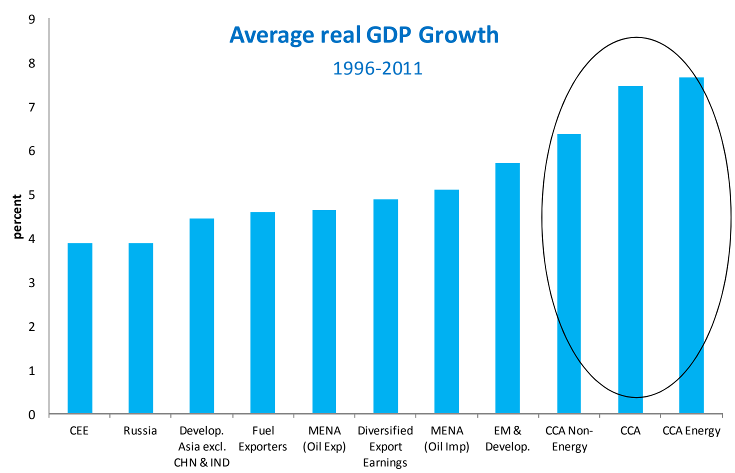
DRAFT 5/12/2013

2013 Caucasus and Central Asia (CCA) Conference
Economic Growth: Moving from Transition to Emerging Markets in the Next Decade

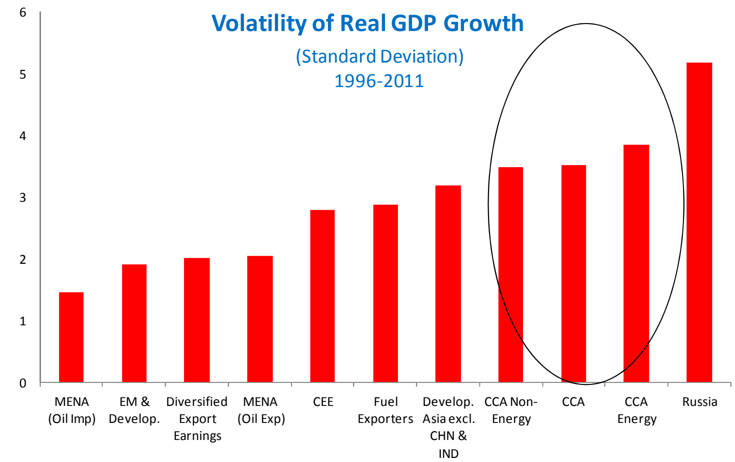
Over the past 15 years, growth in the CCA region has been strong, but quite volatile and uneven. It has been largely driven by commodity and labor exports and has not been supported by regional economic integration. In the next decade, the CCA economies should strive to achieve stable and sustainable growth. If this objective is met, they can expect to become dynamic emerging markets. There are many obstacles and risks to this vision though. Some of these are exogenous (EU spillovers through Russia, Afghanistan 2014) but others, largely linked to macroeconomic policy choices, are under their own control (weak financial, monetary, and fiscal frameworks--including management of resource wealth; difficult business environments that limit investment and job creation, contributing in some cases to large out migration; and poor regional integration). This note reviews the growth experience and vulnerabilities faced by CCA countries; lays out a vision for these countries for the next decade; suggests key macroeconomic policy choices that can be improved to support more stable growth and to mitigate associated risks; and quantifies potential gains from enhanced macroeconomic policies in the CCA region.

Successes and Challenges

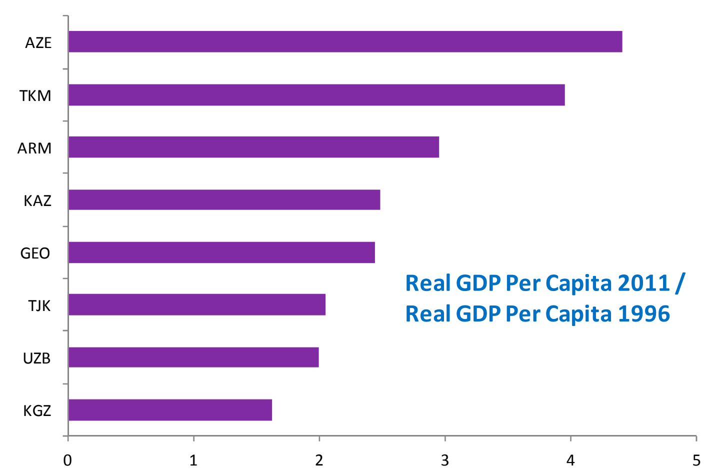


CCA countries grew more rapidly during 1996 – 2011 than other comparable groups of countries. Average real GDP growth totaled 6.4 percent for oil importers and 7.7 percent for oil and energy exporters bringing the CCA region's average growth to 7.5 percent. High growth largely reflects a rebound from transition, untapped natural resources, and high initial physical and human capital. Azerbaijan and Turkmenistan grew the fastest over the period owing to the large shares in GDP of the fast-growing energy sector and also the steep pick-up in their non-energy GDP.

