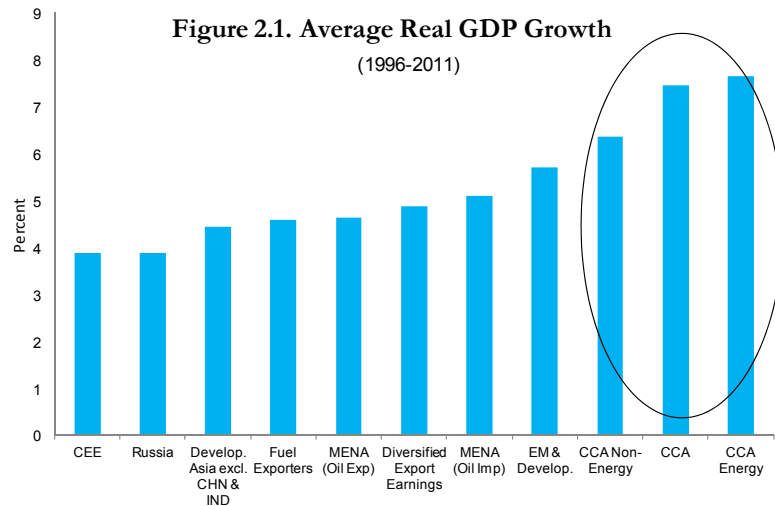
The CCA Growth Experience

Over the past two decades growth in the CCA region has been strong, but volatile, uneven, and narrowly based. Success in raising income per capita has varied across countries and seems tied to natural resource endowments. Growth has been largely driven by commodity and labor exports and has not been supported through significant economic diversification or by regional economic integration. CCA countries exhibit a mixed performance on the inclusiveness of growth. While these countries have benefitted from improvements in total factor productivity, the sources of growth have varied substantially across countries. In the next decade, the CCA countries should strive to achieve stable and sustainable growth through the pursuit of reforms that would allow many of these countries to join the world's dynamic emerging markets.

Successes and Challenges

CCA countries grew more rapidly during 1996–2011 than other comparable groups of countries.⁴ Average real GDP growth totaled 6.4 percent for oil and gas importers and 7.7 percent for oil and gas exporters bringing the CCA region's average growth to 7.5 percent. High growth largely reflects strong initial physical and human capital, untapped natural resources, and a rebound from transition.

⁴ The years 1992–95 are excluded due to the collapse in output and extreme volatility in the years immediately following the dissolution of the Soviet Union.



At the same time, growth in the region has exhibited more ups and downs than in most other countries. This

volatility is explained by: (i) the specialized structure of the economies they inherited from the Soviet period, which were no longer connected to each other in a large, open and integrated economic space; (ii) close economic ties to Russia—which has exhibited even greater volatility than the CCA—during much of the transition; and (iii) their reliance on volatile commodity exports and on remittances.

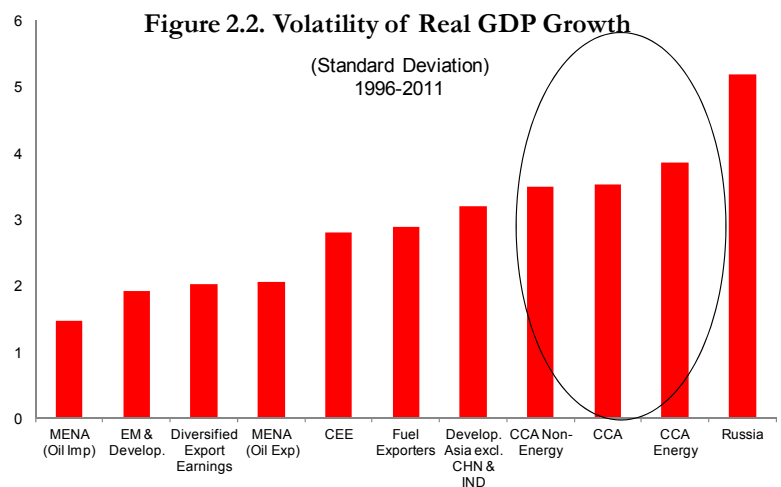
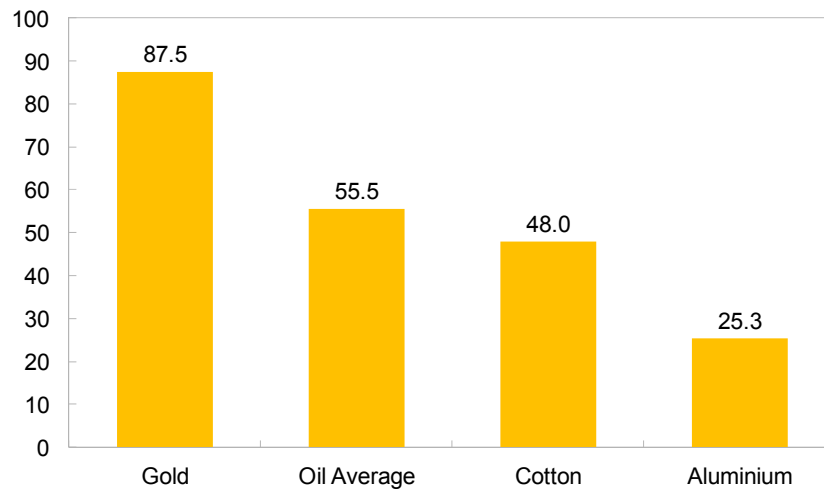


Figure 2.3. Price Volatility
(Standard deviation 1996–2011, Index 2005=100)



Source: World Economic Outlook Global Assumptions.

Success in raising per capita income has varied, in large part reflecting natural resource endowments. For example, output per capita increased by three and a half times

in Azerbaijan during this period while it increased by only half in the Kyrgyz Republic. The strong performance of Azerbaijan, Turkmenistan, and Kazakhstan is perhaps not surprising given their dynamic energy sectors and rapid increase in energy exports. Similarly, the relatively strong performance of Armenia and Georgia among energy importers likely reflects their relatively strong economic policy frameworks, which have helped them to achieve low inflation, keep debt down, and attract substantial FDI. Developments in nominal GDP per capita followed a similar pattern.

Figure 2.4. Real GDP Per Capita 2011/Real GDP Per Capita 1996

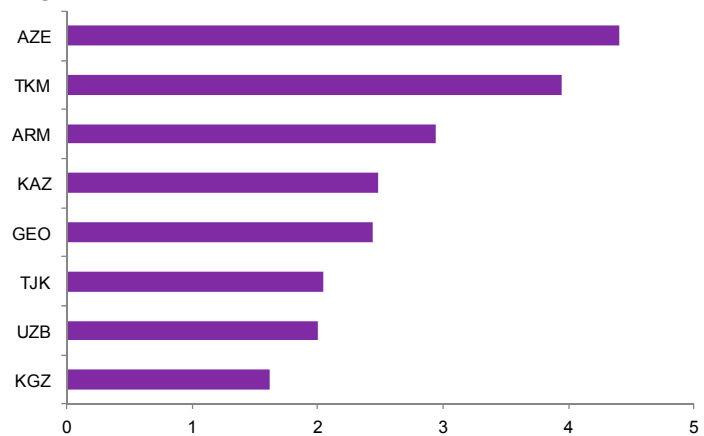
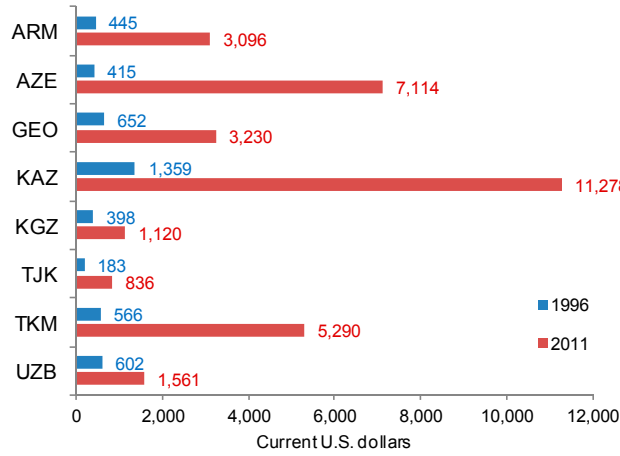
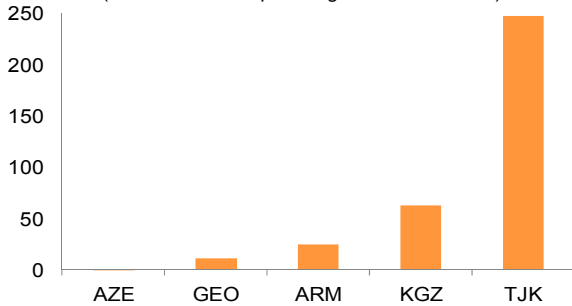


Figure 2.5. Per Capita Nominal GDP



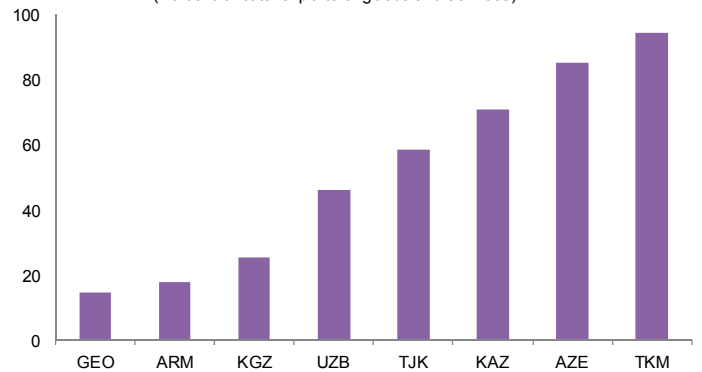
Growth in the region has been driven by commodity and labor exports, leaving many CCA economies highly undiversified. Commodity exports constitute over 60 percent of total exports in Kazakhstan, Azerbaijan, and Turkmenistan, and fiscal revenues from these exports are over 40 percent of total revenues. This has created vulnerabilities that include heavy reliance on exports of commodities that have volatile prices and fiscal revenues that depend heavily on the energy sector. Armenia, Kyrgyz Republic, and Tajikistan are vulnerable to possible fluctuations in remittances due to volatile growth in Russia.

Figure 2.6. Remittances, 2012
(Percent of total exports of goods and services)



Source: WEO.

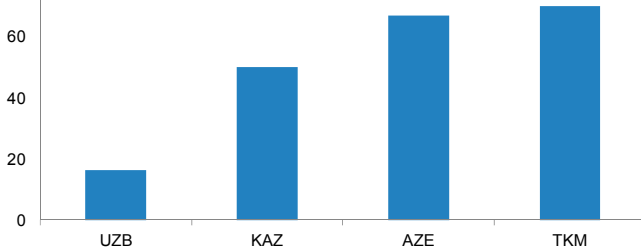
Figure 2.7. Commodity Exports 1/, 2012
(Percent of total exports of goods and services)



Sources: Country authorities, staff estimates, and WEO.

1/ Includes oil, gas, precious metals, aluminum, copper, other metals, metal byproducts, and cotton.

Figure 2.8. Commodity Revenue, 2012
(Percent of total revenue)



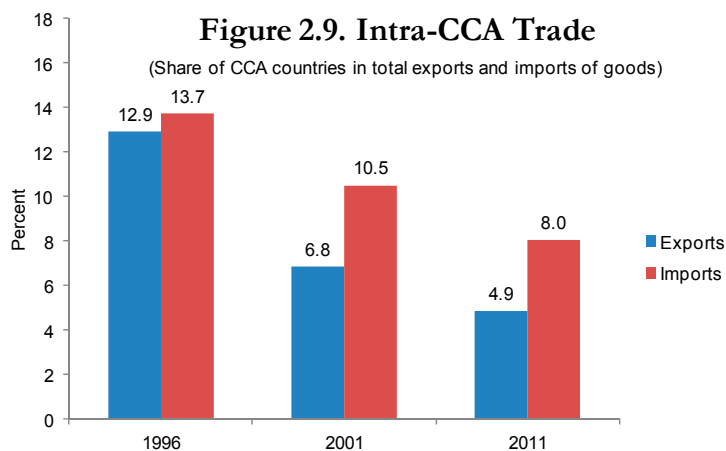
Sources: Country authorities, staff estimates, and WEO.

CCA countries have also exhibited mixed performance in achieving inclusive growth.⁵ Income inequality has decreased only marginally, or has even increased, despite high growth, as illustrated by the Gini coefficient, with Armenia and Uzbekistan being notable exceptions. Poverty reduction has faced mixed success, with dramatic improvement observed in Azerbaijan and Kazakhstan and less progress in Armenia, Georgia and Tajikistan (Figure 1). Poverty headcount rates in the CCA middle-income countries (MICs) are below the MIC average, though poverty rates remain high in Armenia and Georgia. Labor force participation rates in CCA MICs are around or above the MIC average. The situation differs in the CCA low-income countries (LICs).⁶ Labor force participation rates are low and poverty rates remain stubbornly high when benchmarked against all LICs or against LICs with similar “high” LIC incomes (Figure 2.13).

And good growth performance has not been supported by greater regional integration (see also Trade Linkages in Chapter 8). To the contrary, over the last two decades intra-CCA trade has markedly declined.

The share of exports going to CCA economies in total exports of goods fell from 12.9 percent in 1996 to 6.8 percent in 2001 and 4.9 percent in 2011. One could in part attribute this fall to massive energy exports to new markets by CCA energy exporters. However, the share of CCA imports in total goods imports

followed a very similar declining trend, pointing to remaining barriers to trade and a general weakening of regional economic ties.

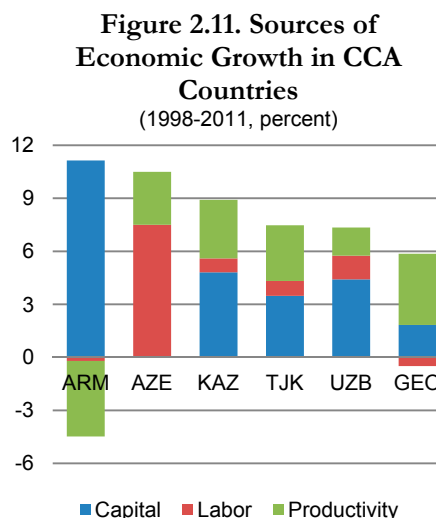
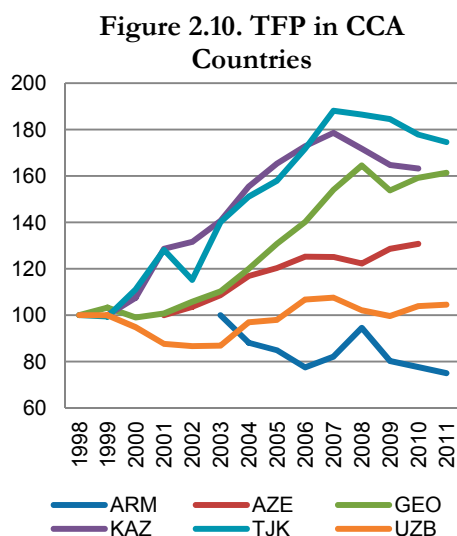


Source: IMF Directions of Trade statistics.

⁵ Growth is considered inclusive if it is high and sustained; provides productive employment; is broad-based across sectors; is inclusive of a large part of a country’s labor force; is characterized by equality of opportunity in access to markets (especially labor and credit markets) and resources; protects the most vulnerable; and minimizes regional disparities in living standards (IMF, Jobs and Growth—Analytical and Operational Considerations for the Fund, pp. 24–31).

⁶ Based on World Bank income definitions. The CCA MICs are Armenia, Azerbaijan, Georgia, Kazakhstan, Turkmenistan, and Uzbekistan. The CCA LICs are Kyrgyz Republic and Tajikistan.

Most CCA countries enjoyed positive total factor productivity (TFP)⁷ growth over the last decade, though sources of economic growth differed across countries. The evolution of TFP in CCA economies between 1998 and 2011 shows that while there were substantial increases in TFP in Georgia, Kazakhstan, and Tajikistan, TFP experienced a declining trend in Armenia and was relatively stable in Uzbekistan.⁸ A decomposition of aggregate output growth by sources reveals that economic growth was accounted for by different factors in each economy. On average, TFP contributed to economic growth most in Georgia and least in Armenia.⁹

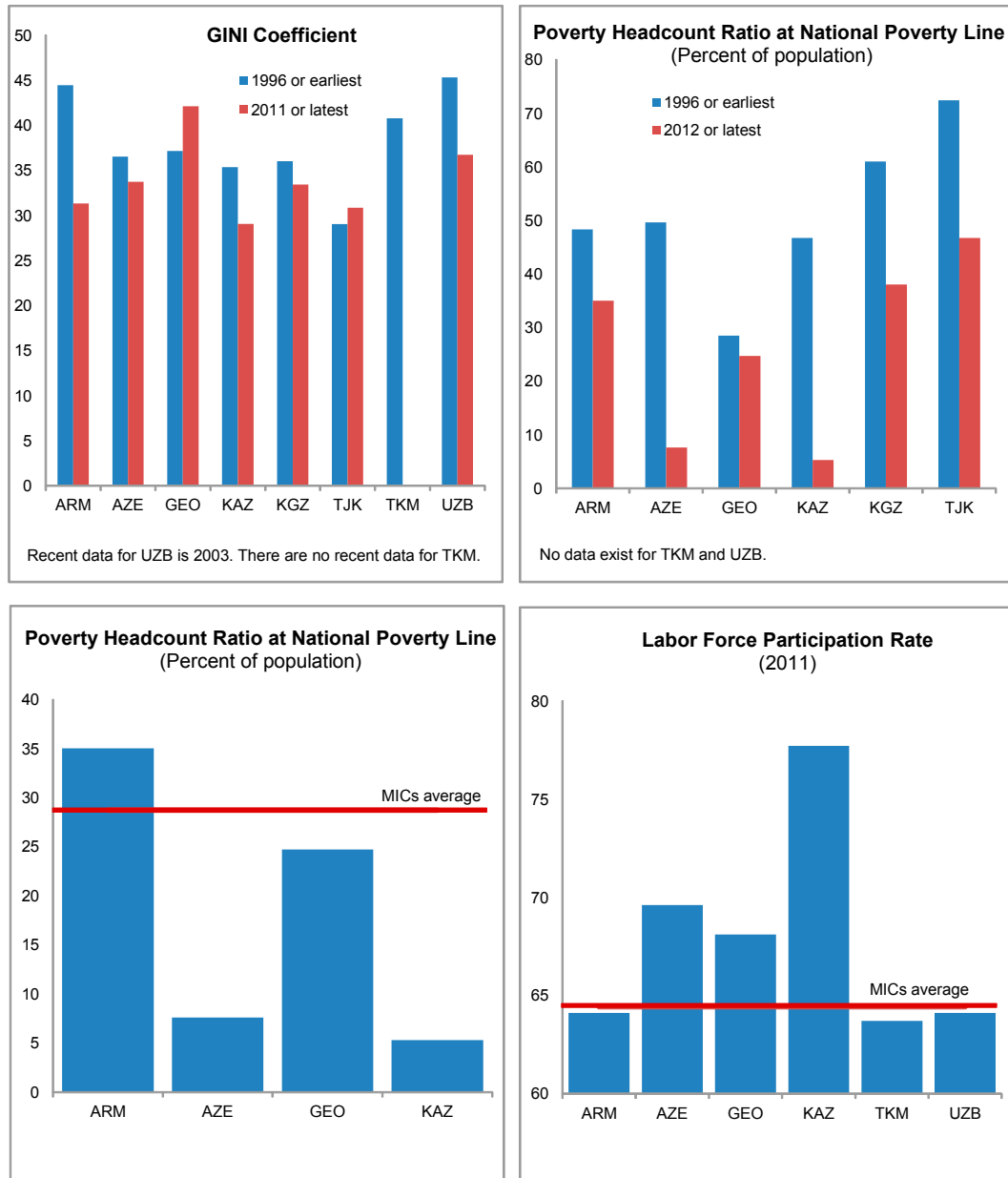


⁷ A growth accounting methodology is applied to estimate TFP and its evolution in CCA countries. It also measures the extent to which TFP contributed to economic growth in CCA countries. Given the shortage of consistent data, this methodology allows comparability of results across countries. It assumes a Cobb-Douglas production function, constant returns to scale, and perfect competition. Output in each country is written as: $Y_{it} = A_{it} K_{it}^{\alpha} L_{it}^{1-\alpha}$, where K_{it} and L_{it} are respectively capital and labor stocks in country i at time t , α is the share of capital in total income, and A_{it} is interpreted as TFP in country i at time t . Real GDP is used to proxy for real output, employment for labor, and capital stock for capital, deflated using an estimated gross capital formation deflator.

⁸ Given data limitations, starting years are different for some countries. TFP is normalized to 100 for the first year for each country.

