Eurasia's Next Frontier

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TWENTY years ago, following the collapse of the Soviet Union and amid heavy fighting over the disputed Nagorno-Karabakh region, the Republic of Azerbaijan faced difficult circumstances. A political crisis saw the abrupt departure of the country's president in mid-1993. Output declined by a staggering 23 percent in 1993, 20 percent in 1994, and 13 percent in 1995. Inflation raged, reaching 1,350 percent in 1993, 1,800 percent in 1994, and 500 percent in 1995. One bright note: oil exports brought $200 million to Azerbaijan in 1994.

By 2003, the situation in Azerbaijan had improved considerably. Growth had rebounded, averaging 7½ percent annually during 1996–2003. Per capita income increased fivefold, and inflation was at or below 3½ percent annually after 1997. In 2003, Azerbaijan's oil exports reached $2.25 billion.

Now, Azerbaijan's headline figures look even better. Growth averaged 13½ percent during 2003–12, and per capita income increased from $900 in 2003 to $8,000 this year. Central bank reserves stand at $14 billion—the equivalent of eight months of imports—and assets of the state oil fund, SOFAZ, add another $32 billion. SOCAR, the state oil company, has made major acquisitions throughout the Black Sea region and Europe in fuel retailing, petrochemicals, and media. Azerbaijan's oil exports are now $30 billion a year.

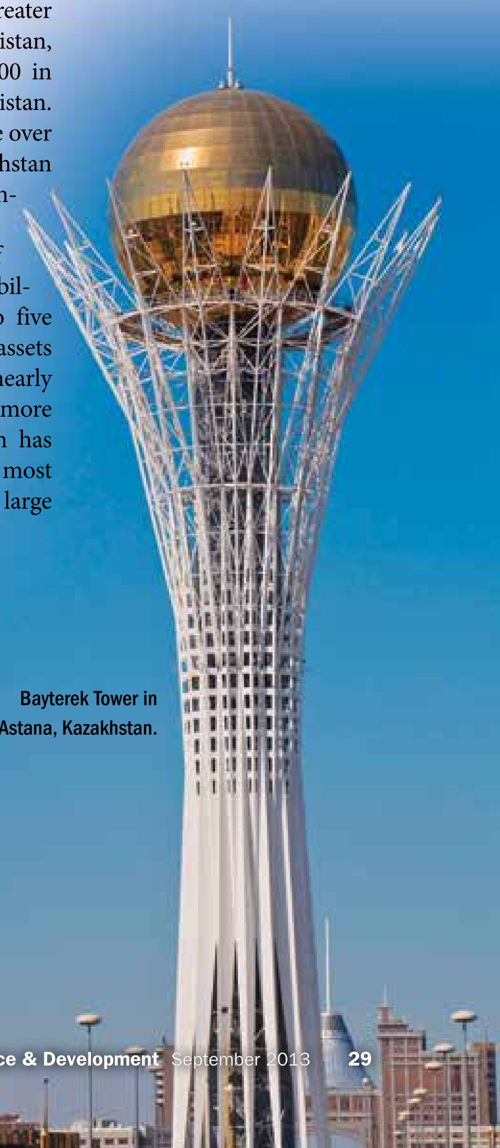
Azerbaijan is one of the eight countries of the Caucasus and Central Asia, the region bordered by China, Russia, Turkey, Iran, and Afghanistan. If the region's countries were merged into one, its land area would make it the world's seventh largest—more than four times larger than France and Germany combined. The aggregate GDP of the eight countries—approaching half a trillion dollars annually—would rank the region in the top 25 globally.

Role of natural resources

The countries of the Caucasus and Central Asia have significant natural resource endowments. Azerbaijan and Kazakhstan are among the world's 25 largest oil exporters and, together with Turkmenistan and Uzbekistan, are among the world's 25 largest exporters of gas. The region's other countries—Armenia, Georgia, the Kyrgyz Republic, and Tajikistan—do not produce oil or gas, but do benefit from the transshipment of these and exports of other commodities.

As in Azerbaijan, higher oil and gas revenues have contributed to significantly greater prosperity in Kazakhstan and Turkmenistan, with per capita income reaching $12,000 in Kazakhstan and $6,000 in Turkmenistan. These figures represent a tenfold increase over the past 15 years. Like Azerbaijan, Kazakhstan and Turkmenistan have built up substantial savings while raising income levels. Gross reserves of the National Bank of Kazakhstan amounted to nearly $30 billion at the end of 2012—equivalent to five and a half months of imports—while assets of the country's National Fund were nearly $60 billion. Together, these represent more than 40 percent of GDP. Turkmenistan has run substantial overall fiscal surpluses in most years, allowing it to build up similarly large central bank and fiscal reserves.

For the Caucasus and Central Asia, natural resource wealth holds the key to achieving emerging market status



Bayterek Tower in Astana, Kazakhstan.