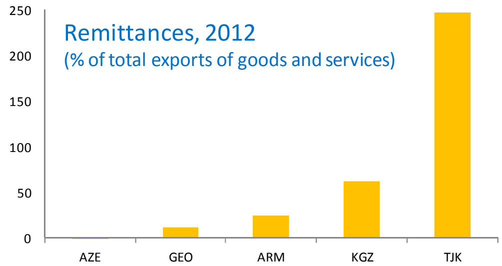
At the same time, growth in the region has **exhibited more ups and downs than in most other countries.** This volatility is explained by: (i) the specialized structure of the economies they inherited from the Soviet period, which were no longer connected to each other in a large, open and integrated 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 remittances.



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 in the CCA region likely reflects their relatively strong economic policy frameworks, which have helped them achieve low inflation, keep debt down, and attract substantial FDI.

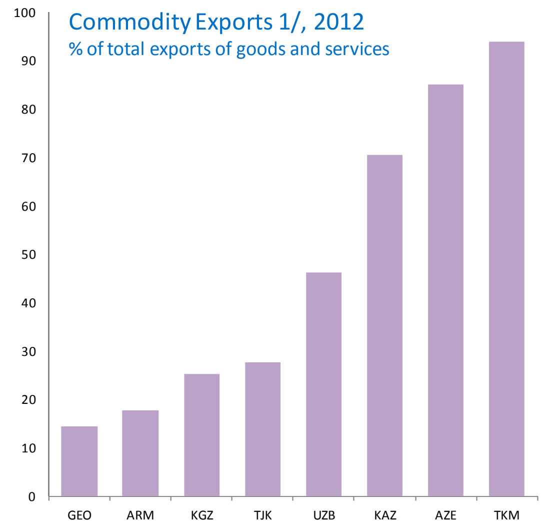


Growth in the region has been driven by commodity and labor exports, leaving many CCA economies highly undiversified. Commodity exports constitute over 60 percent of total exports in Kazakhstan, Azerbaijan and Turkmenistan, and fiscal revenues from these exports are over 40 percent of total revenues.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



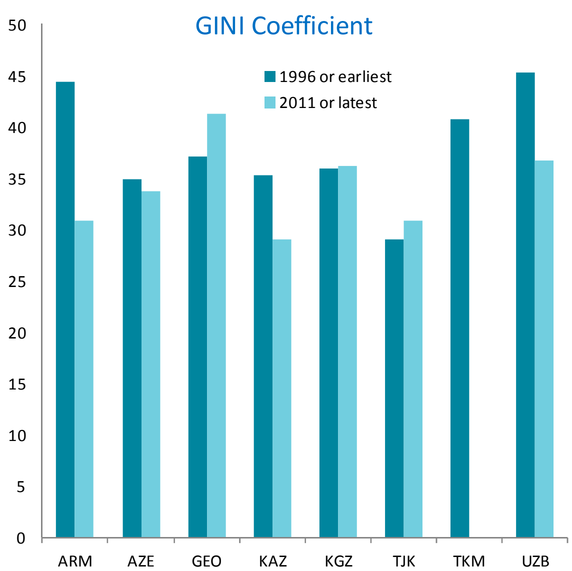
Source: WEO

Source: Country authorities, staff estimates and WEO

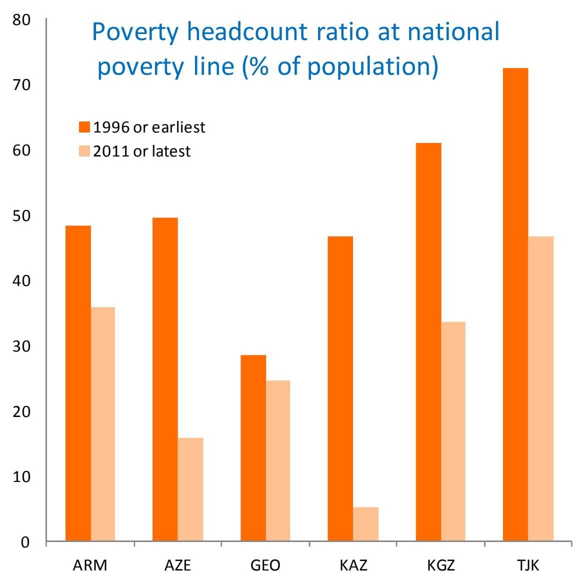


Source: Country authorities, staff estimates and WEO
1/ Includes oil, gas, precious metals, aluminum, copper, other metals, metal byproducts and cotton.