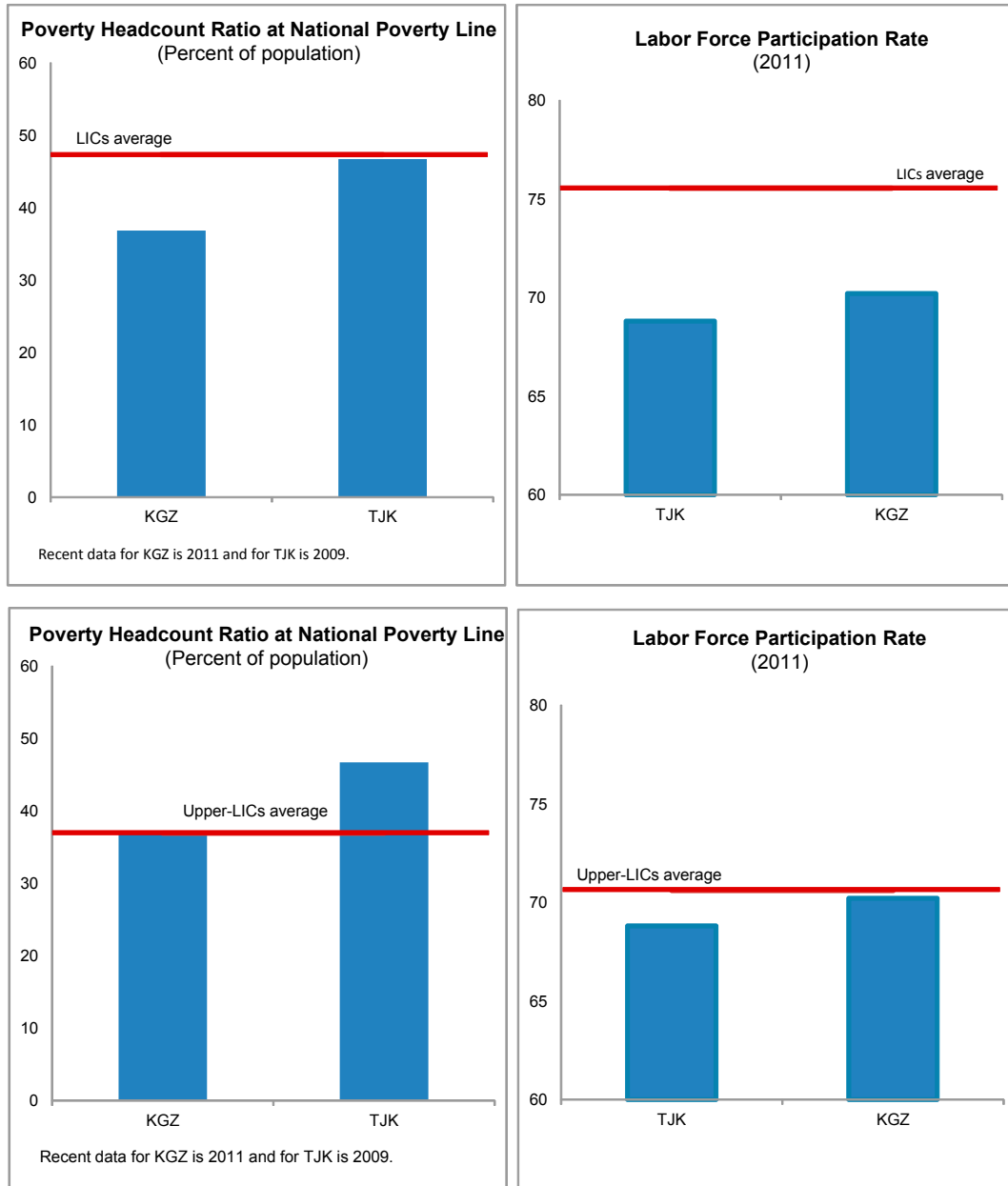
⁹ The growth accounting exercise for Armenia covers only the period 2003–11, meaning that a high growth period from 1998–2002 (average of 7.7 percent per annum) during which efficiency gains may have been the greatest is not captured in the case of Armenia. In addition, for the period 2003–11, Armenia’s growth depended to a larger than normal degree on the construction sector (including real estate), and this sector exhibited large swings of a boom and bust nature. Moreover, due to the global financial crisis, construction largely collapsed during 2009–11, together with its TFP, and never recovered, effectively dragging down the economy-wide TFP.

Figure 2.12. CCA Countries: Gini Coefficient, Poverty Rate, and Labor Force Participation Rate



Source: World Bank.
MICs: Middle-income countries.

Figure 2.13. CCA Low-Income Countries: Poverty and Labor Force Participation Rates



Source: World Bank.
 LICs: Low-income countries.
 Upper-LICs: LICs with GDP per capita above USD700.

The Vision for the CCA and How to Realize It

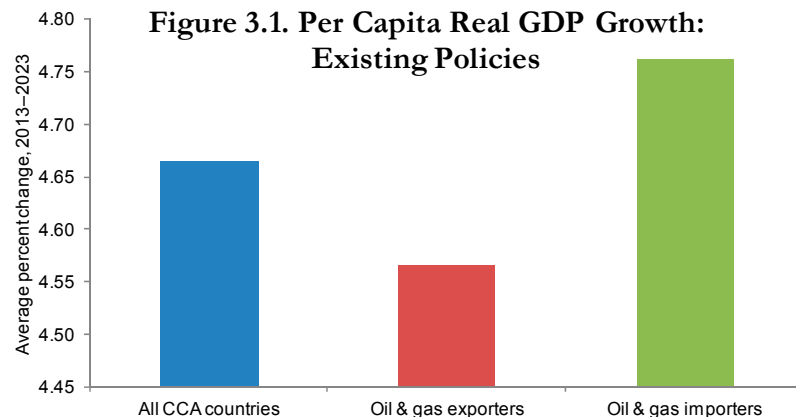
Under current policies, per capita GDP growth in CCA countries will fall short of that achieved in the past two decades. By pursuing ambitious reforms to support higher, more stable, sustainable, and inclusive growth, many CCA countries should be able to join the group of the world's most dynamic emerging economies. Current high energy export prices, robust remittances, and stable food prices provide CCA countries with a unique opportunity to pursue ambitious reforms to drive the growth they need to achieve. These countries face, however, a number of risks and challenges to pursuing bold reforms. On the domestic front these include weak institutions and strong vested interests. External challenges include vulnerability to commodity price movements, weak integration into regional and global markets, frozen conflicts among some CCA countries, and geopolitical shifts that may lead to regional instability (e.g., the withdrawal of NATO troops from Afghanistan).

Growth with Current Policies

Based on their current policies, growth of per capita GDP in CCA countries over the medium term is projected to fall well short of the CCA average of 6.5 percent achieved during 1996–2011.¹⁰ This is not unexpected since CCA countries no longer benefit from largely untapped natural resources or the transition rebound, and many now have weaker human capital than at the start of the transition period. These factors highlight the need to pursue ambitious reforms to achieve high, more stable, sustainable, and inclusive growth through building stronger institutions and

¹⁰ During 1996–2011, average per capita GDP growth was 7.4 percent in CCA oil and gas exporters and 5.6 percent in CCA oil and gas importers.

capital stocks that support greater productivity, and through diversification of exports and domestic production.¹¹



The Vision

CCA countries can create the opportunity to join the world’s dynamic emerging markets through the pursuit of ambitious reforms to support their growth objectives. Reforms that generate greater economic openness and make CCA countries more attractive for foreign investment will support growth through higher productivity going forward. This is shown by the importance of these factors to sustained high growth in the 12 fastest growing emerging markets, which have achieved broad-based growth of 7 percent or higher over two or more decades (see Chapter 8, Trade Linkages and Financial Linkages).¹² In addition, by supporting the expansion of the private sector through improvements to the business environment, strengthening macro-policy frameworks, and strengthening institutions—as, for example, Turkey, a neighbor and country that faced similar structural reform challenges, did from 2002–12—CCA countries should be able to increase substantially income, exports, and FDI while enhancing fiscal sustainability.

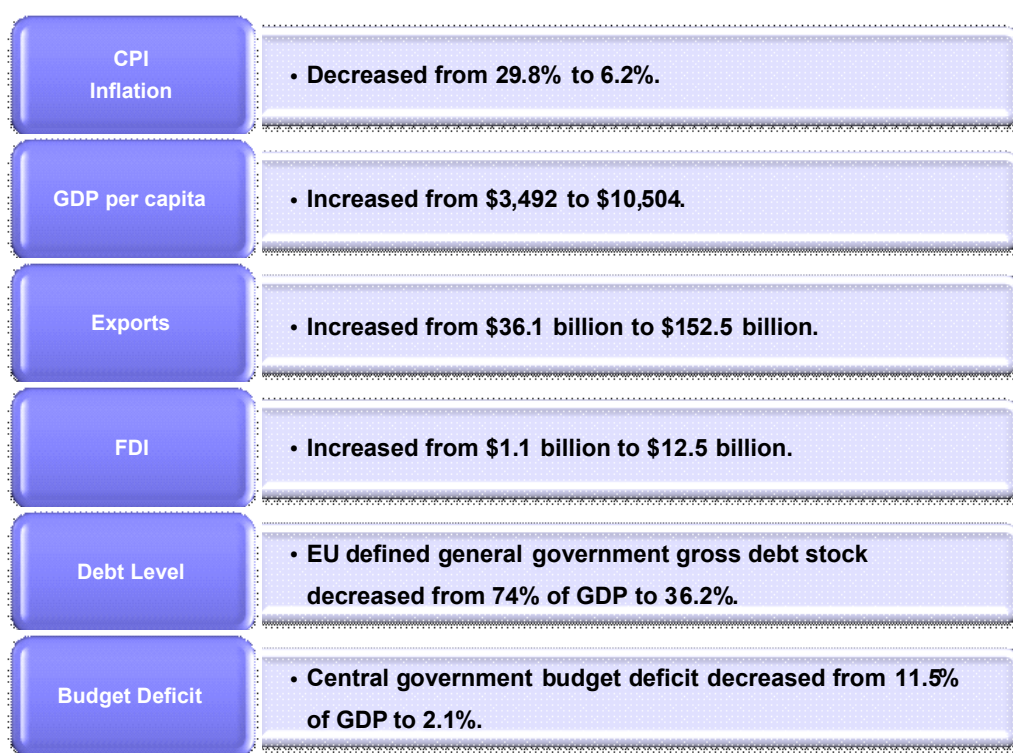
CCA countries face, however, a number of obstacles and risks to achieving the emerging market vision. On the domestic front, challenges to the successful implementation of deep-seated structural and policy

¹¹ See World Bank and Eurasian Development Bank, 2013, “Diversified Development: Making the Most of Natural Resources in Eurasia.” IMF, 2014 (forthcoming), “Sustaining Long-run Growth and Macroeconomic Stability in LICs: The Role of Structural Transformation and Diversification.”

¹² Theory and empirical evidence show that increased international trade leads to faster growth and higher income (see Frankel and Romer, 1999 and Dollar and Kraay, 2004). Empirical analysis shows that FDI plays an important role in contributing to economic growth (see Borensztein et al., 1998 and Alfaro et al., 2004).

reforms that would lay the foundation for sustainable growth include weak institutions, lack of accountability, strong vested interests, and potential political instability. External challenges arise from vulnerability to commodity price movements—in particular food and fuel prices, EU crisis spillovers through Russia, and weak integration of CCA countries with each other and with global markets. CCA countries also face risks connected with unfolding global trends, including geopolitical shifts that could lead to regional instability (e.g., the withdrawal of NATO troops from Afghanistan in 2014), the roles of China and Russia in the region, and unresolved conflicts between some CCA countries.

Figure 3.2. Turkey: Indicators of Economic Transformation, 2002–12



Source: Çanakcı, Ibrahim H., *What Turkey Has Done To Stabilize Its Policy Framework & Strengthen Its Institutions & What Remains To Be Done*, 2013.

Policy Actions to Support the Vision

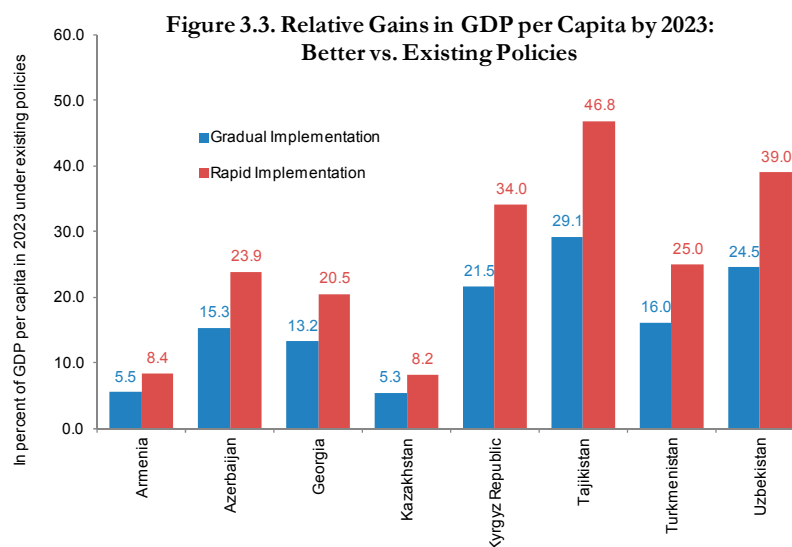
Current strong export commodity prices and stable food prices provide the CCA countries with an opportunity to strengthen structural reforms, their policy frameworks, and their economies. This will support their move to emerging market status and help offset the many challenges and risks they face. Specific reforms CCA countries will need to address are:

- *Strengthen macroeconomic policy frameworks and financial sectors:*
 - Stronger fiscal frameworks—including around energy wealth—would stabilize and support revenue and allow governments to enhance delivery of their core functions in a sustainable way.
 - Improved monetary frameworks and deeper financial systems would support lower inflation, lower interest rates and increase financial intermediation for investment purposes.
- *Improve management of natural resource wealth.* In an environment of rapidly changing commodity prices and given resource exhaustibility in some CCA oil exporters, good management can provide fiscal buffers to dampen growth volatility. Stable and transparent tax regimes for the resource sector can shore up investment and growth.
- *Further open trade and financial channels within the CCA and with the rest of the world, and improve regional cooperation.* Greater trade openness supports growth and deeper financial linkages will support capital market development and investment. Improved regional cooperation would support growth through enhanced energy and water security for all CCA countries.
- *Implement structural reforms to improve business climates.* A stable macroeconomic environment in conjunction with capital markets reforms, strengthened corporate governance, and better regulation would help drive investment, diversification of output, and job-creating inclusive growth.
- *Ease political economy constraints to critical economic reforms.* Stronger and more transparent political institutions and public administration will make it more difficult for powerful interests to seek rents, allow more public resources to flow to education, healthcare and infrastructure, and free regulators to enable competition and a healthy business environment.

The experiences of CCA countries in these reform areas since independence, and reform measures in these areas for the future, are discussed in more detail in the chapters that follow.

Potential Direct Payoff from Achieving the Vision

Aside from creating the opportunity to join the ranks of dynamic emerging markets, there is a significant potential direct payoff to CCA countries from taking strong actions to improve governance and policy frameworks. Based on a panel regression analysis of growth determinants that includes 108 countries, if CCA countries can improve their policy frameworks and move to average levels of government effectiveness, they could achieve significantly higher sustainable growth and GDP per capita. Government effectiveness captures, among other things, economic policy consistency and forward planning, quality of budgetary and financial management, and the quality of public administration.¹³



With gradual improvement in government effectiveness over the next decade to the global average, most CCA countries could raise per capita GDP by at least 15–30 percent relative to expected outcomes under current policies. With more rapid improvement, these gains could be in the range of at least 20–45 percent. These results are consistent with other recent research (IMF: World Economic Outlook, October 2012, Chapter 4) that shows that improved economic growth performance of emerging market and developing countries since 1990 is mostly associated with improvements in policy making and the buildup of policy space (fiscal and external buffers). In the absence of efforts to improve macro policy frameworks, vulnerabilities in the CCA region are likely to remain high in the face of continued volatile growth.

¹³ See World Bank Governance Indicators available at <http://info.worldbank.org/governance/wgi/pdf/ge.pdf>.

4

Monetary and Exchange Rate Policy in the CCA: Progress, Challenges, and Policies for the Next Decade

Over the past twenty years, CCA countries have made significant progress in strengthening monetary and exchange rate policy frameworks and in securing better policy outcomes—lower inflation and interest rates, and deeper financial sectors. In the future, the region’s vision should be to emulate the best practice in monetary policy frameworks of emerging market countries. Consolidating the decline in inflation and reducing its volatility, fostering an environment that promotes lower dollarization and interest rates, and dealing with “fear of floating” concerns will be important steps in attaining this vision.

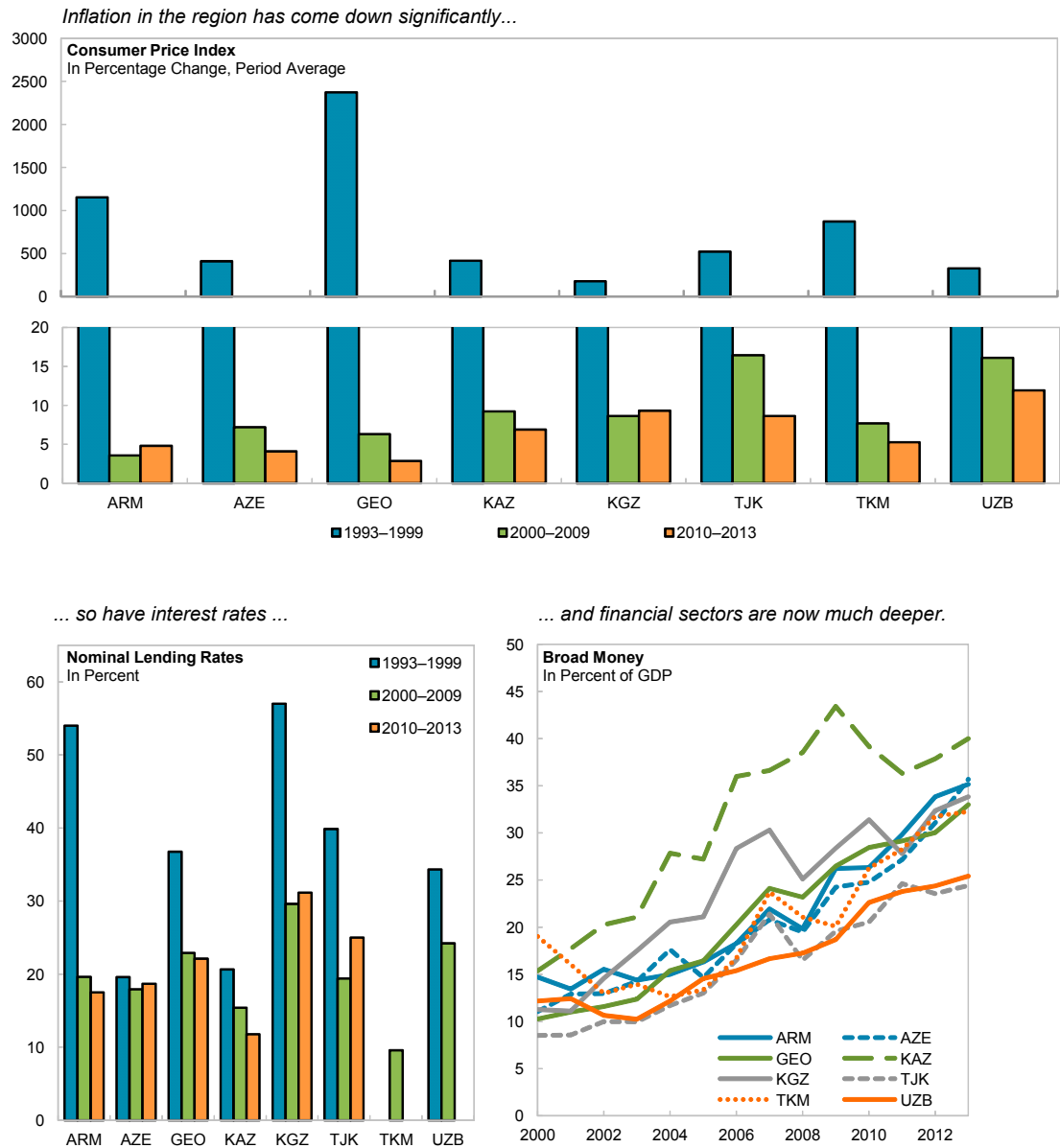
Progress

Monetary and exchange rate policies in the CCA have achieved significant successes over the past twenty years. This progress is evident when judged either in terms of the operational frameworks for monetary and exchange rate policies, or in terms of the outcomes that have been achieved:

- *Operational frameworks.* CCA central banks have been given greater independence to conduct monetary and exchange rate policies and, although to varying degrees, have improved their technical expertise. In addition, central banks in the region now operate with better quality national statistics, and have become much more transparent with the public about a wide range of economic developments and policies.
- *Outcomes.* The improvement in outcomes has perhaps been even more significant. Inflation rates have declined from triple-digits in the mid-1990s to single-digits in most of the CCA countries. Even in those countries where inflation has reached double digits in recent years, it has typically been below 15 percent. Nominal interest rates have also declined significantly.

In this context, monetary and exchange rate policies have helped improve the functioning of financial systems and have supported growth. With lower inflation and less uncertainty regarding exchange rate developments, financial sectors in the CCA countries have been able to intermediate resources more efficiently. Over the last decade, the decline in inflation and interest rates has led to significant financial sector deepening.

Figure 4.1. CCA Monetary Policy—Successes



Sources: National Authorities, IMF WEO, IMF IFS, and IMF staff estimates.