What explains the success of the Caucasus and Central Asia's oil and gas exporters? Favorable oil and gas prices over the past decade have certainly played a role. But western, Russian, and Chinese oil and gas companies have also brought expertise and capital to Azerbaijan, Kazakhstan, and Turkmenistan, taking an active part in the development of their hydrocarbon sectors. The three countries have also worked with other countries in the region to develop new transportation routes for oil and gas exports.

Wealth begets wealth

In addition to these factors, Azerbaijan, Kazakhstan, and Turkmenistan have also generally followed good practices in managing their resource revenues. The three countries follow fiscal rules (that is, formal or informal constraints on fiscal policy through numerical limits on budget figures) and have established savings funds to help insulate their domestic economies from volatile oil and gas revenues. These funds accumulate substantial savings when oil and gas prices and exports are high, and help ensure that the spending of commodity revenues is relatively smooth and stable when oil and gas prices decline or when other shocks hit (see "Extracting Resource Revenue" in this issue of *F&D*). To ease the impact of the 2008–09 global financial crisis, for example, these savings were tapped.

In Kazakhstan, the savings fund receives 90 percent of income taxes, royalties, and shares from production-sharing agreements directly from the oil sector. The savings fund is managed abroad by the National Bank of Kazakhstan on behalf of the Kazakh government, with annual spending capped at $8 billion (about 4 percent of GDP), all of which goes through the budget. Other fiscal indicators are subject to legislative requirements or rules. These include a floor on the minimum balance of the savings fund (20 percent of the current year's GDP) and on the budget deficit net of its transfers, as well as a rule that caps interest payments on government debt at the interest earnings of the savings fund.

Azerbaijan follows an ad hoc rule to save about half of its oil revenues abroad in its state oil fund. In 2005, Azerbaijan and its savings fund became the first in the world to issue a report under the Extractive Industries Transparency Initiative (EITI), a global standard that promotes revenue transparency and accountability in the extraction sector. Azerbaijan's savings fund operations are fully consolidated with the state budget, which is key to ensuring full coordination of fiscal policy. (In some countries, spending of oil revenues is not aligned with budgetary spending, giving the finance minister little control over fiscal policies.) Regular audits of the savings fund's operations by leading international audit companies are made public.

Twenty years of transition

Besides improving resource management, the region has had other achievements since independence. This year marks 20 years since the countries of the Caucasus and Central Asia introduced their own national currencies, and more than two decades of transition from the Soviet planned economy. After an initial period of sharp dislocation and turbulence, growth in the region has averaged 7 percent a year since 1996, faster than in virtually any other region of the world. The oil and gas exporters grew by an annual average rate of nearly 8 percent, compared with 6½ percent a year in the region's four other countries.

In all eight countries, inflation fell sharply and has remained in the single or low double digits. Fiscal deficits and debt levels were reduced significantly in the decade leading up to the 2008–09 global financial crisis, reflecting natural resource revenues but also improvements in fiscal institutions, especially public expenditure management and control systems. Income levels increased rapidly, and poverty was reduced.

However, there are also gaps in these countries' track records and major challenges going forward.

With the development of the hydrocarbon sector, dependence on oil and gas exports has grown over the past decade. Hydrocarbons now account for 45 percent of Azerbaijan's GDP and more than 90 percent of its total exports, up from 60 percent 15 years ago. Oil and gas exports also constitute more than 90 percent of Turkmenistan's exports. Kazakhstan is more diversified, with oil and gas amounting to 10 percent of GDP and 60 percent of exports. This dependence has increased vulnerability to swings in global oil prices, such that the region's growth and inflation rates have been among the most volatile in the world. Savings funds have helped moderate this volatility, but not fully.

Rapid growth over the past 15 years has also helped raise overall incomes, but it has not generated significant increases in employment or reduced inequality. This phenomenon reflects the fact that the oil and gas sectors—the main drivers of high growth—are highly capital intensive and do not require much labor. Generally difficult business climates have also constrained non-oil investment and job creation. Moreover, high oil revenues have not translated into improved indicators for health and education, as public spending in these areas remains relatively low, and outcomes lag other countries with similar per capita income levels. In addition, significant infrastructure gaps (for example, roads, water, and communications) have not been fully addressed.

Revenue management issues

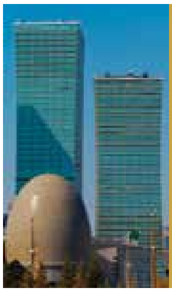
While the Caucasus and Central Asia's oil and gas exporters have followed some good practices in managing their natural resource revenues, there are also shortcomings.