CCA countries have also exhibited mixed performance in achieving inclusive growth. Income inequality has decreased only marginally, or has even increased, despite high growth, as illustrated by the Gini coefficient. Poverty reduction has faced mixed success, with dramatic improvement observed in Azerbaijan and Kazakhstan and less progress in Armenia, Georgia and Tajikistan.

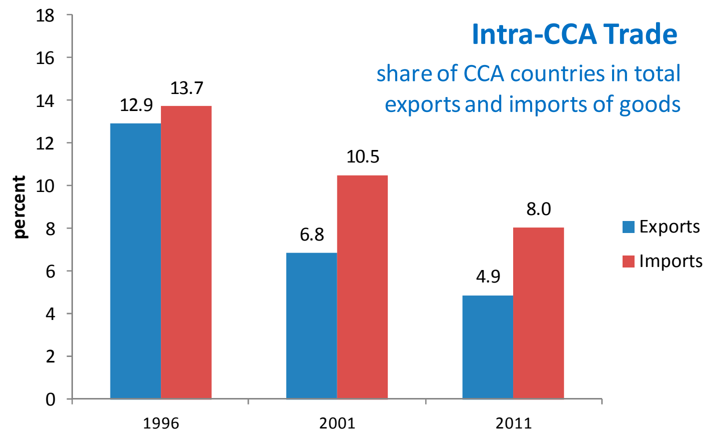


Source: World Bank
Recent data for UZB is 2003. There are no recent data for TKM.



Source: World Bank
No data exist for TKM and UZB.

And good growth performance has not been supported by greater regional integration. 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 higher barriers to trade and a general weakening of regional economic ties.



Source: IMF Directions of Trade statistics

The Vision

In the coming years, CCA economies face the challenge of achieving stable and sustainable growth. The objectives for CCA countries going forward should be to:

- Maintain or accelerate high growth;
- Reduce the volatility of growth and make it more inclusive;
- Achieve more even growth across the CCA region;
- Increase economic diversification supported by structural transformation.

This can be achieved through structural transformation to diversify their economies and greater regional cooperation to support shared growth across the CCA region.

If these objectives are successfully met, CCA countries may be able to become dynamic emerging markets in the next decade. Their economies should ideally be characterized by (i) high rates of investment, both domestic and foreign, in a range of sectors and not only in the resource sector; (ii) well-diversified output and exports; (iii) sustainable and less volatile growth; and (iv) strong gains in per capita income.

There are many obstacles and risks to this vision. CCA countries face, a number of challenges to the successful implementation of deep, second-generation reforms that would lay the foundation for sustainable growth and allow them to reach emerging market status. Domestic challenges include:

- Weak institutions and lack of accountability;
- Strong vested interests and potential political instability.

External challenges arise from:

- Vulnerabilities to commodity price movements, in particular food and fuel prices, and EU crisis spillovers through Russia;
- 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) and the roles of China and Russia in the region.

Policy Actions to Support the Vision

Let us now turn to the macroeconomic policy measures that can be taken by CCA countries to move themselves toward dynamic emerging markets status and to help offset the effects of the many challenges and risks that they face

CCA countries should seize the current opportunity of strong export commodity prices and stable food prices to strengthen their policy frameworks and economies. To support the vision of becoming emerging markets, CCA governments will need to:

- *Strengthen macroeconomic policy frameworks (fiscal and monetary) and financial sectors:*
  - Stronger fiscal frameworks—including around energy wealth—would stabilize and support revenue and allow governments to deliver in a sustainable way on their core functions.

    - 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, 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.

- *Implement structural reforms to improve business climates.* A stable macroeconomic environment in conjunction with strong structural reforms would drive investment, diversification of output, and job-creating inclusive growth.

- *Address energy and water security through regional cooperation*. Improved regional cooperation would support growth through greater trade and through enhanced energy and water security for all CCA countries.