Challenges

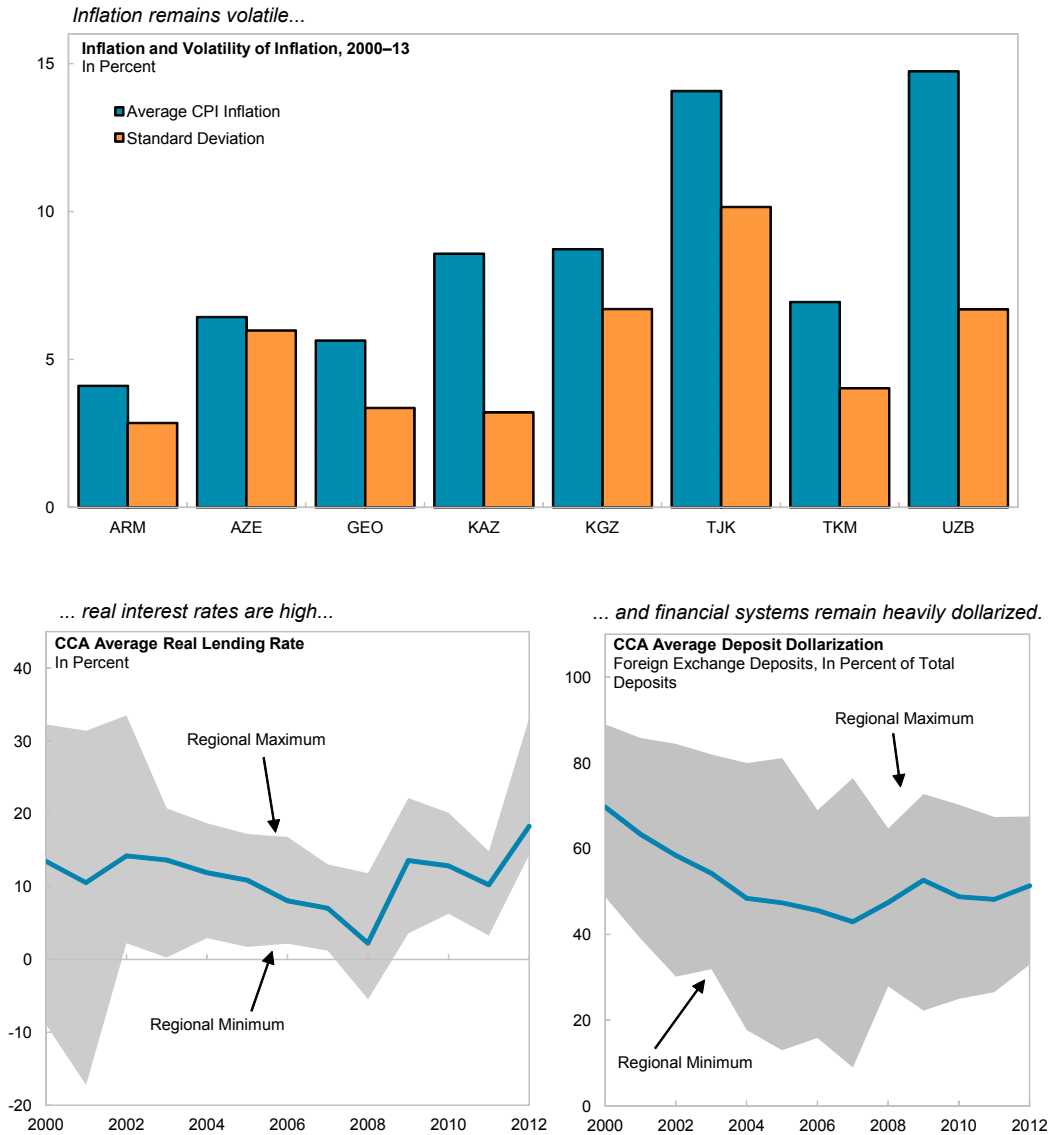
Despite these important successes, there is still scope for further improvements in monetary and exchange rate policy:

- *Regarding operational frameworks*, there is room for strengthening central bank independence, communications, and accountability in all CCA countries, although to varying degrees. Dincer and Eichengreen (2010) calculated that CCA countries lagged countries in other regions in terms of central bank transparency by a wide margin.¹⁴ Even in CCA countries that have made significant progress in developing policy frameworks and instruments, including related to inflation targeting regimes (e.g., Armenia, Georgia), there is a need to strengthen communications with the market and the public. Data quality and analytical research can also be strengthened.
- *Regarding outcomes*, inflation volatility remains high, which adds uncertainty to investment and savings decisions. While this inflation volatility in part reflects volatility in commodity prices—beyond the countries' control—domestic policies have also played a role. Real interest rates and interest rate spreads also remain high, and have increased since the beginning of the global financial crisis. Finally, but no less important, there is significant scope for reducing financial dollarization. Dollarization had declined during the last decade as economic stability improved. But this trend was reversed in the late 2000s, as the global crisis hit the CCA. Dollarization exposes countries to balance sheet losses in case of disorderly exchange rate adjustment, weakens the transmission mechanism of monetary policy, and forces central banks to accumulate substantial international reserves if they are to act as lenders of last resort.

Some countries in the region are trying to address these challenges by developing modern monetary policy frameworks. This is a promising strategy, and one which the IMF and other international organizations have supported (see for instance the [2011 CCA and CEE workshop](#)). Yet, perhaps more important than the specific framework that CCA countries choose is the articulation of a policy vision that properly guides policy frameworks and measures and that this vision is well communicated.

¹⁴ Nergiz Dincer and Barry Eichengreen, Central Bank Transparency: Causes, Consequences and Updates; Theoretical Inquiries in Law, Vol. 11, Number 1, January 2010. Their assessment includes five dimensions of transparency: political, economic, procedural, policy, and operational.

Figure 4.2. CCA Monetary Policy—Challenges



Sources: National Authorities, IMF WEO, IMF IFS, and IMF staff estimates.

Transformation of Monetary Policy Frameworks

As the region embarks on its third decade of transition, it should strive for monetary and exchange rate policy frameworks in line with best practices in emerging markets. Those frameworks should help to:

- *Consolidate stability.* Consolidate the gains in terms of inflation reduction, so that price stability becomes engrained in the expectations of economic agents.
- *Enhance flexibility.* Help the economy respond to external shocks—such as changes in commodity prices or capital inflows—but also to domestic business cycles. For this, central banks will need to develop the capacity to run countercyclical monetary policy and to strengthen the monetary policy transmission mechanism. Also, it is important to reduce the dollarization of the financial system, so that exchange rate movements do not produce large adverse balance sheet effects in the economy.
- *Support growth.* Enabling an environment that allows lower domestic interest rates, and financial systems that can produce an efficient and broader allocation of credit across the economy (including through having access to foreign financing).

Naturally, each country needs to tailor its monetary policy framework to its own economic characteristics, but there are important common areas where CCA countries should make further progress:

Strengthen the transmission mechanism of monetary policy

Central banks need to act in a variety of circumstances, such as responding to business cycle fluctuations related to domestic or external shocks, or reacting to economic crises. No matter what the situation is, the central bank's job will be easier if its monetary policy transmission mechanism is stronger. But a strong transmission mechanism cannot be achieved overnight and, as a result, central banks need to invest significant time and resources into building it—ideally during good times.

- *One key element of a strong transmission mechanism is the capacity of the central bank to communicate* with the public and with markets, particularly regarding forward-looking guidance and policy intentions. The central bank can also communicate worthy goals, such as de-dollarization or the need to strengthen the financial system. Central banks' communication infrastructure should, at a minimum, include periodic reports on inflation and monetary policy. Ideally, central banks should also be communicating with market participants, and the public in general, via periodic press releases and press conferences (e.g., after meetings of the

central bank’s monetary policy committee and after publication of key reports). A number of CCA countries’ central banks—for example in Armenia, Georgia, Kazakhstan, and Tajikistan—follow these practices. Further transparency and guidance could be achieved through publication of the minutes of central bank meetings where monetary policy decisions are made, and regular testimony in national assemblies. The style of communication, not just the amount, is important for any good communications strategy. Central banks should be prepared to convey their messages in a way that is clear to people without any training in economics. And the discipline of having to communicate and explain may itself improve the quality of monetary policy. Limiting communications may be desirable in some circumstances, but to lack the capacity to communicate effectively and therefore not do so is not sustainable. CCA central banks should develop a communications strategy and specific capabilities.

- *Another key element of a strong transmission mechanism is a robust and deep financial sector.* In particular, as argued by Fischer (2011), “If the financial system is intact, the standard anti-cyclical monetary policy response of cutting interest rates produces its response in the encouragement of purchases of durables, ranging from investment goods and housing to consumer durables.”¹⁵ But this standard monetary policy response will not work if banks are unable to expand credit due to weak balance sheets. For instance, Saborowski and Weber (2013) find that higher NPLs hinder the transmission from policy rates to market rates while Hoshi and Kashyap (2013) argue that failure to recapitalize banks’ balance sheets was one of the factors that contributed to Japan’s stagnation after its banking crisis in the 1990s.^{16,17}

Weak bank balance sheets can disrupt the monetary policy transmission mechanism and reduce credit growth, slowing the economy. A main cause can be high NPLs: banks may be unwilling to lend to firms, even if they have profitable investments, if they have a debt overhang problem. Monitoring and dealing with NPLs can also take away bank management time and resources, which reduces the bank’s capacity to extend new credit. Sitting on NPLs indefinitely may lead recovery values to fall and prevent new money and new players from entering. In the worst case, high NPLs may also lead

¹⁵ Stanley Fischer (2011), Central Bank Lessons from the Global Crisis, Dinner Lecture at the Bank of Israel Conference on “Lessons from the Global Crisis”.

¹⁶ Christian Saborowski and Sebastian Weber (2013), Assessing the Determinants of Interest Rate Transmission Through Conditional Impulse Response Functions, IMFWP/13/23.

¹⁷ Takeo Hoshi and Anil Kashyap (2013), Will the U.S. and Europe Avoid a Lost Decade? Lessons from Japan’s Post-crisis Experience. Paper presented at the 14th Jacques Polak Annual Research Conference.

banks to take new risks, in particular if they have incentives to “gamble for resurrection” by taking on riskier and higher return projects.

- *A third key element of a strong transmission mechanism is a financial sector with low levels of dollarization.* In a dollarized economy it is harder for central banks to target the relevant monetary aggregates or interest rates, as a significant share of economic and financial transactions are denominated in foreign currency. Central banks also have to accumulate higher international reserves, if they are to be able to fulfill their lender of last resort function. De-dollarization in the CCA, especially in countries with more flexible exchange rates, can be further encouraged, though this is a gradual process in any country. In particular, there is scope to improve the fundamentals of the local currency by implementing sound monetary policies (delivering low and stable inflation), and sound fiscal policies (including fiscal sustainability). The central bank can facilitate access to local currency funding for banks (for example, by relaxing collateral standards on central bank lending), while encouraging banks to issue long term certificates of deposit (in local currency), to increase the stability of local currency funding. Additional measures to encourage de-dollarization include raising reserve requirements on foreign exchange funding (e.g., Kazakhstan in 2012), increasing the risk weighting of foreign exchange loans (for calculating bank capital requirements), and boosting the foreign exchange liquidity ratio. In Armenia, Azerbaijan, and Georgia, exchange rate appreciation helped drive de-dollarization as households and firms saw the purchasing power of their dollar balances declining, though this factor is unlikely to be a major one going forward.

Tackle challenges associated with the choice of the exchange rate regime

To support a more robust monetary policy framework, central banks need to clarify their objectives, and may need to be more open in coming to terms with their “fear of floating”. If choosing to adopt “pure” inflation targeting regimes is a priority, then countries ought to strengthen their commitment to exchange rate flexibility, which is needed for price stability. If instead choosing “flexible” inflation targeting, i.e., when central banks also pursue an exchange rate objective (which is possible when capital market integration is incomplete), then there are advantages from being transparent about this. Acting with dual objectives, without being clear about this, can cause confusion and undermine the credibility of the central bank.

Energy exporters also face some unique challenges arising from their managed exchange rate regimes. Resource exporters with managed exchange rates are prone to circumstances that can make it difficult to manage liquidity. For example, balance of payments surpluses and the transfer of oil export receipts to the budget may result in large excess liquidity in the

financial system, which can be difficult to sterilize. Moreover, in these energy exporting countries, central banks should clarify the trade-offs between the conflicting goals that their monetary policy regime faces; in particular, ensuring price stability, while supporting the nominal exchange rate and promoting economic diversification. Central banks should be clear on how these objectives are traded off if they come into conflict.

Looking ahead, central banks in energy-exporting CCA countries that are considering allowing greater exchange rate flexibility in the future should prepare for this now. In particular, building capacity (e.g., further enhancing the communication strategy, deepening the financial sector) now will allow central banks to improve the effectiveness of monetary policy under a new, more flexible exchange rate regime in the future.

Table 4.1. IMF De Facto Classification of Exchange Rate Arrangements

Armenia	Floating
Azerbaijan	Stabilized arrangement
Georgia	Floating
Kyrgyz Republic	Other managed arrangement
Kazakhstan	Crawl-like arrangement
Tajikistan	Stabilized arrangement
Turkmenistan	Conventional peg
Uzbekistan	Crawl-like arrangement

Source: 2012 IMF Annual Report on Exchange Arrangements and Exchange Restrictions.

Strengthen central bank independence and focus on their core mandate

Central banks in the CCA region generally have strong legal provisions that aim to safeguard their independence. They typically also have strong technical expertise and financial resources, particularly in the local context. This is certainly advantageous, but in some CCA countries this has also made central banks the recipient of requests to take on a number of noncore tasks or quasi-fiscal activities, which vary in terms of scope and complexity. For instance, one central bank in the region has been engaged in large-scale education reforms, while another has run a rating system for private sector companies and became involved in civil aviation polices, when a large local carrier encountered financial difficulties. Another has been involved in financing construction of government residences, recreational facilities, and housing, while yet another has been tasked with managing a new unified national pension fund system.

While it may be tempting to hand these important tasks to central banks for them to solve, this approach may prove counterproductive and risky and undermine central bank independence. It confuses the central bank's mandate, forcing the central bank to devote staff and managerial time to solve noncore tasks. In addition, as these activities are outside the core of central bank operations and taken on at the behest of policymakers, they are likely to be less transparent than direct government action, impeding governance and accountability and making it much harder to assess central bank performance. In addition, the approach may have unintended consequences, such as creating the perception that the central bank may step in to provide a bailout if problems were to emerge (for example, if pension returns were to fall short, or if high-rated companies were to face financial difficulties and lenders demand compensation). This may also create conflicts of interest when setting the monetary policy stance. Finally, the extension of operations of the central bank may impede the development of government or private sector expertise in the area taken over by the central bank. As such, the central bank may remain “on the hook” for future noncore or quasi-fiscal requests.

But more important, by giving inherently political decisions to the central bank, ultimately the central bank's independence will be undermined—for if it steps in on non-core questions, it moves closer to the political arena and further away from the technical design and implementation of monetary policy—the very means by which the central bank acquired its reputation for competence and technical expertise. Central banks need, therefore, to have the independence to be able to keep away from noncore goals and objectives, however worthy they may be.

The CCA Financial Sector

Over the last 20 years, and particularly during the decade that followed their independence, CCA countries put in place the first pillars of a modern financial system, allowing for substantial financial deepening, most markedly in the banking sector. Notwithstanding this progress, a number of challenges remain, including still shallow financial markets and limited intermediation, high dollarization, and excessive state involvement. Over the next decade, CCA countries should aspire to develop competitive banking sectors and create nonbank financial institutions that support private-sector-led growth. The financial system should follow international standards (Basel) of regulation and supervision to deepen and broaden financial intermediation, ensure the financial soundness of banks and other financial institutions, and increase the financial sector's contribution to growth.

Achievements and Current Challenges

Since their independence, CCA countries have dismantled the obsolete Soviet one-tier centralized banking system and have taken significant steps toward establishing a modern and sound financial system.

- A commercial banking system was instituted and the core supervisory framework was put in place, contributing to a notable increase in financial intermediation, in terms of depth, breadth, and access.
- Foundational elements of regulation and supervision of capital markets, investment funds, the insurance sector, private pension funds, and microfinance institutions were also put in place. The number of microfinance institutions and credit unions has grown rapidly, while, in some countries, stock exchanges and nonbank financial institutions have become important players in the money markets.
- Modern retail payment systems were created and real time gross settlement systems are now operational in most countries. International Financial Reporting Standards are now mandatory. Reforms on

accounting and auditing standards have supported the development of the financial sector.

- Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) legislation was adopted and its implementation started. However, some countries remain under Financial Action Task Force monitoring as they are not making sufficient progress in eliminating AML/CFT deficiencies.

Financial crises have affected the pace of reforms and financial development.

- The reform momentum was interrupted after the 1998 financial crisis hit the region. The latest global crisis also affected financial sectors in the region although, the most isolated financial systems (e.g., Uzbekistan) were hardly affected, while the internationally integrated ones (e.g., Kazakhstan) suffered as wholesale financing dried up, debt rollover needs became large, and nonperforming loans surged because of weaker economic performance (particularly in Kazakhstan) or were underreported due to problems of loan classification (e.g., in Azerbaijan and Tajikistan).
- The region's financial sectors are recovering, albeit only gradually, from the legacy of the past banking crises and remain shallow (Figures 5.1–5.2). Banks appear well capitalized and liquid, but provisioning against bad loans is often inadequate. Profitability of banks (which dominate the financial sector) has generally recovered from the troughs experienced during the recent financial crisis, yet remains below precrisis levels. Balance sheet repair is an urgent priority, but risk management capabilities for work-outs and distressed assets resolution remain relatively weak both within banks and among regulators.

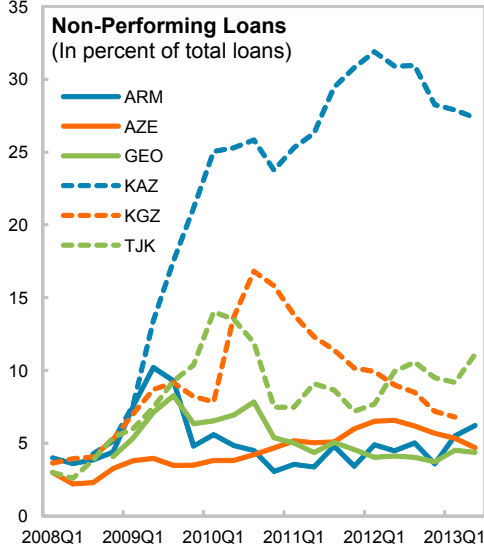
Financial sector development and intermediation remain relatively limited.

- While substantial, the progress in the CCA banking sector has been slow relative to peers, with EBRD transition indicators showing comparatively weak banking sector development.¹⁸ Development of the nonbank financial sector is also slow and access to finance is limited. Capital and private equity markets are underdeveloped in most CCA countries and the insurance business is picking up very slowly (Figure 5.2). The absence of effective three-pillar pension systems further limits the demand for domestic debt and equity. Micro-finance is playing a growing role, but only in some economies.

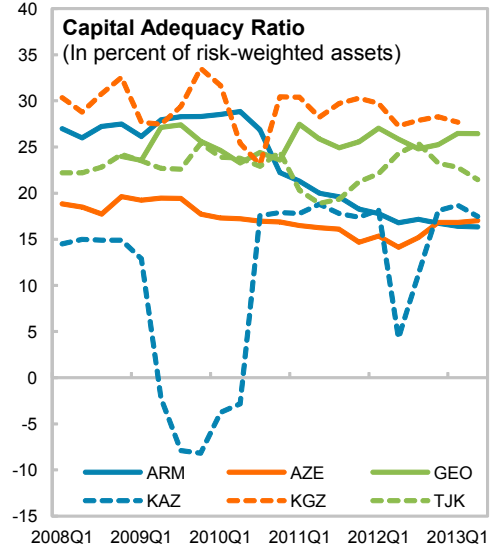
¹⁸ In the banking area, the EBRD transition indicators indicate that most CCA countries have made little progress beyond basic two-tier banking systems, have not sufficiently liberalized interest rates or credit allocation systems, rely too much on directed credit and interest rate ceilings, and do not have frameworks for prudential supervision and regulation that are aligned with BIS standards (EBRD, Transition Report 2013, p. 109).

Figure 5.1. CCA: Financial Soundness Indicators

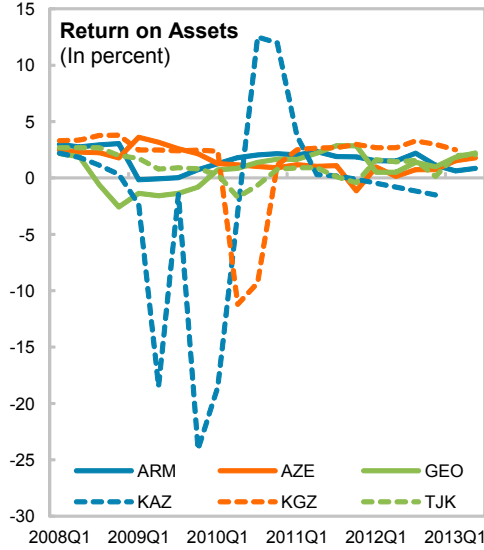
The CCA commercial banks are gradually recovering from the financial crisis, with NPLs declining in most countries.



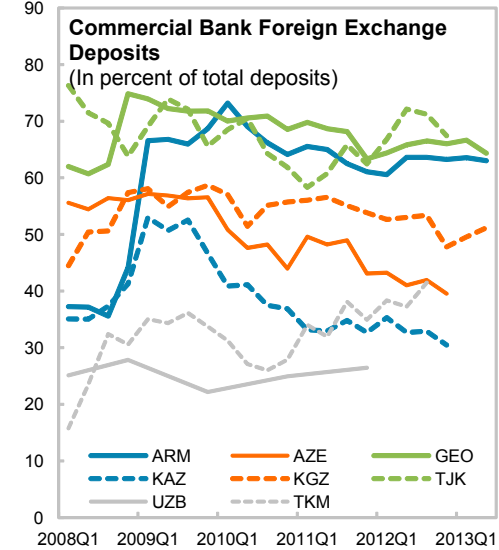
Banking sectors appear well-capitalized...



... and have returned to profitability in most countries.



High dollarization remains a source of vulnerability.