The non-oil fiscal deficit, which excludes hydrocarbon-related revenues, is quite large in Azerbaijan, at more than 40 percent of non-oil GDP. This is a source of concern, given the country's relatively short expected duration of large-scale oil and gas production before output begins to decline. This means that Azerbaijan will need to find sources of revenue that are not linked to oil and gas or reduce spending—or both. The non-oil fiscal deficit is also large in Turkmenistan, but the country's reserves are significantly larger than those of Azerbaijan, giving it more of a cushion.

Moreover, while Azerbaijan and Turkmenistan have not significantly strengthened social indicators or resolved infrastructure gaps, domestic spending levels have contributed to stronger real exchange rates, putting pressure on other exporting sectors. And wages have increased faster than productivity.

Recent IMF consultations with Azerbaijan and Turkmenistan have raised concerns about high levels of investment spending and the need to improve the planning, evaluation, and efficiency of these outlays. In Kazakhstan, significant expenditures are carried out through public-private partnerships and extrabudgetary institutions, notably the giant state investment holding company Samruk Kazyna. This raises questions about the coordination of fiscal policy with the budget, as well as about transparency and potential contingent liabilities. Finally, the transparency of Turkmenistan's oil- and gas-related funds—and, indeed, of Turkmenistan's economy more generally—is quite limited.

Some of the factors that have contributed to the successful development of natural resources in the Caucasus and Central Asia have been much less evident in other sectors. Foreign direct investment and involvement by major global firms have been limited outside the resource sector (except in telecoms).



Growth has averaged 7 percent a year since 1996, faster than in virtually any other region.

Foreign investment is important to help drive diversification and bring technology, management practices, and nondebt financing to sectors outside the realm of natural resources, but stronger business environments are needed in the region to attract foreign investment and spur domestic investment.

In addition, although exports of oil and gas have relied on major investments in cross-border pipelines, regional cooperation has been less visible in other sectors. Over the past decade, trade between most countries in the Caucasus and Central Asia and other countries in the region has declined as a share of total trade, and there are few signs of intraregional cross-border investment.

The low levels of regional cooperation stem in part from the fact that, although major roads in the Caucasus and Central Asia are being upgraded and maintained, many corridors are characterized by inefficient border crossings and detours around disputed areas. Regional infrastructure for electricity trade has also deteriorated, and water management systems have become less efficient. These problems highlight the need to improve public expenditure management, increase the efficiency of spending, and tackle corruption.

The road ahead

While the region has generally performed well over the past 20 years, further progress is needed to sustain strong growth and make it more diversified, inclusive, and resilient to shocks. An ambitious-but-realistic vision is that the region's countries can use their natural resources to become dynamic emerging market economies over the next decade.

Cross-country evidence suggests that diversification is strongly associated with sustained improvement in living standards, and the region's energy-rich countries should aim to use their resource wealth to diversify their economies. Of course, diversification is a major challenge for hydrocarbon exporters, not only in the Caucasus and Central Asia but also worldwide, and there are few clear success stories or formulas to follow. A starting point is to make clear the challenges that energy exporters should tackle and the mistakes they should avoid.

At a minimum, these governments must address the efficiency of resource use and spending and the transparency with which such spending choices are made. While some of the region's countries adhere to international standards like the EITI, the efficiency of public spending and its transparency are not up to international standards. This is seen in the limited progress the countries have made in addressing infrastructure gaps, despite high investment spending. Public spending should also be supported by stronger mechanisms to evaluate efficiency, ensure effective implementation, and limit corruption.

Making sure that growth is strong, diversified, inclusive, and resilient will require action in other policy areas. It is critical to improve access to finance for the nonresource sectors, including small and medium-sized enterprises. In the fiscal sector, actions include limiting inefficient activities (such as the provision of energy subsidies) and bringing public financial management and revenue administration practices closer to international best practices. In the monetary and financial area, actions should target reduced government intervention and ownership, stronger central bank independence and communications, and greater exchange rate flexibility. Across the board, major efforts are needed to reduce administrative barriers and corruption that stifle competition and lead to the inefficient use of public resources.

The experience of the past decade underscores, however, that it is far easier to come up with a to-do list of measures than it is to see them implemented. Obstacles—and risks—to achieving the vision of becoming dynamic emerging market economies over the next decade are significant.

They include external vulnerability to commodity price movements, weak regional integration, and geopolitical challenges, such as tension between countries in the region and the withdrawal of western forces from nearby Afghanistan in 2014. Finally, there are serious domestic issues, such as vested interests, weak institutions, and limited political channels for voice, accountability, and policy debate.

The potential payoff is large and would see the countries of the Caucasus and Central Asia moving beyond their success in natural resources to greater and more diversified success. Only then can they take full advantage of their considerable human capital resources and their strategic location at the crossroads of Europe, Asia, and the Middle East. ■

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This article is based on a May 2013 conference in the Kyrgyz Republic on the lessons of the post-Soviet transition and future challenges (see www.imf.org/external/np/seminars/eng/2013/cca/).