Potential Payoff from Achieving the Vision

There is significant potential payoff to CCA countries from taking strong actions to improve 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[1].

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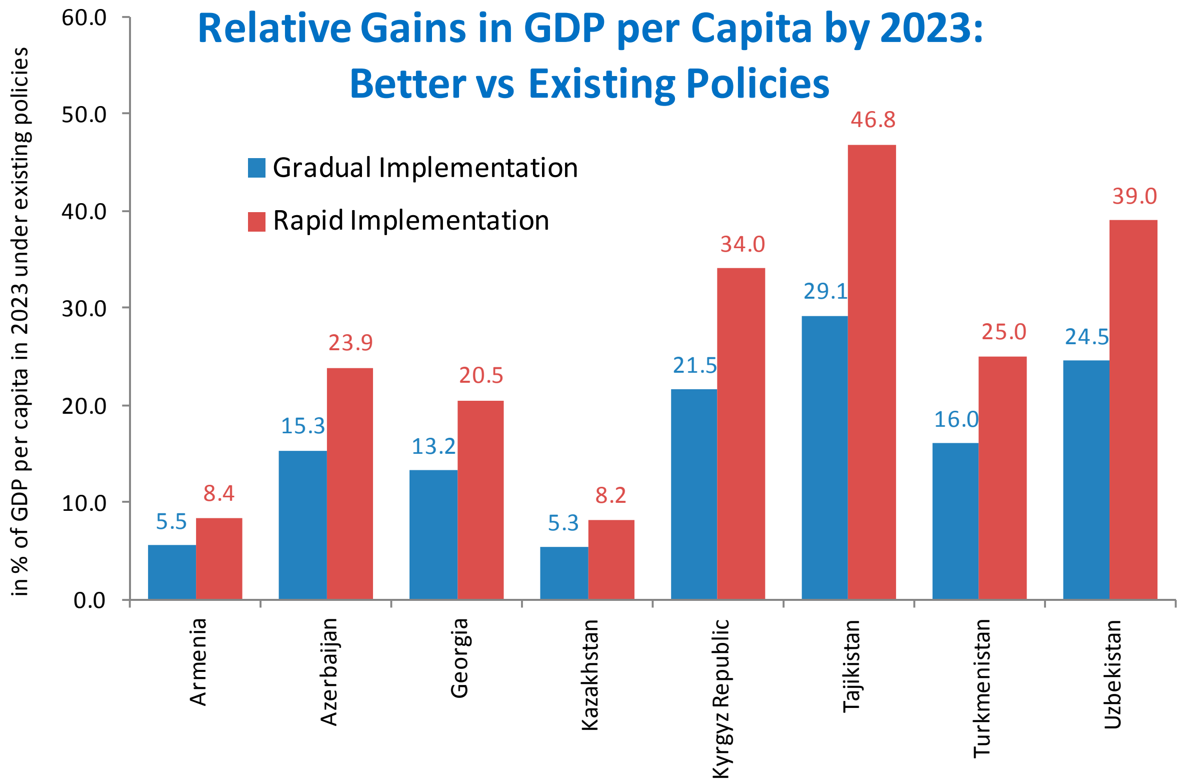
[1] See World Bank Governance Indicators available at http://info.worldbank.org/governance/wgi/pdf/ge.pdf



For example, with gradual improvement in government effectiveness over the next decade to the global average, most CCA countries could raise per capita GDP by 15-30 percent relative to expected outcomes under current policies. With more rapid improvement, these gains could be in the range of 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.

DRAFT 5/12/2013

MONETARY POLICY CHALLENGES AND VISION—BACKGROUND NOTE FOR THE CCA CONFERENCE

1. Monetary policy has made a significant contribution to growth and economic stability in the region over the past 20 years.

By the mid-1990s, countries in the CCA were facing very high inflation and interest rates, and their financial systems were quite underdeveloped. Sounder macroeconomic policies, and monetary policy in particular, played a key role in achieving progress in all these areas.

Today, the regions' inflation and nominal interest rates are much lower, and its financial system has become much more developed. In particular:

National central banks have been established, with varying degrees of independence.

Inflation rates have declined from triple-digits in the mid-1990s to single-digits in most of the countries. While in some countries inflation has reached double digits in recent years, it has typically been below 15 percent.

Nominal interest rates have also declined significantly.

The depth of the financial sector has more than doubled since early 2000, broad money rising from 10-15 percent of GDP to 30 percent of GDP.