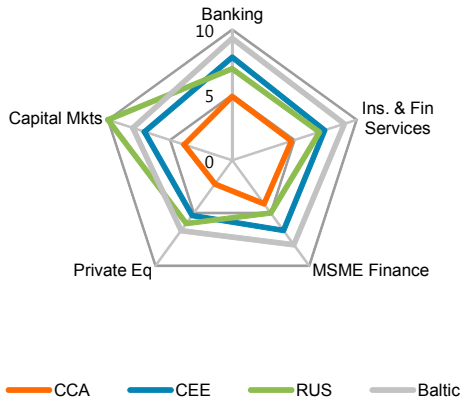


Sources: National Authorities and IMF.

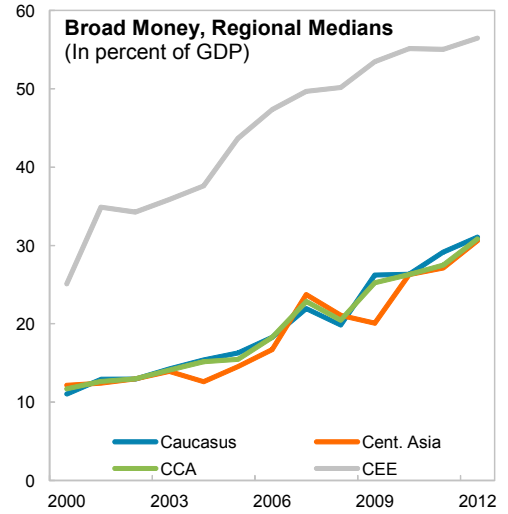
Figure 5.2. CCA: Financial Reforms and Deepening, 2012 1/

Despite substantial progress since their independence, CCA countries lag their peers in terms of reforms...

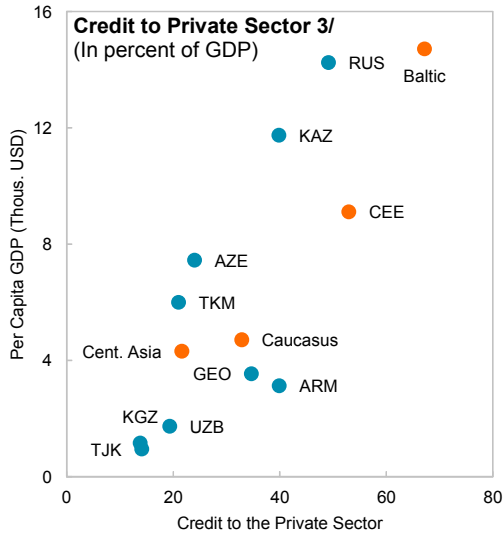
State of Financial Sector Reform 2/



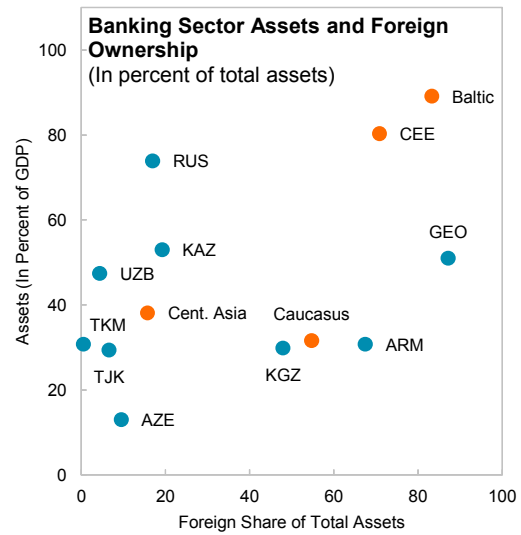
...financial deepening...



...intermediation...



...balance sheet size, and foreign ownership.



Sources: EBRD, National Authorities, and IMF.

1/ Or latest available.

2/ EBRD methodology. The highest score reflects the standards of an industrialized market economy.

3/ CEE excludes Kosovo.

- Financial markets remain shallow—monetization is rising but remains well below that of Central and East European economies. Credit intermediation to the private sector is still low when compared to other transition economies and middle income countries (Table 5.1 and Figure 5.2).

Table 5.1. CCA: Financial Intermediation
(In percent of GDP)

	CCA Average			Low	Middle	High
	2005	2010	2012	Income	Income	Income
	2009	2009	2009			
Banking Sector Total Assets	29.3	36.7	44.7	32.0	50.7	128.9
Banking Sector Total Deposits	10.6	15.6	19.4	26.3	51.3	110.5
Bank Credit to the Economy	12.4	17.4	20.7	19.6	40.6	117.3

Sources: National authorities, World Bank, and IMF staff calculations.

- The public footprint in the banking sector remains significant, as government ownership in banks is wide-spread and the practice of state- or elite-directed lending to preferred borrowers at below-market rates continues to prevail in many CCA countries. This creates an unlevel playing field for other investors and limits the scope for competitive private-sector-led growth.
- In most CCA countries, and most notably in Central Asia, there are severe weaknesses in corporate governance of many domestically-owned banks and participation by reputable foreign banks in the banking sector remains low.
- The financial system is still functioning in the presence of a large informal economy with strong preference for holding cash and dollar assets.

Key Obstacles

Relatively limited financial sector development reflects a number of barriers to effective intermediation.

- Volatile inflation and uncertainty about exchange rates contribute to lack of confidence in local currencies and financial systems. The hyperinflation of the early 1990s, soft lending to state enterprises, and the lost deposits after the financial crisis in 1998 put a dent in market

confidence (Figure 5.3). Many households and businesses (especially SMEs) avoid official financial systems (Table 5.2).

Table 5.2. Banking Sector, Risk Perception Remains High

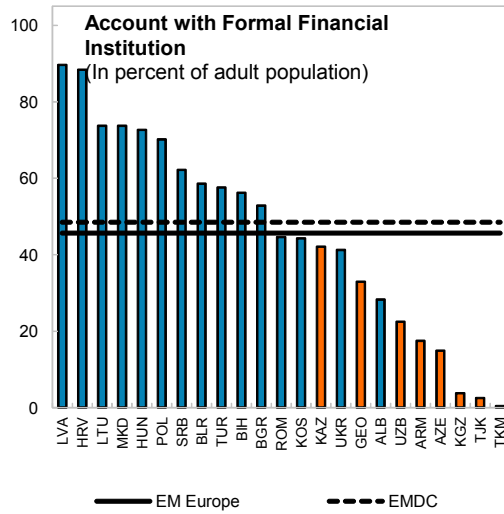
	CCA Average		
	2005	2010	2012
Currency outside banks (in percent of broad money)	62.4	48.7	43.9
Broad money (in percent of GDP)	13.4	23.0	26.4
Lending-deposit rate spread (national currency, in percent)	11.0	12.5	14.6
Lending-deposit rate spread (foreign currency, in percent)	10.8	10.5	13.2
Deposit dollarization (in percent of total deposits)	63.1	51.1	41.4
Loan dollarization (in percent of total loans)	66.8	55.0	55.9
Average inflation (in percent)	7.3	6.9	4.0
Average real deposit rate (national currency, in percent)	3.8	2.4	3.9
Policy rate (in percent)	5.1	5.2	4.2

Sources: National authorities, World Bank, and IMF staff estimates.

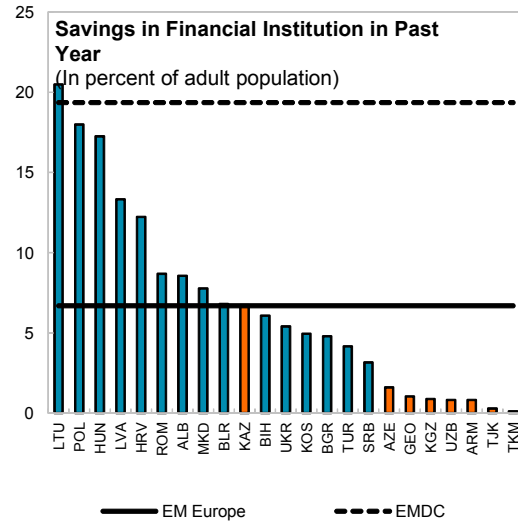
- Frequent state intervention, lack of central bank independence, weak governance, and widespread connected lending exacerbate financial sector problems. Lending—particularly by state-owned banks—is subject to political influence and private banks are often too small to pool risks and create a level playing field. Connected lending and opaque ownership have become particularly wide-spread in some CCA countries and hamper healthy development of banks.
- With few exceptions, investor participation in CCA financial markets is limited by non-transparent regulation, inadequate disclosure frameworks, weak protection of shareholder’s rights, government intervention, and directed lending.
- CCA Financial Sector Assessment Program (FSAP) reports highlight some important obstacles. Even where there has been progress in supervision and regulation, banks continue to operate in an overly risky environment with inadequate protection of creditor rights. In addition, tax authorities often seek to use banks in ways (e.g., inappropriate requests for account information) that undermine confidence in the banking system. Supervision is still mostly compliance-based with limited emphasis on issues of corporate governance and risk management.

Figure 5.3. CCA: Financial Sector Infrastructure, 2011 1/

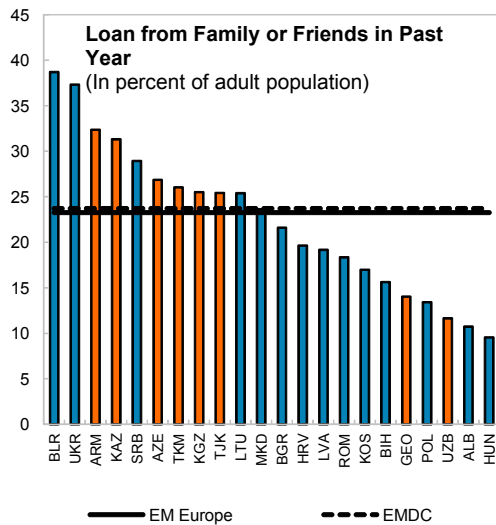
Many in the region lack accounts with formal financial institutions...



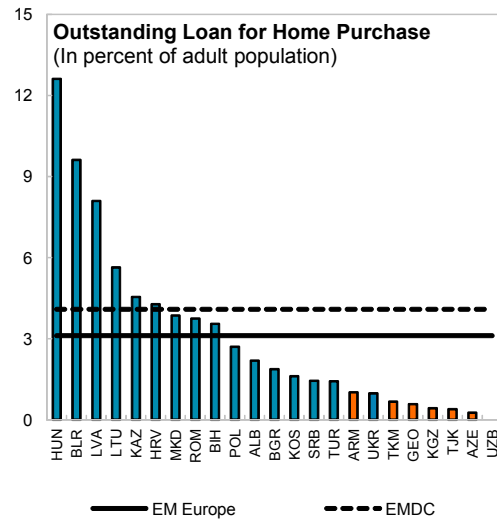
...contributing to low formal savings rates...



...dependence on informal credit sources...



...and a lack of quality credit for large purchases.



Sources: World Bank, Global Findex, and IMF staff calculations.

1/ EM Europe refers to emerging Europe and is an average of the countries included here. EMDC refers to emerging market

These factors contribute to the weak state of the financial infrastructure and financial markets. Financial systems in some CCA countries remain largely closed to foreign direct investment, preventing FDI from playing in those countries its common role of accelerating sustainable financial sector development. These factors are, in turn, compounded across a number of CCA countries by insufficient provision of information and unsupportive legal environments.

Transitioning to a Diversified, Modern, and Strengthened Financial System

To transition to financial systems that match those in dynamic and less dollarized emerging markets, CCA countries should aim to establish:

- A diversified and market-based financial system that supports competitive private sector-led growth and promotes national savings through an expansion of financial instruments and services. This would include reduced state intervention in, and ownership of, banks and other financial institutions (e.g., pension funds) and strengthened corporate governance in banks in many CCA countries (e.g., by tightening fit and proper requirements, applying them continuously—not only for licensing—and ensuring independence of boards of directors in undertaking management decisions for commercial bank operations to protect the value of the bank from political influence and unwarranted lending decisions).
- A modern financial sector infrastructure, with deep capital and interbank markets, with mechanisms to hedge risks, enhanced access to information, and supportive legal and judicial systems.
- Strengthened supervision frameworks and institutions that ensure the soundness of financial institutions, apply prudential norms uniformly, including for provisioning and classification and loan concentration (like single borrower and sector exposure limits), promote transparency and good governance, provide clear guidelines for permissible collateral and for resolving nonperforming or restructured loans, and deal decisively with problem banks.

Policy Requirements to Transform CCA Financial Systems

To bring their financial systems in line with those of dynamic emerging markets, CCA countries will need to adopt and implement bold financial sector reforms in the areas discussed below. Recent FSAP reports, IMF technical assistance, and CCA IMF country team recommendations have included the following:¹⁹

Deepen banking intermediation and capital markets to support an efficient allocation of long-term savings and investments, and contribute to private sector development.

- **Develop interbank and secondary markets for government securities** to contribute to the development of the broader financial market. This requires strengthening the program of issuance of government securities and developing a public debt management strategy in some countries. For countries with strong policy frameworks and institutions, and the need, a legal framework for municipal bonds should also be developed. The elimination of regulatory shortcomings related to the use of government papers as collateral (e.g., registry, etc) would also facilitate financial and real transactions. Once markets for government securities are developed, the market for private papers will follow.
- **Introduce products and instruments that facilitate short- and long-term savings and the hedging of financial risk** (such as corporate bonds, life insurance, unemployment insurance, and forward contracts). This will allow a broader range of institutions (e.g., pension funds) to manage better their financial positions. In some countries, regulatory and prudential practices will need to be better aligned with international standards (see also below). More generally, introduce and strengthen credit bureaus, collateral registries, and foreclosure procedures to enable better functioning of credit markets.
- **Make local currency assets more attractive** to hold through coordinated efforts to ensure macroeconomic stability and strengthen the business environment (see Chapter 9).

More clearly define the responsibilities of each institution and regulator in the financial sector (including the central bank, ministry of finance, securities commission, pension and insurance regulator, deposit protection agency, etc.) and ensure that they regulate to promote competition

¹⁹ The latest FSAP and FSAP updates took place in Armenia in 2012, in Azerbaijan in 2004, in Georgia in 2007, in Kazakhstan in 2004, in the Kyrgyz Republic in 2013, and in Tajikistan in 2008. No FSAPs have been conducted to date for Turkmenistan and Uzbekistan.

and address market failures (e.g., encouraging banks through appropriate regulation and supervision to go out of their niches and allowing small banks to compete for deposits).

Bring financial supervision practices in line with international standards to improve the soundness and resilience of financial institutions and their risk management.

- **Develop and execute strategic plans to strengthen supervisory capacity** and provide for a robust supervisory program. Some countries should amend their central bank laws to ensure legal protection of bank supervisors and strengthen the governance and autonomy of the central bank.
- **Move further toward a modern risk-based approach to supervision**, including by ensuring effective corporate governance and risk management in banks. Improve oversight of liquidity management by banks to contain risks. Strengthen capacity for risk analysis, monitoring of risk, and stress testing by central banks.
- **Supervision should be even-handed and leave no room for regulatory forbearance.** Apply prudential norms equally across banks, shareholders, and borrowers.

Reduce public sector involvement in the financial sector and promote advanced governance practices to help create a business climate more conducive to competitive private-sector led development.

- **Limit state intervention and ownership in the financial sector.** This should include the elimination of state-directed lending and investment through financial institutions and the divestiture of state shares in commercial banks.
- **Enhance the independence of central bank independence and central bank authority over corporate governance within commercial banks.** This would include the legal authority to apply fit and proper criteria for all owners, determine the source of owners' capital, and require replacing management when needed.
- **Require commercial principles of operation for financial institutions, including for any development banks.** Ultimately, eliminating financial repression by allowing price discovery, such as through competitive auctions for government paper; removal of interest subsidies; and selection on a commercial and competitive basis of all projects are crucial steps for enhancing market confidence and competitiveness.

- **Strengthen the framework for bank resolution and crisis management.** Improve bank bankruptcy laws, establish clear and early triggers for a provisional administrator to conduct bank resolution, and adopt a formal inter-agency crisis management and resolution plan, including for systemically important banks.
- **Improve transparency and communication to boost confidence in policies and in financial institutions.** This should notably include the full disclosure to regulators and the public of ownership structures, disclosure of compliance with AML/CFT legislation, and the publication of all relevant bank information—consistent with international financial disclosure standards—on websites and in other media. This would also include improved communication by the monetary authority on the monetary and exchange rate policy stance, the economic outlook, and the health of the overall banking system.
- **Improve regional coordination on supervision of financial institutions to strengthen financial markets and accelerate their development, including by providing confidence that banks are complying with AML/CFT regulations.** Consolidated supervision within CCA countries and improved cross-border supervision and cooperation are needed. Amending regulations so that prudential requirements can be applied on a consolidated basis, allowing for sharing of information among domestic financial sector regulators, and transitioning to an integrated and consolidated supervision in the longer run will help create the necessary environment for the expansion of cross-border financial flows.

CCA Fiscal Policy and Fiscal Frameworks

The fiscal situation and fiscal institutions of CCA countries improved substantially over the last 20 years, although fiscal and public debt positions deteriorated following the global crisis and in most CCA countries have not fully recovered. In the near term, CCA countries should consolidate the gains made to date in fiscal institutions and rebuild fiscal buffers that were depleted in response to the global crisis. A decade forward from now, fiscal policy in CCA countries should be providing increasingly effective core governmental functions, in a non-distortive, transparent, and accountable way. In addition to their security, justice, and regulatory functions, governments should notably aim at fostering long-term growth prospects and protecting the most vulnerable groups, through efficient spending on health, education, and infrastructure. To meet these objectives, governments will need to develop and implement fiscal frameworks that anchor policies on clear fiscal paths; undertake revenue and spending measures to consolidate further their fiscal positions and provide sustainable fiscal space; and advance public financial management (PFM) reforms aimed at promoting transparency and accountability and better fiscal policy outcomes.

Successes and Challenges Ahead

The fiscal situation and fiscal institutions of CCA countries improved substantially in the years prior to the crisis. In particular:

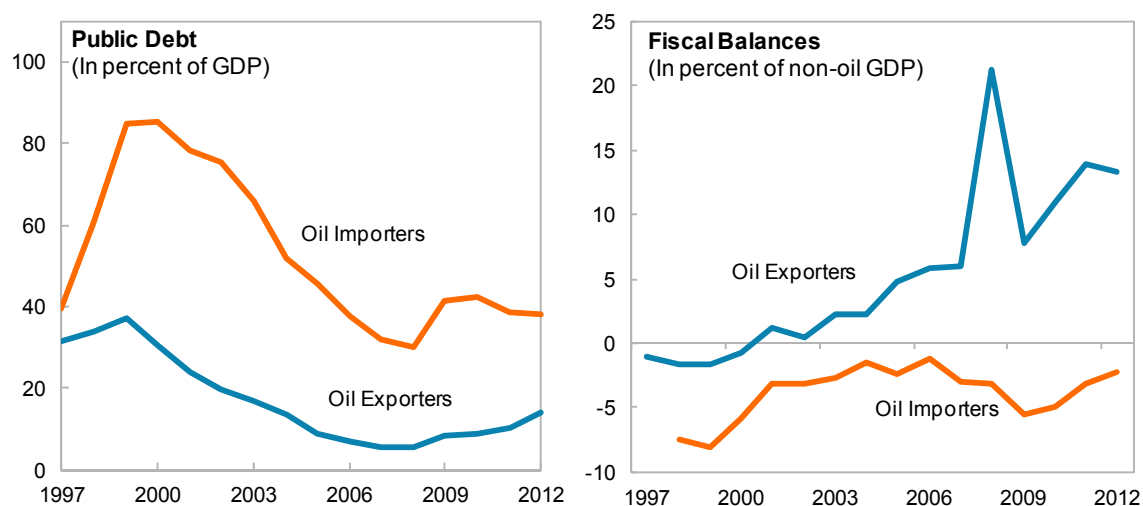
- Fiscal deficits declined significantly in oil importers and turned to large surpluses in oil exporters, aided by booming production (Azerbaijan and Kazakhstan) and high oil prices.
- Public debt fell sharply throughout the region, due to better primary fiscal positions (reduced deficits or actual surpluses) as well as higher growth and lower interest rates.

- These gains stemmed from increases in revenue and streamlined expenditures with reduced subsidies and better targeting of social spending.
- At the same time, fiscal institutions were strengthened, including tax systems and administrations, laying the groundwork for increased taxpayer compliance.
- Progress in PFM systems was also evident with the establishment of core public expenditure management institutions, including treasury and budget systems.

Fiscal positions weakened following the 2008–09 global crisis, in most countries owing both to the impact of automatic stabilizers on the revenue side and to discretionary stimulus policies. In the Kyrgyz Republic, the fiscal position weakened following the 2010 domestic crisis. Since then:

- **Oil importers** (Armenia, Georgia, Kyrgyz Republic, and Tajikistan) have made significant progress with fiscal consolidation, including in the context of IMF-supported programs. Nevertheless, some challenges remain. In Armenia, while deficits are low, revenue is as well, and this constrains spending that would enhance growth and more rapidly reduce poverty. In the Kyrgyz Republic, the debt ratio is still rising, though this is due primarily to temporary increases in public investment. In Tajikistan, the fiscal position is at times put at risk due to contingent liabilities linked to directed lending and weak oversight of SOEs.
- **Oil exporters** (Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan) have made less progress in bringing non-oil balances back to precrisis levels, as, in the context of high oil prices, governments have found it difficult to unwind the large increases in public spending they implemented to stimulate their economies. Maintaining this policy in good times is increasing risks of inflationary pressures and vulnerability to oil price shocks. Fund engagement is through surveillance.

Figure 6.1. CCA: Public Debt and Fiscal Balances, 1997–2012

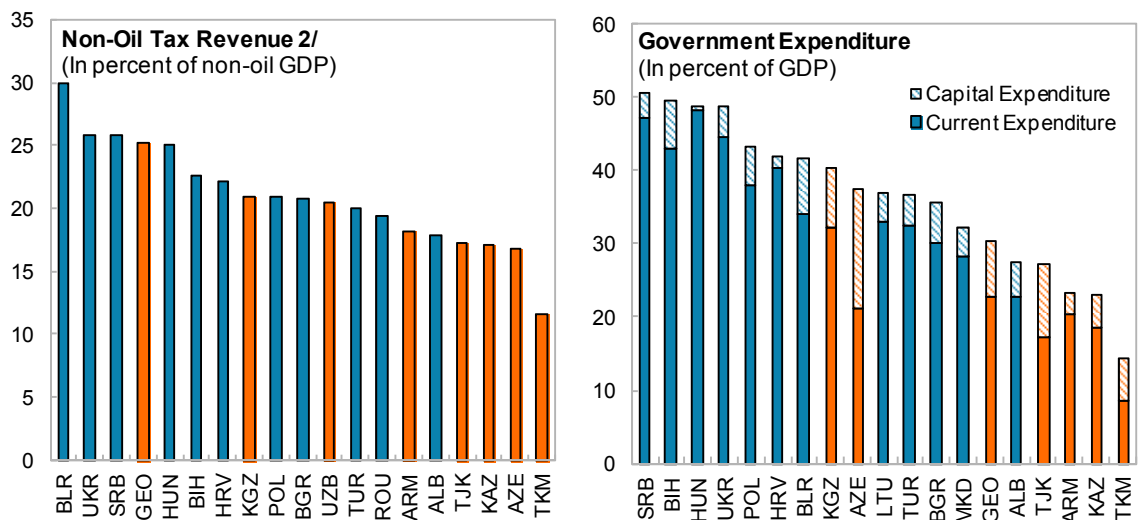


Sources: National authorities and IMF.

Long-standing weaknesses in fiscal frameworks remain, including in the following three areas:

- **Tax revenue performance** is still an issue in most CCA countries. Tax revenue in oil importers and non-oil tax revenue in oil exporters remain low, both relative to countries with comparable income levels and relative to what would be necessary to finance social and capital spending needs in a sustainable way. While this reflects, in part, reliance of CCA oil exporters on oil revenues, it also points to weaknesses in tax policies and revenue administration given the proliferation of ad hoc tax exemptions and the lack of evenhandedness in applying tax procedures. These weaknesses also contribute to distortions and business environment impediments.

Figure 6.2. CCA: Revenue and Expenditure, 2012 1/



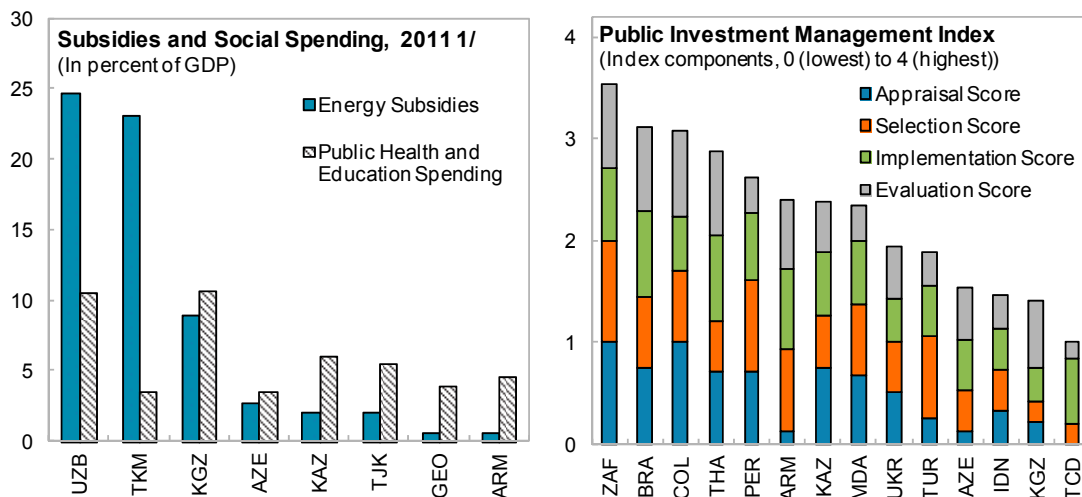
Sources: National authorities and IMF.

1/ Countries highlighted in orange represent CCA countries.

2/ Non-oil tax revenue and non-oil GDP are not available for UZB.

- While CCA spending levels are moderate relative to comparable countries, inefficiencies in public spending are significant.** These stem in particular from large and poorly targeted subsidies, including energy subsidies in CCA oil/gas exporters. In Turkmenistan and Uzbekistan, energy subsidies, which are provided implicitly through low-cost domestic energy resources, are among the highest in the world. Besides distorting resource allocation by encouraging excessive energy consumption and the production of energy-intensive goods and services, these subsidies divert public resources from more productive uses, including investment in human and physical capital. Spending inefficiencies also reflect lingering weaknesses in systems for designing and managing public investment projects and for procuring goods and services (as evidenced by the poor ranking in the joint World Bank/IMF public investment management index).

Figure 6.3. CCA: Public Spending Efficiency

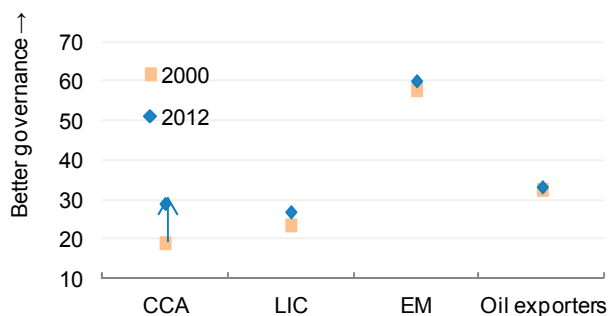


Sources: World Bank; Dabla-Norris, E., J. Brumby, A. Kyobe, Z. Mills, and C. Papageorgiou (2011); and IMF staff estimates.

1/ Or latest available.

- Fiscal control and fiscal transparency are still insufficient,** particularly given undisclosed quasi-fiscal activities by public and private financial and corporate institutions. In spite of improvements over the past two decades, PFM systems in CCA countries continue to be characterized by critical weaknesses, including insufficient coverage of the fiscal and public sector accounts (which often do not fully capture extra-budgetary funds, local governments, and government financial institutions, and which miss directed lending and investment through private entities) and a lack of well-developed strategic medium-term spending plans. CCA countries are therefore exposed to considerable fiscal risks and hampered in their ability to focus on core functions of addressing market failures and reducing poverty. These shortcomings, in turn, undermine public and investor confidence.

Figure 6.4. Changes in Governance (Percentile rank)



Sources: Worldwide Governance Indicators (government effectiveness, regulatory quality, rule of law and control of corruption); and IMF staff calculations.

Sustainable and Accountable Delivery of Core Government Functions

Achieving the status of dynamic emerging market economies will require CCA governments to focus on core government functions, such as providing high quality health and education services and high quality infrastructure facilities, and truly public goods (including, defense, police, and justice) and well-targeted social safety nets, while cutting inefficient expenditures, such as energy subsidies, transfers to uncompetitive SOEs, and untargeted social assistance.

Governments should deliver on these core functions in a sustainable way to support private sector-driven and inclusive growth. This would involve avoiding excessive borrowing or sharp changes in revenue, spending, or service provision. Inefficient or counter-productive activities, such as the provision of energy subsidies, would be substantially reduced and replaced with well-targeted transfers.

In addition, CCA countries should adhere to the best international standards for fiscal transparency and accountability to improve efficiency in budgetary activities and the provision of public services. This would be reflected in strengthened PFM systems, enhanced medium-term budget frameworks, eliminating quasi-fiscal activities, and reporting contingent liabilities and other fiscal risks in the budget.

Policy Requirements for Successful Delivery of Core Government Functions

To successfully deliver on core government functions, CCA governments' efforts will need to focus on the following actions:

Developing fiscal frameworks that anchor policies on clear paths for key fiscal indicators. Clarity in the deficit, debt, and revenue paths, based on cautious growth projections and robust risk assessments, would help address fiscal sustainability concerns, reduce potential risks of overheating, and foster the building or rebuilding of buffers to withstand potential shocks.

- **For oil importers**, fiscal consolidation should aim at bringing overall deficits to sustainable levels, as determined by rigorous and conservative debt sustainability assessments, and at building fiscal buffers to better deal with shocks.
- **For oil exporters**, consolidation paths should be defined as part of fiscal sustainability frameworks, possibly anchored on permanent income hypothesis assumptions or price-based rules (see Chapter 7).

Strengthening the fiscal position while minimizing the negative impact on growth. This entails adopting non-distortive revenue-enhancing measures (e.g., increasing the tax mix more towards indirect taxes on consumption such as value-added tax or excises) while improving the effectiveness and efficiency of public spending (e.g., obtaining better health, education, and services provision for given spending levels). In addition, some CCA countries would need to balance better human capital and infrastructure needs when deciding on the composition of public spending, given the pressing need to develop human capital. In the case of oil exporters, this could be achieved through scaling back and improving the efficiency of capital spending while increasing investment in health and education. More specifically:

- **Revenue Reform**
 - **Widening tax bases** by reducing tax incentives and exemptions (all CCA countries). For oil exporters, strengthening non-oil tax revenue is a priority to reduce dependence and vulnerability to price shocks (Azerbaijan, Kazakhstan, and Turkmenistan) but also to deal with near-term exhaustibility of hydrocarbon resources (Azerbaijan).
 - **Increasing low rates in indirect taxes should be considered** in a few countries (Armenia, Kazakhstan, Kyrgyz Republic, and Tajikistan).
 - **Strengthening tax administration** and ensuring evenhanded treatment of taxpayers (most CCA countries).
- **Current spending reform**
 - **Expanding and ensuring effective targeting of social safety nets** (all CCA countries) to ensure that social transfer programs reach the neediest. While some CCA countries have pro-poor social transfer programs which are noncontributory and means-tested (Armenia, Azerbaijan, and Georgia), these programs reach only a small portion of the poor.
 - **Scaling down energy subsidies** (Uzbekistan and Turkmenistan) as part of a comprehensive energy sector reform, providing for appropriately-phased price increases and measures to alleviate impacts on the most vulnerable. Building public support for this reform will be crucial and will entail explaining the fiscal costs and economic distortions arising from these subsidies, as well as the benefits of using these resources in other ways.

- **Ensuring the financial sustainability of pension systems** (Azerbaijan and Kyrgyz Republic). Notwithstanding pension reforms in recent years, pension systems in some CCA countries are not financially sustainable and their dependence on annual transfers from the budget has continued to increase over time. In Azerbaijan, for example, reforming the system will entail rationalizing the basic pension; restructuring the notional defined contributions; and separating contributions for old-age and disability benefits.
- **Increase the efficiency of capital spending**
 - **Bringing large-scale domestic infrastructure projects** in most CCA oil exporters in line with absorptive capacity constraints. Sovereign wealth funds should be fully integrated within the budget framework of oil exporters (further developed in Chapter 7 on the management of energy resource wealth). In CCA oil importers, capital spending should be consistent with debt sustainability (Armenia, Georgia, Kyrgyz Republic, and Tajikistan). CCA countries should also explore the scope for greater regional cooperation on infrastructure projects.

Implementing second-generation PFM reforms aimed at promoting fiscal transparency and accountability and thereby better policy design, implementation and outcomes, including:

- Medium-term fiscal frameworks, budget classification, program budgeting, and public procurement.
- Quantification and reporting in the budget on main quasi-fiscal activities, implicit energy subsidies, fiscal risks (including those associated with PPPs and SOEs), and contingent liabilities.
- Strengthening public sector statistics, covering local governments, extra-budgetary accounts, SOEs, PPPs, and government financial institutions, to allow for a better assessment of the public footprint on the economy and support decisions by policy makers.
- Introducing fiscal responsibility laws, endorsing international standards (including the IMF's new Fiscal Transparency Code, and, in the case of oil exporters, the Extractive Industries Transparency Initiative), and ensuring greater independent oversight of the use of public resources (e.g., fiscal councils).

Management of Energy Resource Wealth in the CCA

The energy-rich CCA countries (ER-CCA; Azerbaijan, Kazakhstan, and Turkmenistan) have achieved significant improvements in living standards with the development and use of their energy wealth since the breakup of the Soviet Union.²⁰ Over the next 10 years, the ER-CCA countries should aim to leverage their resource wealth to ensure sustained improvement in living standards, achieve economic diversification—including within the energy sector, and reduce reliance on natural resources. To meet these objectives, governments will need to establish fiscal anchors and sound resource fund management, and support macro policies through decisive improvements in governance and business climates.

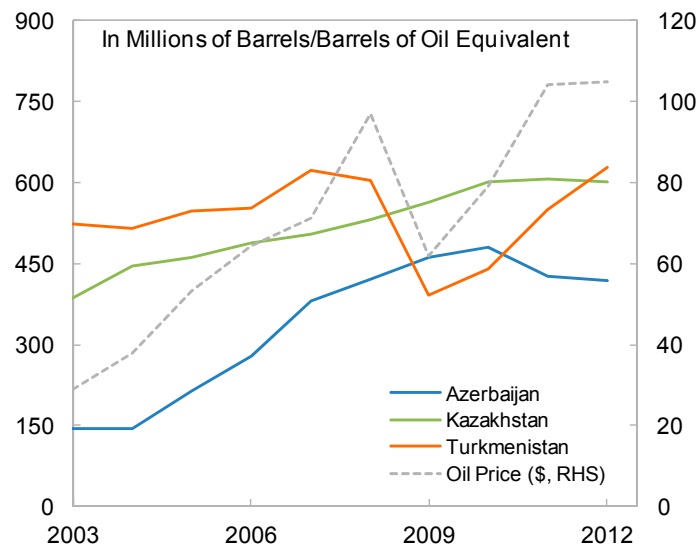
Successes and Challenges Ahead

Energy sectors in Azerbaijan, Kazakhstan, and Turkmenistan have surged since the breakup of the Soviet Union. This reflects various factors:

- New discoveries and production booms in the early 2000s in all these countries, accompanied by favorable hydrocarbon prices since 2003.
- Opening up of new export destinations (Turkey, China) and improving transport infrastructure, including the Baku-Tbilisi-Ceyhan oil pipeline and the Central Asia-China gas pipelines.

²⁰ This section focuses on Azerbaijan, Kazakhstan, and Turkmenistan and does not include Uzbekistan as energy resources play a considerably smaller role in Uzbekistan than in the other three energy rich countries of the CCA region.

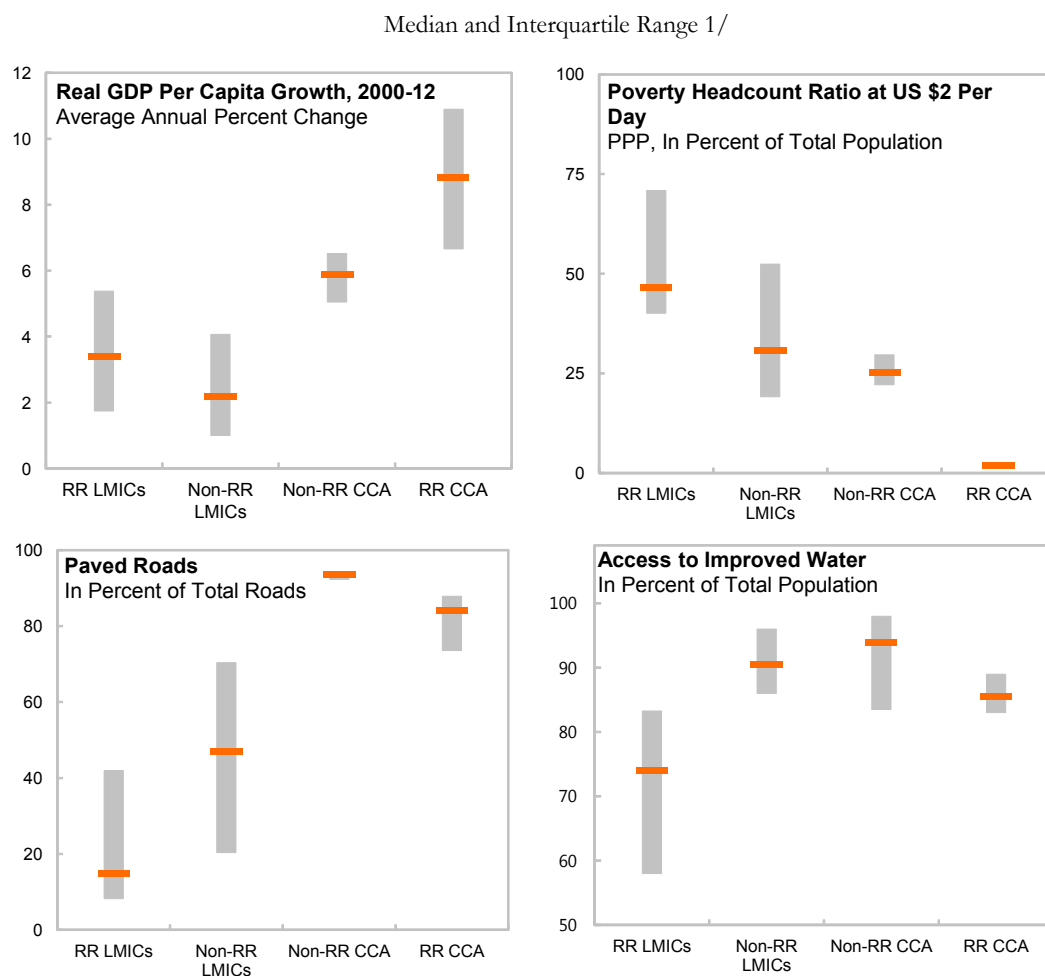
Figure 7.1. CCA Hydrocarbon Production



The expansion of energy sectors has led to significant improvements in living standards, although progress in addressing infrastructure needs has been more modest.

- **The improvement in living standards** is evidenced by substantial increases in GDP per capita and in poverty alleviation relative to other energy rich countries and to CCA oil importers over the last decade.
- **Infrastructure gaps** are, however, still larger than in other countries despite relatively high resource-financed public investment.

Figure 7.2. Development Indicators for Resource-Rich and Non-Resource-Rich Developing Countries



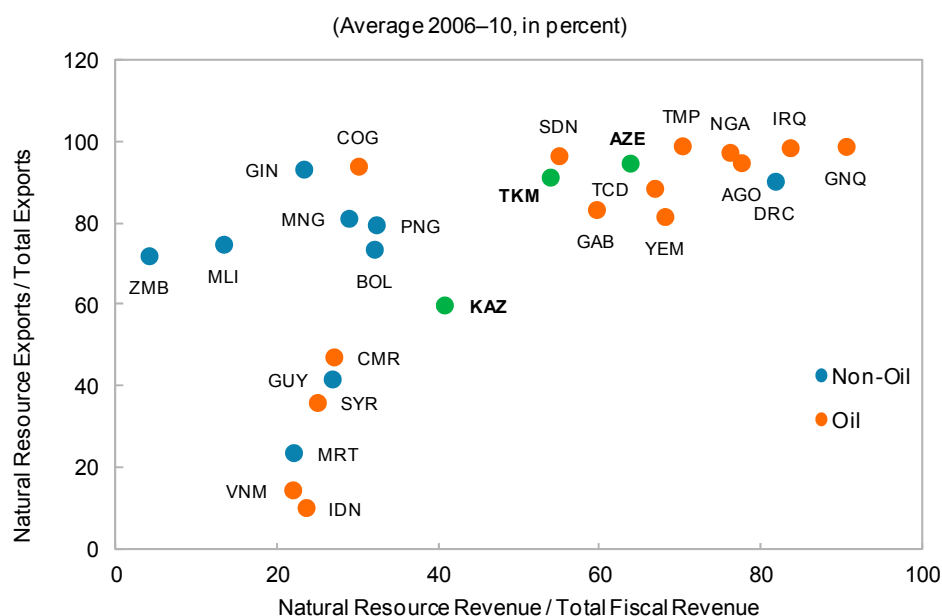
Sources: National authorities, World Bank, and IMF staff calculations.

1/ Using latest available data since 2000. LMIC: Low-Middle Income Countries; RR: Resource-rich; Non-RR: Non-resource-rich.

Despite the benefits from large endowments, resource abundance poses challenges (often referred to as the “natural resource curse”). If not managed properly, adverse macroeconomic outcomes may occur and harm the country’s growth prospects.

- **Volatility in resource prices and production can translate into macroeconomic volatility.** This vulnerability is exacerbated when the dependence of external and fiscal accounts on resource revenue is high, as is the case for the ER-CCA countries.

Figure 7.3. Exports and Fiscal Revenue from Natural Resources

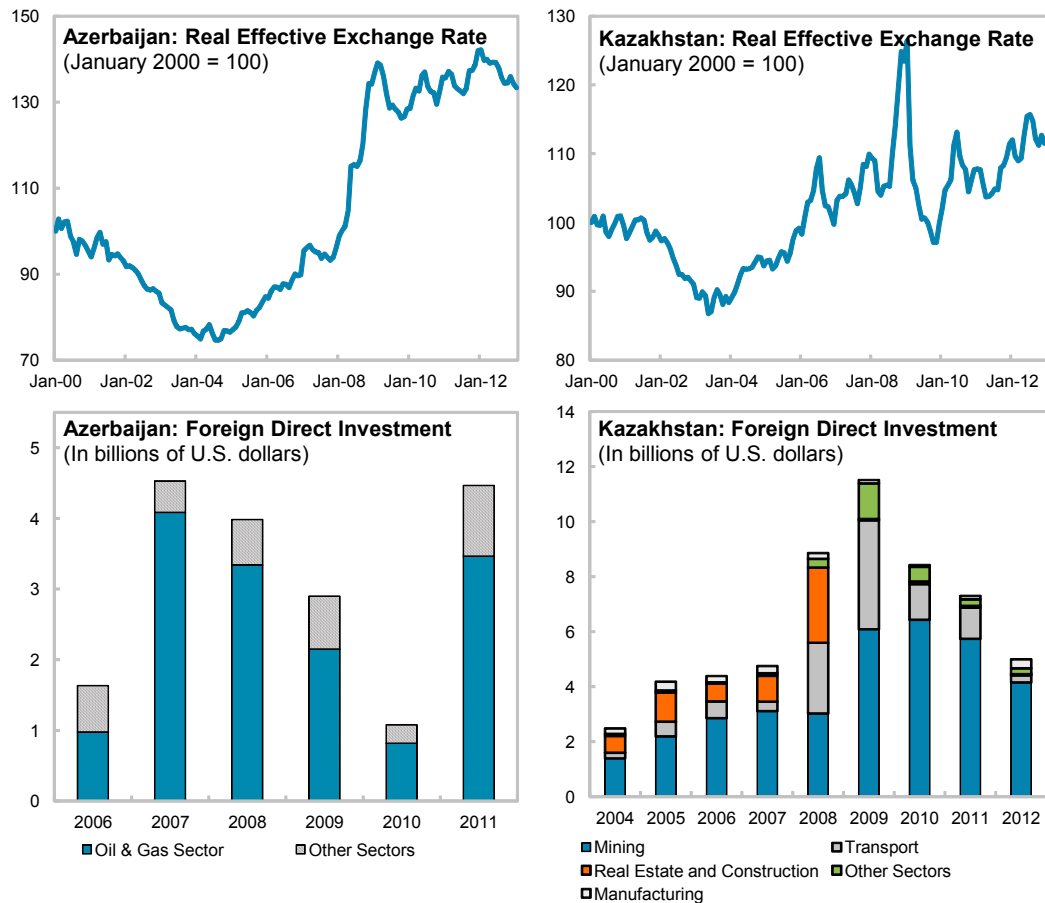


Sources: World Development Indicators, World Bank; World Economic Outlook, IMF; and IMF staff estimates.

- **Real exchange rate appreciation can harm the competitiveness of the nonresource tradable sector, thus negatively affecting prospects for diversification and growth.** Spending a large part of resource revenues rather than saving these revenues externally can exacerbate Dutch disease. There are several warning signs that ER-CCA countries are affected by Dutch disease. In particular, (i) real exchange rates have appreciated substantially; (ii) investment, especially FDI, has been highly concentrated in the energy sector; and (iii) wages have been growing faster than productivity.²¹

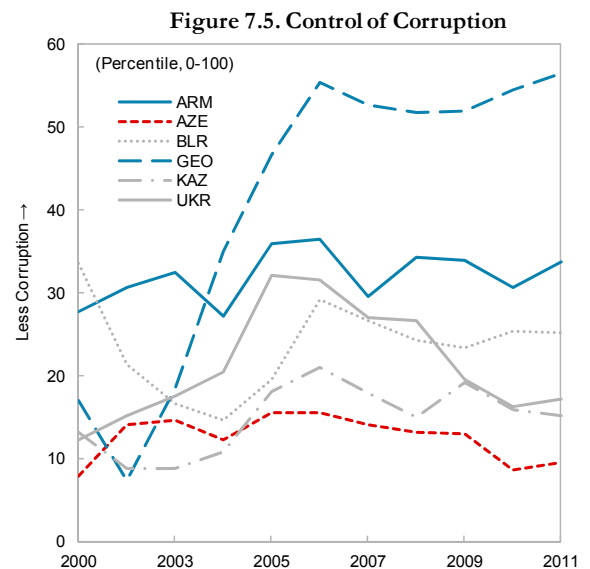
²¹ Turkmenistan’s real effective exchange rate has been broadly stable following the exchange rate reunification in 2008 and the subsequent redenomination of the manat. No sectoral breakdown of FDI is available.

Figure 7.4. Real Effective Exchange Rates and Foreign Direct Investment



Sources: National authorities and IMF staff estimates.

- The transparency and efficiency of large public spending can be seriously undermined** through rent seeking and short-sighted approaches in the use of resource wealth (such as for prestige projects), even when resource funds are in place. For example, relatively high resource-financed public investments in the ER-CCA have had limited success in closing infrastructure gaps. This pattern is observed even in countries committed to full adherence to international standards of revenue transparency such as the Extractive Industries Transparency Initiative. High energy subsidies via the provision



exhaustibility of natural resources, inform the assessment of long-term sustainability, and guide the management of short- to medium-term demand by smoothing resource revenue and delinking expenditure from short-term resource price movements.

- Following recent IMF guidance to resource-rich developing countries, a permanent income hypothesis (PIH) rule with a focus on sustainability is now considered appropriate for Azerbaijan given the short depletion horizon.²³ Such a rule can address fiscal sustainability concerns and help establish, sustain, or rebuild buffers to withstand potential shocks.²⁴
- Price-based rules combined with a target for the structural primary fiscal balance may be more appropriate for Kazakhstan and Turkmenistan, where sustainability is less of an issue and a priority is short-term management of aggregate demand. In Kazakhstan, management of oil revenues should also be better integrated into broader macroeconomic policy frameworks (currently there is only a fixed annual transfer from the resource fund to the budget).²⁵
- **Sound management of resource-based funds** to support fiscal policy and intergenerational objectives. Funds should be transparently linked to the budget and foster the accumulation of fiscal buffers and intergenerational funds. Resource funds in the three ER-CCA countries have helped to secure savings from resource windfalls and delink spending from volatile revenue. However, these funds still need to be fully integrated with the overall fiscal strategy of these countries, by deriving the accumulation of assets in the fund from actual fiscal surpluses and ensuring that any spending from these funds is fully integrated into the budget process.
- **Reduce the budget's reliance on resource revenues in the medium term.** This entails strengthening nonresource tax revenue (Azerbaijan and Kazakhstan). A review of the performance and structure of non-oil tax revenue in Azerbaijan suggests that broadening the non-resource tax

²³ IMF, 2012, “Macroeconomic Policy Frameworks for Resource-Rich Developing Countries”, (Washington: International Monetary Fund).

²⁴ Azerbaijan—2013 Article IV Staff Report and Selected Issues. The permanent income hypothesis (PIH) rule is based on the net present value of resource wealth. The optimal spending annuity benchmark can then be compared to baseline projections of non-oil primary balances to determine long-term fiscal sustainability.

²⁵ Kazakhstan—2013 Article IV Staff Report and Selected Issues. Applying a structural-balance rule entails (i) estimating structural oil revenues using long-term resource prices and (ii) targeting a specific non-oil primary balance using the structural revenue projections. The NOPB target can then be calibrated to be consistent with accumulation of fiscal buffers over the medium term.

base (through limiting exemptions and uniform treatment of taxpayers); reducing compliance costs (e.g., through e-filing); and enhancing tax system transparency could strengthen non-resource revenue collection. These actions will help bring the tax system closer to standards in other emerging market economies.²⁶

Ensure that resource revenue is well used and supports the transformation of subsoil wealth into productive assets. Most countries have ambitious plans for infrastructure investment and economic diversification that are to be at least partly funded from resource savings. It is crucial that these plans do not compromise sustainability and intergenerational equity through funding projects that do not have good growth returns.

- **Governments need to assess realistically the tradeoff between the return on financial assets versus the net gain from resource-financed public investment projects.** Use of resource revenues for domestic investment (such as diversification and industrialization initiatives) can be justified only if it is in line with capacity and high efficiency standards. In some cases, some frontloading of consumption by increasing funding for healthcare and education also may be desirable, such as in Turkmenistan.
- **Assessments of different consumption-savings/investment strategies** have been discussed with Azerbaijan or will be discussed with Kazakhstan and Turkmenistan authorities, building on the recent IMF work on resource-rich countries cited above and in the context of annual IMF Article IV consultations.
- **Supportive fiscal reforms need to move forward,** including improvements to fiscal transparency and public financial management systems to provide a better picture of total public resources and contingent liabilities. This would also facilitate more comprehensive assessments of the macroeconomic impact of fiscal activities.
- **A priority in the ER-CCA countries is to recognize implicit and large energy subsidies.** Subsidy reform will not be easy and will require disseminating information on the cost of those subsidies, which is significantly greater than public spending on health and education, and on the distortions they create for the real economy, competitiveness, and growth.

²⁶ See 2011 Azerbaijan Article IV Staff Report and Selected Issues.

Advance reforms to support diversification and reduce reliance on natural resources.

- **Trade and competition reforms are needed to encourage private sector investment in non-resource sectors and facilitate regional cooperation and integration with global markets.** These would include accelerating plans for WTO accession and new customs codes to reduce informal and formal barriers to trade and competition. Streamlining regulatory and other requirements of government should help reduce non-oil companies'—especially SMEs'—costs and limit opportunities for corruption (see also Chapter 9).
- **Financial sector reforms (see also Chapters 5 and 8)—including in banking supervision—and greater access to finance for nonresource sectors on a commercial basis would support diversification.** This will require significant policy and institutional change. Reducing directed lending is a priority in Turkmenistan, and remains important in Azerbaijan and Kazakhstan, to level the playing field for all savers and investors. Equally important is the development of well-regulated and supervised capital markets, with strong legal frameworks, infrastructure, and instruments for savers and nonresource sector investors.

8

Policies to Strengthen CCA External Linkages

Enhanced economic and financial cooperation with the rest of world and within the CCA offers tremendous opportunities for economic diversification and structural transformation to ensure sustainable growth. CCA countries' strong growth performance over the past two decades has been accompanied by the region's increasing trade openness. Nonetheless, intra-regional trade remains low due to the dominance of major trading partners (China and Russia), the high cost of trade, and the similarity of product structure across CCA countries. Moreover, external financial linkages are limited, reflecting the underdevelopment of local financial markets. These challenges and vulnerabilities reinforce the need for sound policy frameworks.

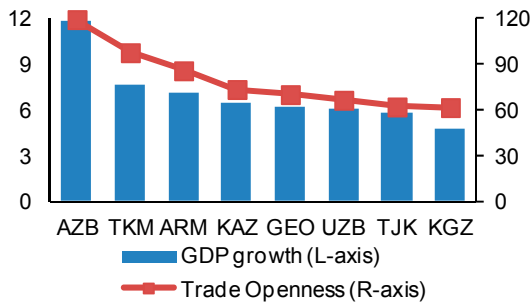
Trade Linkages

Trade openness supports economic growth. The literature supports the premise that increased international trade leads to faster growth (Frankel et al. and Kraay et al.). Trade allows producers to access bigger markets and encourages the development of technological knowhow, thereby increasing returns to investment and economic growth. Growth in the CCA has been associated with its greater trade openness (Figure 8.1),²⁷ but trade openness for the region as a whole has still lagged the fast growing emerging economies²⁸ (Figure 8.2).

²⁷ Trade openness is defined as the ratio of trade (exports plus imports) to GDP. Within the CCA, openness and growth are biased by energy exporters, with three of the four most open and highest growth economies being large hydrocarbon exporters.

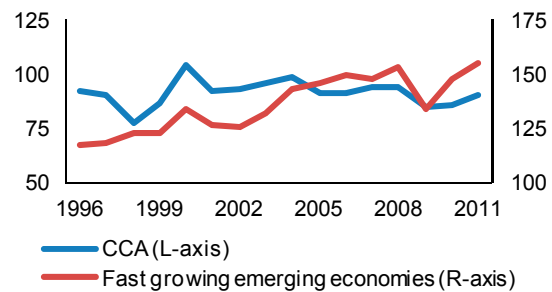
²⁸ Botswana, Brazil, China, Hong Kong, Indonesia, Korea, Malaysia, Malta, Oman, Singapore, Taiwan, and Thailand have grown at above 7 percent for a period of more than 20 years within the past four decades.

Figure 8.1. CCA: Economic Growth vis-a-vis Trade Openness in 1996–2011



Source: World Development Indicators.

Figure 8.2. Trade Openness in CCA vis-a-vis Fast Growing Emerging Economies



Source: World Development Indicators.

Regional cooperation has long been seen globally as an instrument for promoting economic growth. Sophisticated buyer-supplier networks and the emergence of a value-added chain have been major features of globalization in the world’s most dynamic regions, such as Southeast and East Asia. Likewise, increased specialization generates more trade, which can

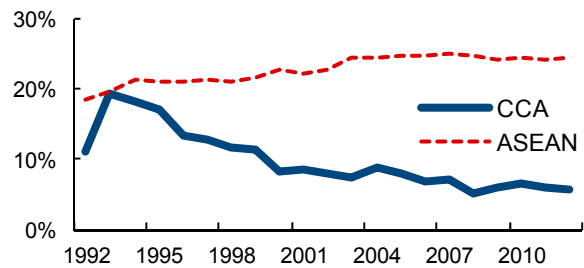
provide opportunities for small, poor, and landlocked CCA economies. However, most CCA countries do not have the required number of skilled workers, local financial capacity, or ability to sustain clusters of suppliers and complementary services.

Economic cooperation among countries with shared borders

can help create larger markets and allow for efficiencies and economies of scale by reducing barriers to trade, capital, and labor mobility. Cross-border cooperation also facilitates the development of regional infrastructure networks that support trade, and permits the efficient management of cross-border spillovers. This is particularly important for landlocked countries like those in the CCA, since they have neighbors on all sides with whom they must cooperate not only to increase integration within the region but also to permit integration with global markets. Increased regional economic cooperation should also allow CCA countries to support growth through enhanced energy and water security and possibly to make progress on long-standing conflicts and tensions.

While the CCA has made significant progress in integrating with the rest of the world, intra-regional trade has yet to expand. Despite rapid economic growth, the share of intra-regional trade in the CCA relative to the region’s overall global trade dropped significantly over the past two decades (Figure 8.3). This lower intra-regional trade in the CCA contrasts with that of

Figure 8.3. Intra-regional Trade over Total Trade



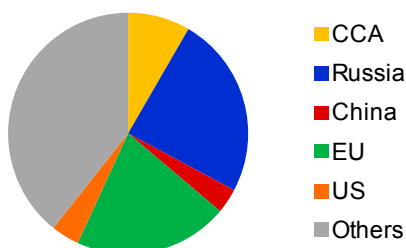
Source: IMF Direction of Trade Statistics.

the gradually rising figure among the Association of Southeast Asian Nations (ASEAN) countries.

Several factors explain the relatively slower pace of regional trade integration and economic cooperation.

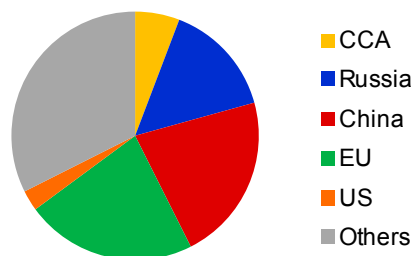
- **CCA economies have benefitted from trade with two major trading partners, China and Russia, more than within the CCA (Figures 8.4 and 8.5).** Russia's ties with the CCA remain strong, although trade with Russia, which had reached 25 percent of total CCA trade in 2000, fell to 15 percent in 2012.

Figure 8.4. CCA: Trade Composition in 2000
(Percent of total)



Source: IMF Direction of Trade Statistics.

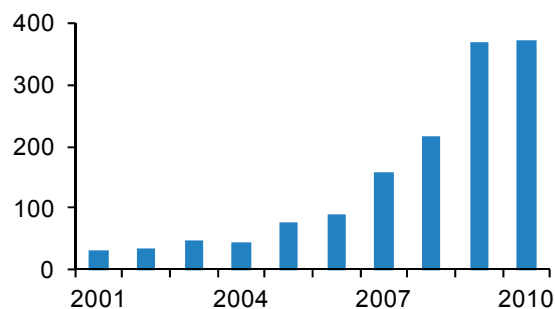
Figure 8.5. CCA: Trade Composition in 2012
(Percent of total)



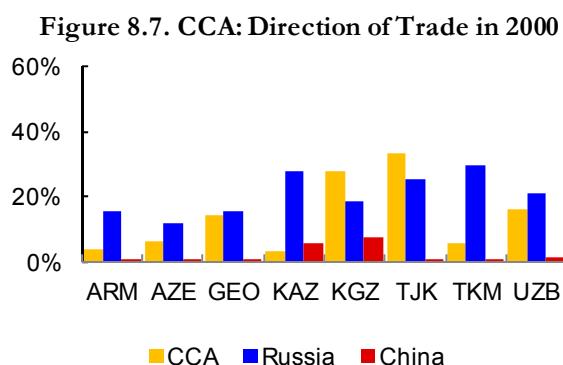
Source: IMF Direction of Trade Statistics.

Forced to look outside for energy supplies in the CCA, China opened up its borders and routes to foster trade with the region, expanding its economic engagement in the region (Figure 8.6). Agreements focused on energy, trade and finance, and infrastructure, cementing China's role as Central Asia's primary economic partner. Indeed, trade between the CCA and China rose from 3 percent of total CCA trade in 2000 to about one quarter by 2012. Notably, China has become the largest trading partner of CCA countries sharing their borders with China (Kazakhstan, Kyrgyz Republic, and Tajikistan) and with Turkmenistan (Figures 8.7 and 8.8).

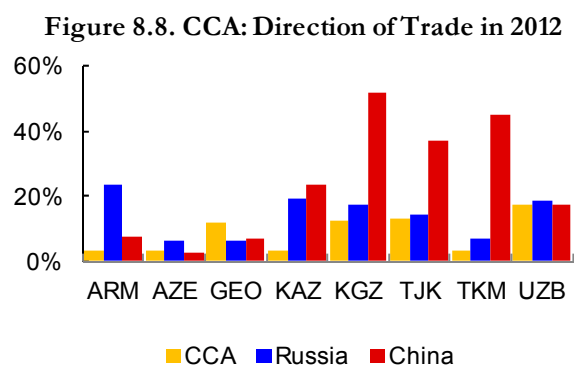
Figure 8.6. China's Official Assistance in CCA
(Project contracted amount, US\$ millions)



Source: National Bureau of Statistics of China.



Source: IMF Direction of Trade Statistics.



Source: IMF Direction of Trade Statistics.

- Intra-regional trade costs remain exceedingly high.** Given that much of the CCA is landlocked, sea access for traded goods is primarily through Russia and Iran. Much of the region faces geographic and climate barriers, leading to high costs of transportation, communications, and energy, as well as extended transit and delivery times, including at borders. In addition, limited and weak physical infrastructure contribute to making trade costs in the CCA the highest among Asian sub-regions (Table 8.1).

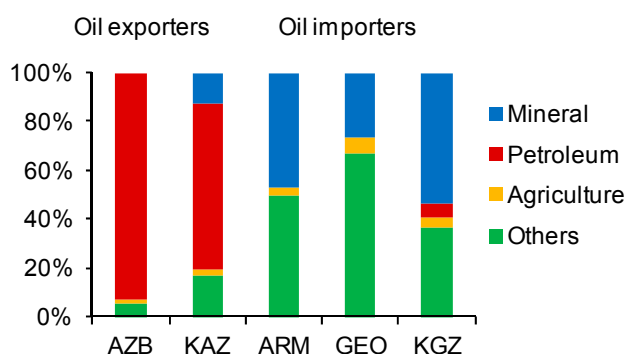
CCA	SAARC	ASEAN	EAST Asia	NAFTA	EU5
162%	150%	61%	128%	62%	72%

Note: CCA (for this table: Armenia, Azerbaijan, Georgia, Kazakhstan, and Kyrgyz Republic); SAARC (Bangladesh, India, Pakistan, and Sri Lanka); ASEAN (Indonesia, Malaysia, Philippines, and Thailand); East Asia (China, Japan, Korea, and Mongolia); EU5 (France, Germany, Italy, Spain, and UK).

Source: UNESCAP, Intra-regional Trade Costs in Asia, 2010.

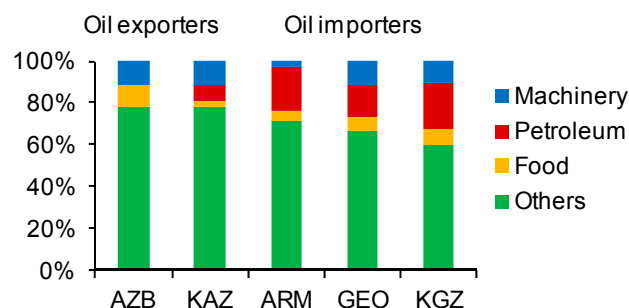
- CCA economies are similar in terms of their product structure.** CCA energy exporters and importers produce, respectively, roughly the same set of final goods (Figure 8.9). As a consequence, the market for these goods lies elsewhere. Meanwhile, in the ASEAN region, intermediate goods account for as much as 40 percent of intra-ASEAN trade with a high degree of product chain dependence on Japan and China.

Figure 8.9. Selected CCA Countries: Export Composition



Source: UN Comtrade Database .

Figure 8.10. Selected CCA Countries: Import Composition



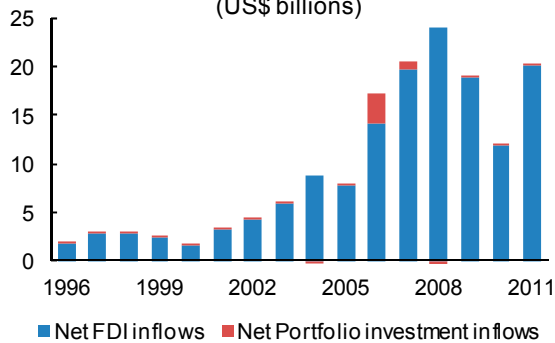
Source: UN Comtrade Database .

Financial Linkages

Enhanced financial linkages provide better opportunities for consumption smoothing and efficient capital allocation. Increased liquidity in the capital market allows better access to finance that is crucial to support economic activity (La Porta et al. and Rajan et al.). Given their relatively low levels of physical capital and their inherently greater volatility, developing economies, in particular, have the most to gain from increased financial linkages (some already discussed in Chapter 5).

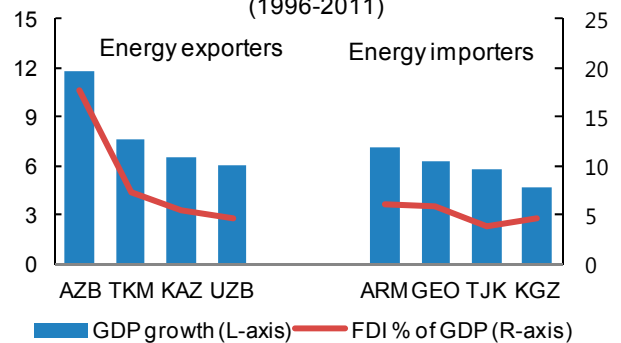
Financial inflows to the CCA have grown rapidly since 2000, predominantly driven by foreign direct investment (FDI) (Figure 8.11). The literature widely supports the view that FDI contributes to economic growth (Borensztein et al., and Alfaro et al.). In the CCA, selected countries with higher FDI have enjoyed faster growth rates (Figure 8.12). This is particularly true for the energy exporters. Since the global crisis, FDI inflows have largely flowed to energy sectors (Figure 8.13). For the region all together, FDI flows are stronger than fast growing emerging economies (Figure 8.14).

Figure 8.11. CCA: Financial Flows (US\$ billions)



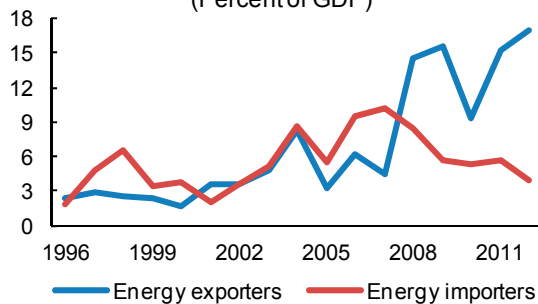
Source: IMF staff calculations.

Figure 8.12. CCA: Economic Growth and FDI (1996-2011)



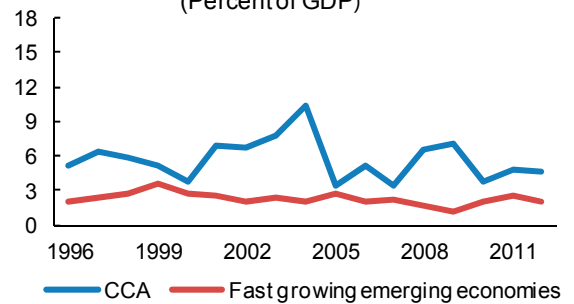
Source: IMF staff calculations.

Figure 8.13. CCA: FDI in Energy Exporters vis-a-vis Energy Importers (Percent of GDP)



Source: IMF staff calculations.

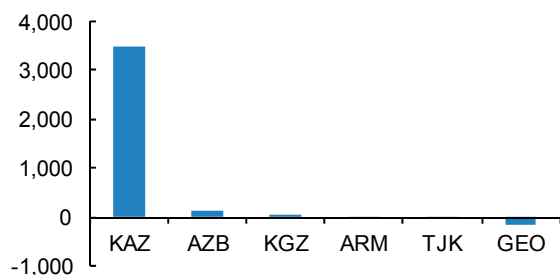
Figure 8.14. FDI in CCA vis-a-vis Fast Growing Emerging Economies (Percent of GDP)



Source: IMF staff calculations.

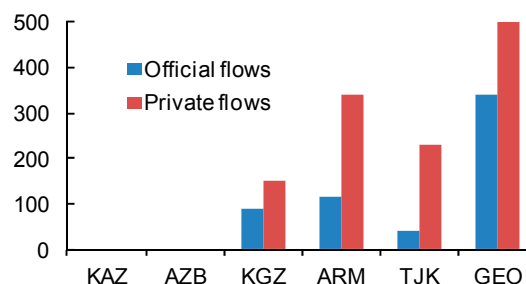
Foreign investors' appetite for CCA financial assets has yet to materialize. Portfolio inflows to the CCA remain largely limited to Kazakhstan, a market access country (Figure 8.15), while debt financing flows remain a predominant financing source for low income CCA countries (Figure 8.16). A combination of factors constrain foreign portfolio investment: a low level of capital market liberalization, underdevelopment of financial markets, few bond offerings by CCA corporate, a lack of institutional capacity, weak governance, and the fragility of security in some countries.

Figure 8.15. Portfolio Investment in CCA
(Average in 2005–2011, US\$ millions)



Source: IMF staff calculations.

Figure 8.16. Other Financing Flows in CCA
(Average in 2005–2011, US\$ millions)



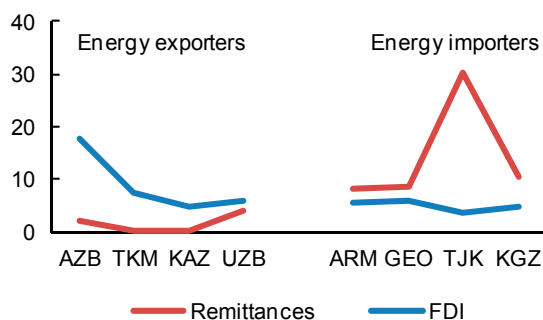
Source: IMF staff calculations.

Other Linkages—Remittances

Remittances are an important source of income for Armenia, Kyrgyz Republic, and Tajikistan (see also Chapter 2). Russia is the primary destination for labor migration in the region, though there are also substantial CCA migrant worker populations in Belarus, Ukraine, and Kazakhstan. Russia is by far the largest source of remittances for CCA remittance-receiving countries, with, for example, Tajikistan receiving more than 80 percent of its remittance income from Russia. CCA countries and the destination countries for their migrant workers have recently taken steps to regularize the labor migration process and simplify documentation requirements for migrant workers. Remittances are an important source of growth and of external financing for Kyrgyz Republic and Tajikistan. Given these two countries' limited access to external market financing, they have benefitted from the availability of international financial institutions' official financing when faced with falling remittance inflows triggered by a severe deterioration of the external environment (Figures 8.17 and 8.18). Armenia, on the other hand, is less dependent on remittances and has market access.²⁹

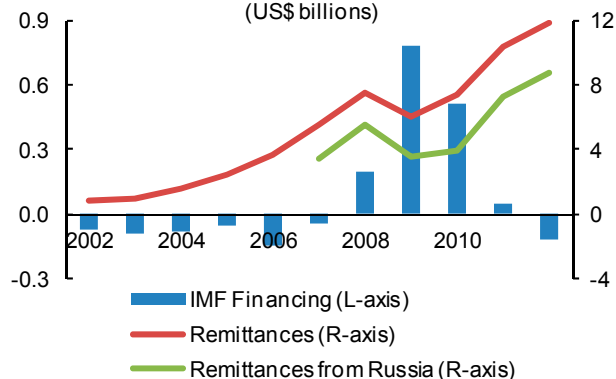
²⁹ Armenia issued a \$700 million Eurobond in September 2013.

Figure 8.17. CCA: Remittances vis-a-vis FDI
(Percent of GDP, average in 1996–2011)



Source: IMF staff calculations.

Figure 8.18. CCA: Remittances vis-a-vis
IMF Financing
(US\$ billions)



Sources: IMF staff calculations and Central Bank of Russia.

Policies and Actions to Strengthen External Linkages

While deeper economic and financial cooperation can yield substantial benefits, it also poses macroeconomic challenges and vulnerabilities.

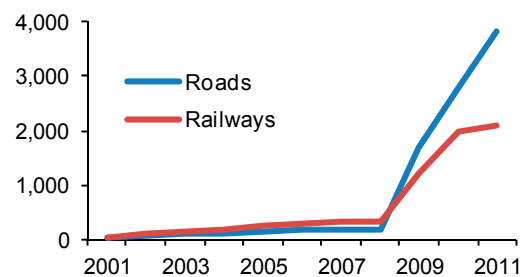
Key challenges and their associated vulnerabilities are as follows:

- Limited diversification of exports and imports make CCA countries particularly susceptible to sudden fluctuations in terms of trade and foreign demand shocks.
- Sudden changes in the direction of capital flows can induce boom-bust cycles in developing countries, most of which do not have financial sectors that are developed enough to cope with highly volatile capital flows.
- Country size is an important factor, and developing economies in the CCA are relatively much smaller than industrialized countries. Both terms of trade shocks and foreign aid flows are particularly important in accounting for highly volatile macroeconomic fluctuations in low-income countries.

Exploit existing opportunities to become “land-linked” to the world.

- Significant divisions among CCA countries persist due to intra-CCA political tensions (see Chapter 9). This prevents beneficial interaction and the pooling of resources. The current low share of intra-regional trade

Figure 8.19. CAREC Corridors
(Kilometers, cumulative progress)



Source: Asian Development Bank, 2012.

in the CCA total trade demonstrates that there remains much to be done to improve their inter-connectedness, and highlights that many CCA countries are currently handicapped by their landlocked positions. Various efforts have been made through sub-regional arrangements to foster regional cooperation (Box 8.1). Some notable progress is being made in reducing intra-regional trade costs. For example, the six CAREC corridors are being constructed to link the region's key economic hubs to each other, and connect the landlocked CAREC countries to other Eurasian and global markets (Figure 8.19).

Box 8.1. Institutional Arrangements to Foster Regional Cooperation

Several institutional arrangements have been put in place to promote regional cooperation. Early efforts to maintain cooperative arrangements to prevent economic disintegration were not successful, notably the failure of the Commonwealth of Independent States (CIS) to maintain open borders, trade, transport, and capital mobility. Since then, various efforts have been made to forge improved economic links through sub-regional cooperative arrangements. There are some signs that regional cooperation has been given a new impetus in the last few years, albeit coming from very different directions. Three of the most prominent examples: the Eurasian Economic Community (EEC), involving mainly a customs union; the Shanghai Cooperation Organization (SCO), led by China and Russia; and the Central Asia Regional Economic Cooperation program (CAREC), led by the Asian Development Bank with the support of China.

Notwithstanding these institutional efforts, progress on regional cooperation has been slow. The multiplicity of regional organizations among CCA countries has tended to dissipate the limited managerial and decision-making capacity in the region and perhaps has led to a degree of cynicism about regional cooperation.

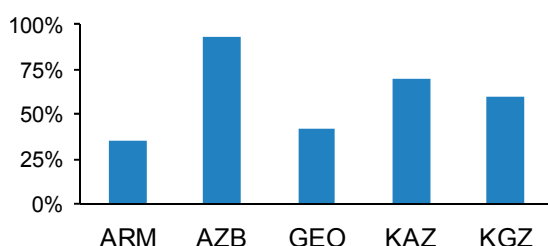
- EEC: Comprised of Belarus, Kazakhstan, and Russia, the EEC presently involves mainly the Eurasian customs union (ECU). Armenia announced its intentions to join the ECU in September 2013. Asymmetry of economic size of the member states and high external tariffs under the associated ECU complicate economic cooperation. The disparity in the economic size of the largest state, Russia, and that of the other members of the ECU is perhaps greater than in any other regional economic grouping. Kazakhstan's population and GDP are around one-tenth of Russia's, while Belarus's GDP is $\frac{1}{5}$ of Kazakhstan's.
- SCO: Established in 2001 with six members: China, Kazakhstan, Kyrgyz Republic, Russia, Tajikistan, and Uzbekistan. The leading two member countries, China and Russia, often have not reached agreements on key issues of energy and trade development, particularly regional oil and gas transit.
- CAREC: Emerging from a regional initiative in 1997, the current membership consists of 10 countries: Afghanistan, Azerbaijan, China, Kazakhstan, Kyrgyz Republic, Mongolia, Pakistan, Turkmenistan, Tajikistan, and Uzbekistan. Some key regional players are missing, foremost among them Russia. Russia was invited to join CAREC but has yet to respond to the invitation.

Successful economic integration in the CCA critically depends on how to cooperatively involve both Russia and China as well as the European Union. Russia and China are competing to maintain their influence in Central Asia, and Russia and the EU have been competing in European part of the former Soviet Union and in the Caucasus countries. Greater cooperation could accelerate economic integration in the region and further buttress the relationship among China, Europe, and Russia.

Diversify exports and strengthen buffers.

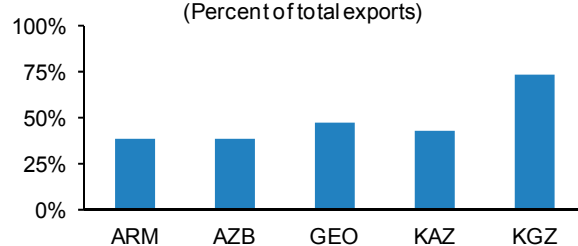
- Export diversification in CCA countries is quite low. For example, in Azerbaijan, the top three export commodities account for 92 percent of total exports (Figure 8.20). Moreover, geographical concentration of exports shows that Kyrgyzstan’s top three export destinations account for 73 percents of its total exports (Figure 8.21).

Figure 8.20. CCA: Top Three Export Product
(Percent of total exports)



Source: UN Comtrade database.

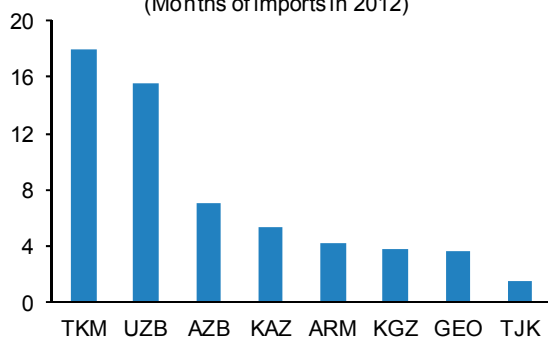
Figure 8.21. CCA: Top Three Export Destination Share
(Percent of total exports)



Source: UN Comtrade database.

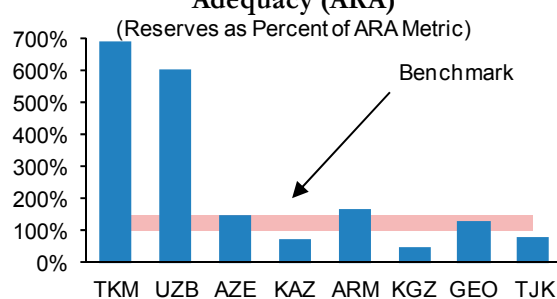
- Given terms-of-trade and external demand shocks, adequate foreign exchange reserve buffers would help countries better manage external volatility. The CCA region maintains broadly adequate reserve buffers, but some countries have seen their reserves depleted during the recent global crisis and need to rebuild buffers (Figures 8.22 and 8.23).

Figure 8.22. CCA: Reserve Cover
(Months of imports in 2012)



Source: IMF staff calculations.

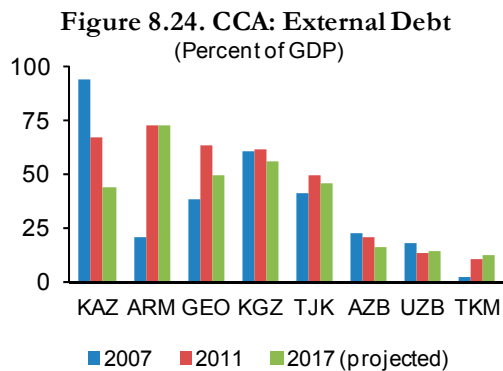
Figure 8.23. CCA: Assessing Reserve Adequacy (ARA)
(Reserves as Percent of ARA Metric)



Note: ARA is composed of 30% short-term debt, 15% long-term debt, 10% M2, and 10% exports.
Source: IMF staff calculations.

Adopt measures to reduce potential vulnerabilities associated with increased financial linkage.

- External debt in most countries in the region is projected to stay at low levels over the medium term (Figure 8.24). CCA countries with a high current level of external debt should be cautious about further borrowing, and all CCA countries should ensure that borrowed funds are used only for productive investment that supports growth.



- For market access countries (e.g., Kazakhstan), the potential for a sudden reversal of capital inflows warrants capital flow management measures (CFMs), which are price-based or administrative tools to limit capital flows. CFMs would be particularly useful in cases where (i) the room for adjusting macroeconomic policies is limited; (ii) the needed policy steps require time, or the macroeconomic adjustments require time to take effect; and (iii) an inflow surge raises risks of financial system instability (See the IMF Board Paper, the Liberalization and Management of Capital Flows, 2012).
- For low-income CCA countries that rely heavily on official borrowing and grants, or on remittances, (e.g., Kyrgyz Republic and Tajikistan), a sharp macroeconomic adjustment would be unavoidable if these channels dry up. Even potential market access countries (e.g., Azerbaijan) might lose their access to international capital markets when faced with greater political instability and worse perceptions of their policies and institutions. Hence, these countries need to step up the implementation of a comprehensive set of structural and policy reforms to help create jobs, foster access to international capital markets, and allow them to manage volatility. See chapters on policy frameworks and on structural reforms.

Ambitious and decisive structural reforms are necessary for a better business environment and strong private-sector-led growth. Throughout their transition, CCA countries have advanced first generation reforms (e.g., privatization, price liberalization) that enable a market economy but have lagged on reforms that deepen and sustain markets. Corruption, labor skills, and infrastructure remain key constraints to more dynamic economies, with the lack of regional cooperation (see Chapter 8) also hampering the quality and spread of growth-facilitating infrastructure. CCA countries exhibit less progress on reforming political institutions and reducing political economy constraints to growth. More forceful structural reform efforts and major improvements in governance frameworks and institutions will be necessary to underpin better macro policy frameworks and make the transition to dynamic emerging market economies.

Structural Reforms and the Business Environment

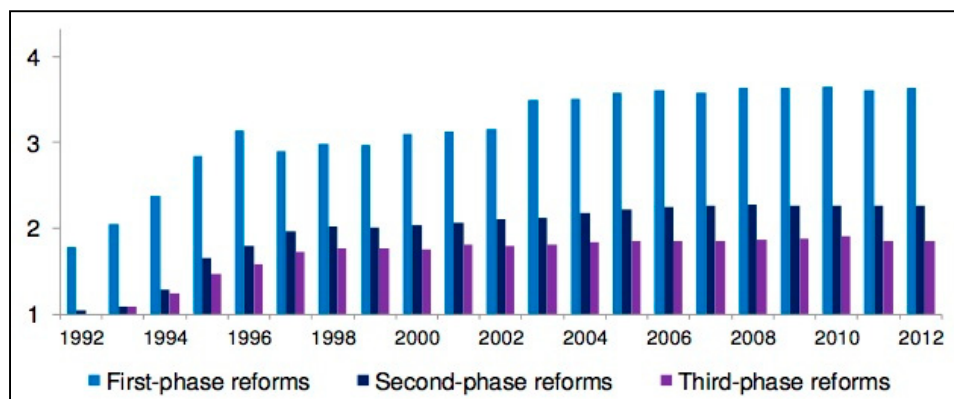
The EBRD’s framework for transition economies captures three phases of market reforms—market-enabling, market-deepening, and market-sustaining.³¹ Market-enabling reforms include privatization of small firms, price liberalization, and exchange rate unification, and most CCA countries completed these by the early 2000s. Progress on market-deepening and market-sustaining reforms—which include privatization of larger firms, strengthening financial institutions, fundamental governance reforms in firms and regulatory bodies, and the commercialization of infrastructure

³⁰This section draws on the inputs of EBRD and World Bank staff presentations at the May 2013 Bishkek conference on “The Caucasus and Central Asia: The Transition Journey and the Road Ahead”. These include Erik Berglöf and Alex Plekhanov (EBRD) “Private sector growth in transition” and Ahmed Eiweda and Evgenij Najdov (World Bank) “Growth and sectoral reforms”.

³¹ These classifications are derived from subcomponents of the transition indicators used in the EBRD’s annual Transition Report.

projects—has, however, stalled in the past decade. These latter reforms are crucial as they are at the core of supporting enterprise development and innovation.³² They are also often more difficult to implement because of resistance from vested interests and the need for strong capacity.

Figure 9.1. Three Stages of Reforms in the CCA: Average Transition Indicators



Source: EBRD Transition Reports. Indicators are measured on a scale from 1 to 4.33; unweighted averages of eight countries.

Improvement in the business environment has been greater in the Caucasus than in Central Asia, while the financial sector and infrastructure are constraints across the region. The EBRD transition indicators show that Armenia and Georgia, and to a lesser extent Azerbaijan, have improved their enterprise sectors faster than the countries of Central Asia except Kazakhstan. Reforms in Turkmenistan and Uzbekistan remain in the very early stages. In the critical area of the financial sector, banking, insurance, and capital markets reforms generally remain limited (see also Chapters 5 and 8). Some corporate reforms, such as in agribusiness and railways, have taken hold in many CCA countries. Outside of railways, there remains an urgent need to improve infrastructure financing and provision, especially for water and urban transport.

³² This message is reinforced by the 2013 World Bank-Eurasian Development Bank report, “Diversified Development: Making the Most of Natural Resources in Eurasia”, which notes that to grow countries must develop strong asset pools of economic institutions (firms and regulators), capital stocks, and natural resources.

Figure 9.2. Medium to Large Transition Gaps in Terms of Market Structure

	Corporate Sector				Energy			Infrastructure				Financial Sector				
	Agribusiness	General Industry	Real Estate	Telecoms	Natural Resources	Sustainable Energy	Power	Water and Wastewater	Urban Transport	Roads	Railways	Banking	Insurance and Fin. Services	MSME	Private Equity	Capital Markets
Armenia	M	M	L	M	M	M	M	M	L	M	M	L	L	M	L	L
Azerbaijan	M	L	L	L	L	L	L	L	L	M	M	L	L	L	L	L
Georgia	M	M	L	M	L	M	S	L	L	L	M	M	L	M	L	L
Kazakhstan	M	L	M	M	M	L	L	L	M	M	M	M	M	L	L	M
Kyrgyz Republic	M	L	L	L	L	L	M	L	M	L	L	L	L	L	L	L
Mongolia	M	L	L	L	M	L	L	L	L	L	M	L	L	L	L	L
Tajikistan	M	L	L	L	L	L	L	L	L	L	L	L	L	L	L	L
Turkmenistan	L	L	L	L	L	L	L	L	L	L	L	L	L	L	L	L
Uzbekistan	L	L	L	L	L	L	L	L	L	L	M	L	L	L	L	L

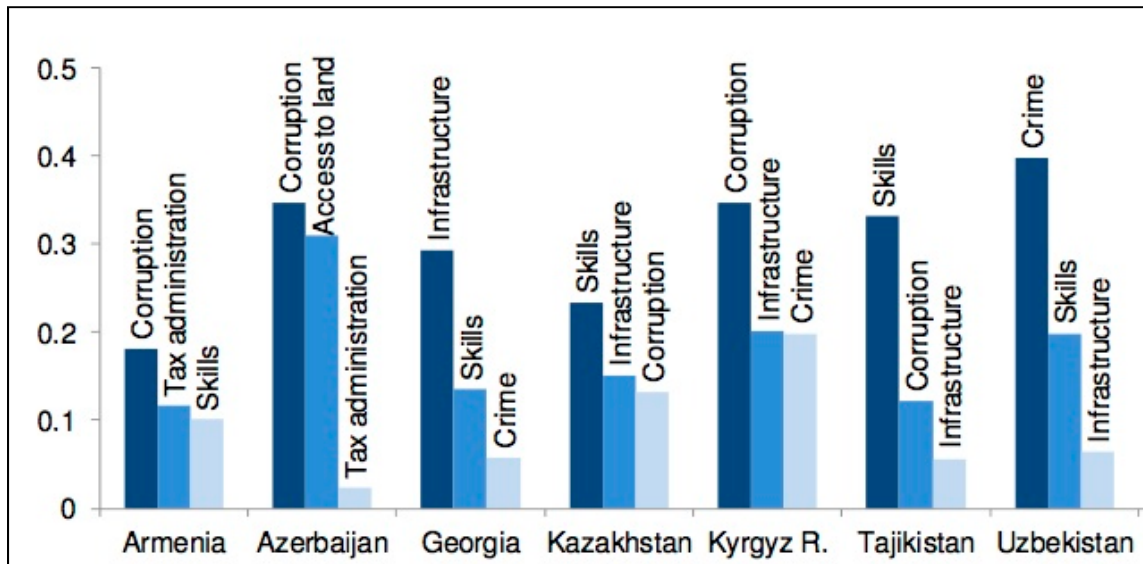
Source: EBRD Transition Report 2012. Transition gaps in terms of market structure are assessed as small (S), medium (M), and large (L).

At the firm level, joint EBRD-World Bank surveys show that corruption, inadequate labor skills, and poor infrastructure are the main obstacles to investment, to growth, and to job creation.³³

Corruption is among the leading three constraints in every country save for Georgia and is the leading constraint in Armenia, Azerbaijan, and the Kyrgyz Republic. Infrastructure was the leading problem identified by Georgian firms and among the top problems faced by businesses in Central Asia. Human capital was the main concern in Kazakhstan and Tajikistan and a major concern across most of the CCA.

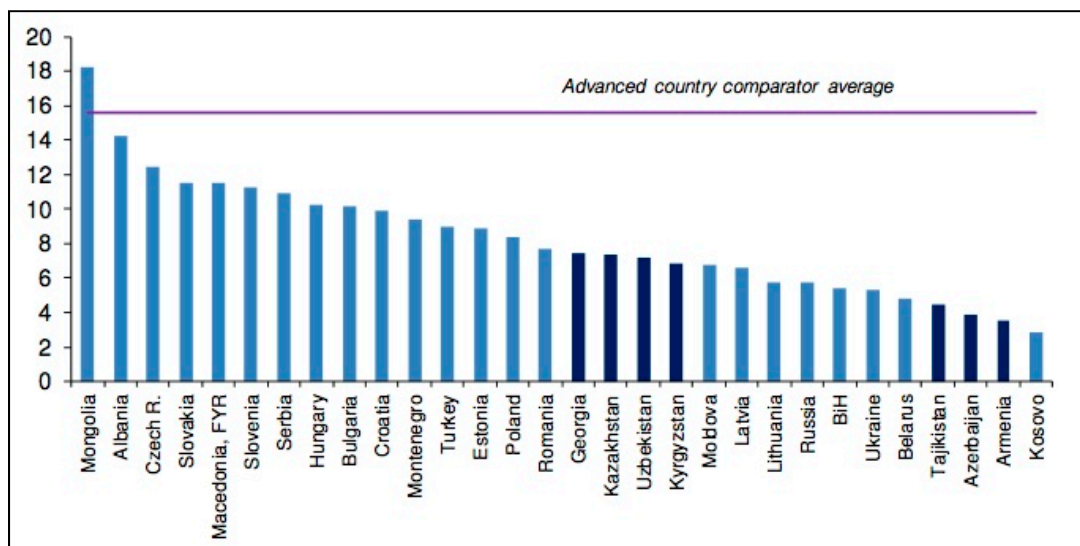
³³ From 1999–2009 the EBRD and the World Bank jointly conducted four times the Business Environment and Enterprise Performance (BEEPs) survey in 30 transition countries in emerging Europe and Central Asia. The firms sampled varied in size and included both domestic and foreign-owned firms.

Figure 9.3. Top Three Obstacles to Firms' Operations



Source: BEEPS, 2008–09.

Figure 9.4. Percentage of Respondents that Successfully Set Up a Business



Source: LiTS II.

Political Economy

While the CCA countries have generated strong economic growth and poverty reduction since the mid-1990s, the majority of the region's countries have made limited progress in improving governance. In areas such as the openness of the political system to civil society and free expression and the implementation of the rule of the law, the CCA as a whole has made limited progress and is the worst performing developing region (Figure 9.5). Political stability has improved since the mid-2000s, yet this has not translated into commitments to improve public sector management. A particular worry is that control of corruption has deteriorated after several years of improvement since 2006 and lags other regions.³⁴

Governance policy challenges vary across the CCA, with Central Asia lagging behind. Georgia has reformed the most aggressively among the CCA countries, improving the accountability of the public sector, the rule of law—in which Armenia has also made some progress, and the control of corruption with reforms that were implemented during 2004–08 (Figure 9.6). Though Kazakhstan has seen improvement in the rule of law and the control of corruption since the mid-2000s, governance indicators mainly deteriorated in the state-dominated economies and societies of Turkmenistan and Uzbekistan over the same period. Azerbaijan, Kyrgyz Republic, and Tajikistan continue to struggle with improving the rule of law and controlling corruption.

The entire region has been slow to introduce civil and political liberties. The Economist Intelligence Unit's (EIU) 2012 Democracy Index shows that five CCA countries have authoritarian governments while Armenia, Georgia, and Kyrgyz Republic have systems that mix democratic and authoritarian features.³⁵ Moreover, the EIU reports that much of the region is becoming less democratic over time, with democratization weakening in Armenia, Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan since 2006.³⁶ Freedom House rated every country in Central Asia

³⁴ The performance of the region is broadly consistent across quantitative indicators of corruption. For example, on Transparency International's latest Corruption Perceptions Index, no CCA country ranks higher than 100 out of a sample of 174 countries except for Georgia and six of the eight CCA countries rank lower than 130. See Transparency International (2012) Corruptions Perceptions Index 2012 <http://cpi.transparency.org/cpi2012/>.

³⁵ Each of the authoritarian governments is led either by the rulers who came to power during the dissolution of the Soviet Union (Kazakhstan, Tajikistan, and Uzbekistan) or by a relative (Azerbaijan) or protégé (Turkmenistan) of those rulers.

³⁶ The 2012 EIU Democracy Index ranks Turkmenistan and Uzbekistan as tied at 161 out of a total sample of 167 countries, making them among the most authoritarian countries in the world.

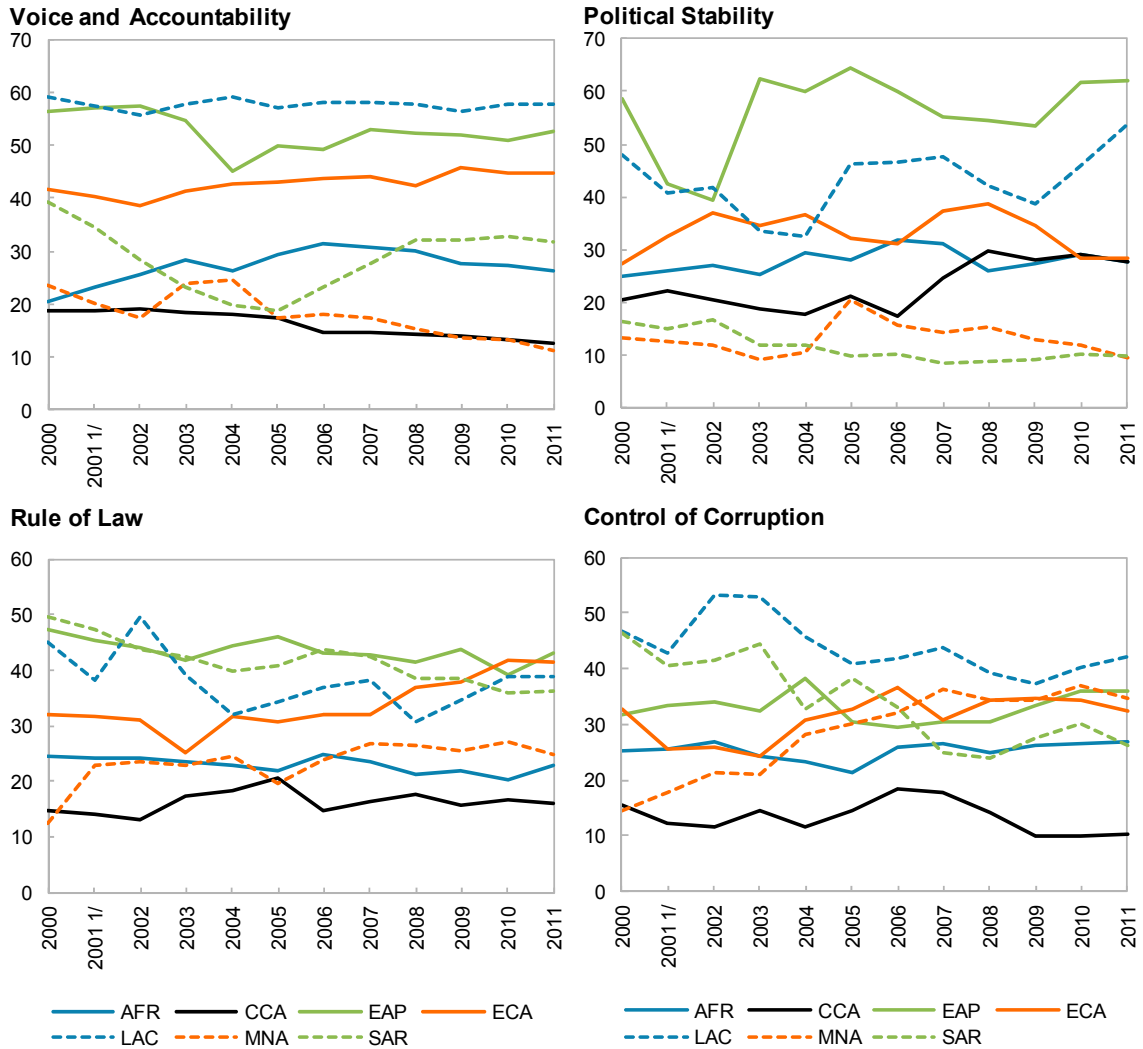
as “partly free” in 1991–92. Today, only Kyrgyz Republic retains that rating, with the remainder of CCA countries rated as “not free”.³⁷

Limited domestic political reform comes against a backdrop of difficult internal and external conflict and tension, which only further complicate the business environment. The post-Soviet period has been characterized by internal conflicts in much of the region, including the 1992–97 civil war in Tajikistan and two episodes of government regime changing civil unrest in the Kyrgyz Republic in 2005 and 2010. Cross-border tensions are also present in much of the CCA and surrounding regions. Territorial disputes are pronounced in the South Caucasus. Armenia and Azerbaijan have been in a cold war since the cessation of large-scale conflict over Nagorno-Karabakh during 1988–94 and Georgia fought a short war with Russia over South Ossetia and Abkhazia in 2008. In Central Asia, tensions are high between Tajikistan and Uzbekistan over the Rogun hydropower project and alleged environmental damage from the Tajikistan Aluminum Company (Talco). In response, Uzbekistan has interrupted Tajikistan’s gas supplies, blockaded roads and rail links with Tajikistan, and raised significantly Uzbek transit fees for Tajikistan’s cargo. Finally, the CCA region as a whole faces increasing uncertainty from the geostrategic and increasingly unstable region all along its southern frontier.

³⁷ In contrast, Freedom House rates Mongolia as “free”, showing that democratization is possible in a resource-rich country with a transition starting point similar to that of many of the CCA countries.

Figure 9.5. Governance in the CCA is Weaker than in Other Regions

World Bank Governance Indicators (Regional Medians, In Percentile Ranks, 2011)

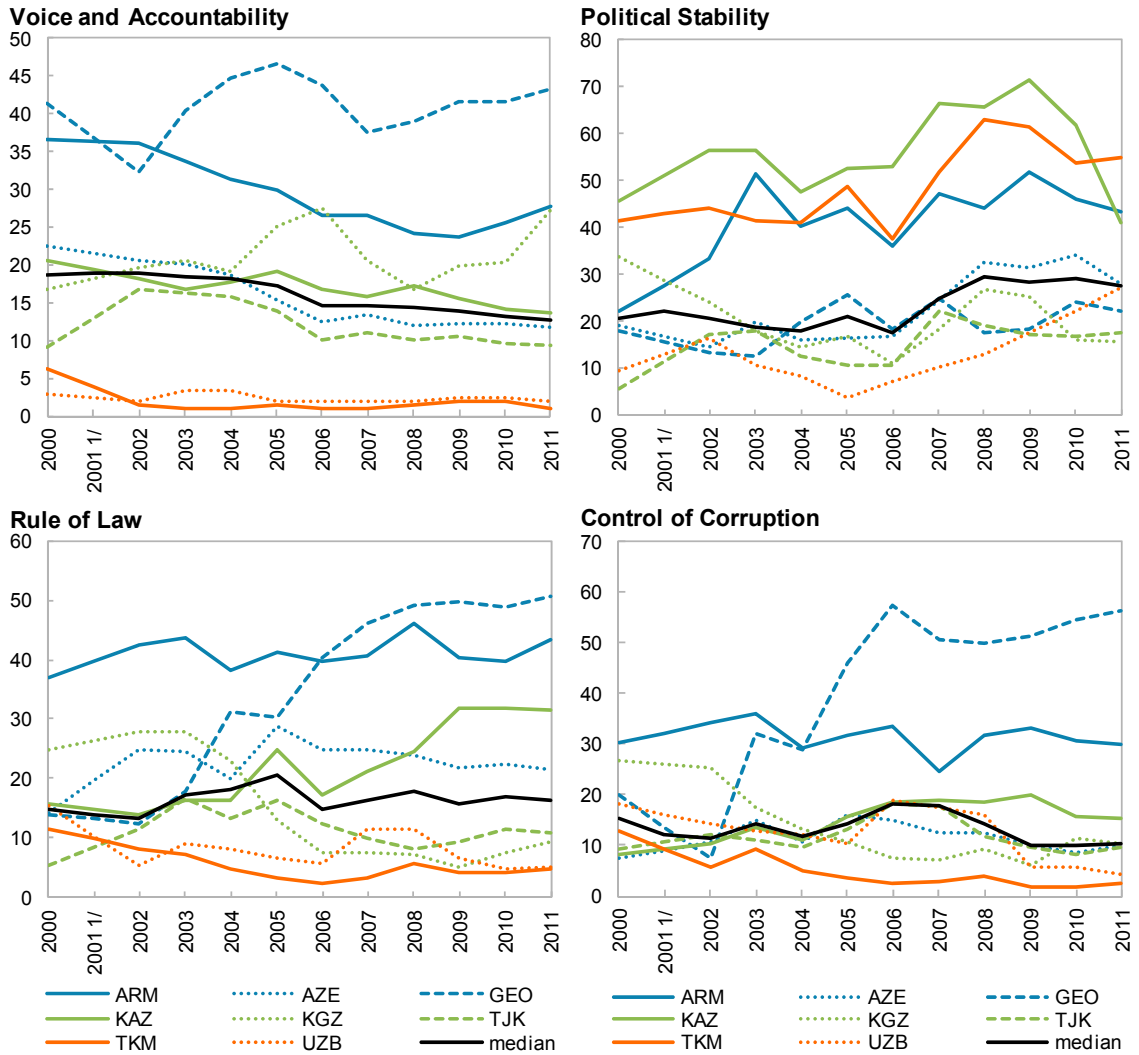


Source: World Bank Worldwide Governance Indicators. Regional acronyms are as follows: AFR - Africa, CCA - Caucasus and Central Asia, EAP - East Asia and the Pacific, ECA - Eastern Europe, LAC - Latin America and the Caribbean, MNA - Middle East and North Africa, and SAR - South Asia. Regional aggregates only include developing countries eligible for World Bank IDA save for CCA where all eight countries are included.

1/ Interpolated by averaging 2000 and 2002 observations.

Figure 9.6. Within the CCA, There is a Considerable Diversity in the Quality of Governance

World Bank Governance Indicators (In Percentile Ranks, 2011)



Source: World Bank Worldwide Governance Indicators. Regional acronyms are as follows: AFR - Africa, CCA - Caucasus and Central Asia, EAP - East Asia and the Pacific, ECA - Eastern Europe, LAC - Latin America and the Caribbean, MNA - Middle East and North Africa, and SAR - South Asia. Regional aggregates only include developing countries eligible for World Bank IDA save for CCA where all eight countries are included.

1/ Interpolated by averaging 2000 and 2002 observations.

Reform of public sector institutions is essential to consolidate past economic reforms and achieve sustainable development. Empirical evidence suggests that well-functioning political institutions matter for growth since they secure good policies even through changes in governments, and protect investors from arbitrary government decisions and expropriation. Hence, while authoritarian governments may be able to deliver predictability by avoiding the volatility of election cycles, over time risks increase as succession is contested. Among the CCA countries classified as authoritarian, succession risks are imminent in Kazakhstan and Uzbekistan and a new cycle will emerge in Azerbaijan and Tajikistan within the next five to seven years as those presidents face constitutional limits to their rule. The strong performance of the CCA region in generating growth (Chapter 2) and reducing poverty could be undone unless reforms are embedded in government institutions that offer legitimacy and stability. Current weak political and other institutions will not be able to deliver sustainable, broad-based growth and economic diversification in the longer term.³⁸

Key Steps to Ease Structural and Political Economy Constraints

CCA countries need to pursue ambitious structural reforms to deepen and sustain markets and firms. Governance mechanisms within firms and financial institutions need to be overhauled and regulatory authorities must facilitate rather than hinder market-deepening competition. Reforms are also needed to market (e.g., Public Private Partnership (PPP) laws) and political institutions (e.g., ministries) that support education and human capital development and facilitate infrastructure provision, as these factors are critical to releasing constraints to firm-level innovation and the establishment of new firms, in which the CCA lags other regions.

CCA countries should address water, energy, and regional infrastructure challenges through stronger regional cooperation. As the EBRD-World Bank firm-level surveys demonstrate, poor infrastructure is another widespread concern and constrains growth opportunities, especially in Central Asia. The World Bank highlights that most CCA countries have particularly large gaps in energy and water infrastructure and that these sectors are far from financially viable. Energy endowments also differ significantly across CCA countries and the former system of regional energy trade has largely broken down. With uneven access to water, improved management of scarce water resources is critical. Long distances and low density require an efficient and well-maintained transport infrastructure to facilitate connectivity and trade in these and other areas. All of these factors

³⁸ Acemoglu and Robinson (2012), Besley and Persson (2011), Evans (1989), Lipset (1959), Rodrik et al. (2002), and World Bank (2012 and 2013).

highlight the importance of strengthening regional mechanisms and institutions for dialog on these challenges (see Box 1 in Chapter 8). In addition, even if CCA countries are able to address country-level institutional and human capital constraints to growth, their development will remain hampered unless they address their weak regional energy and water security and poor transport links.

Broader government and political institutions (e.g., legislatures, presidential administrations, and all ministries) should be reformed to release constraints on the implementation of other structural reforms.

Stronger and more transparent political institutions will make it more difficult for powerful interests to seek rents; allow more public resources to flow to education, healthcare, and infrastructure; free regulators to enable competition and a healthy business environment rather than hinder them; and allow for better policy frameworks. This would complement better governed firms and financial institutions that should, in turn, support improved productivity and innovation, which are among the building blocks for emerging market and middle income status. All firms—including those financed through FDI—would benefit directly by facing fewer barriers from corruption, poor infrastructure, and inadequate labor skills, and these economies generally would benefit from the resolution of long-running conflicts between some CCA countries.

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