2. Despite these significant successes, there is still room for improvement:

Inflation in the region, while lower, remains volatile which adds uncertainty to saving and investment decisions. While part of this volatility is due to volatility in commodity prices, domestic policies have also played a role.

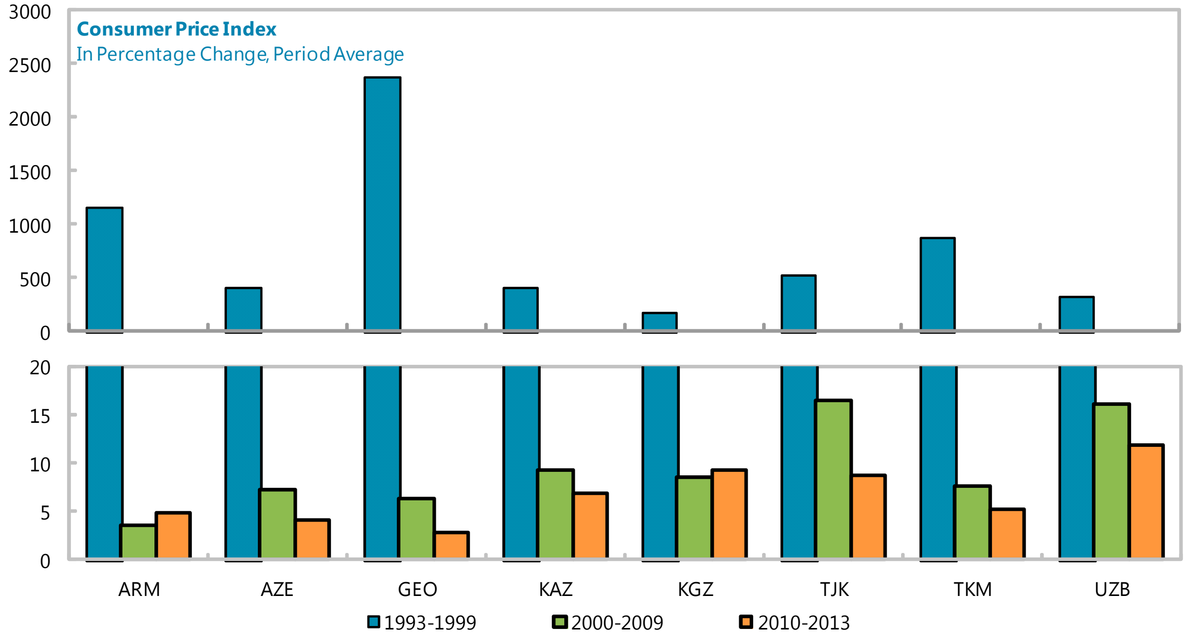
Real interest rates and interest rate spreads remain high at around 15 percent, and have increased since the beginning of the global financial crisis.

Monetary conditions have been procyclical. At times of rapid growth interest rates have been low; in recession, interest rates have been too high – this destabilizes the economy.

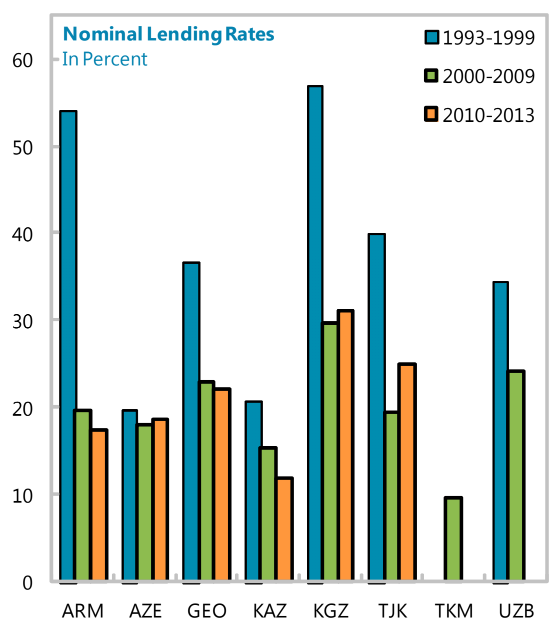
The financial sector remains heavily dollarized. Dollarization had been declining during the last decade as economic stability gained ground. But that trend was reversed in the late 2000s, as the global crisis hit the CCA. Dollarization exposes countries to balance sheet losses in case of disorderly exchange rate adjustments and also weakens the transmission mechanism of monetary policy. Central banks need substantial international reserves if they are to act as lender of last resort.

Figure 1. CCA Monetary Policy – Successes

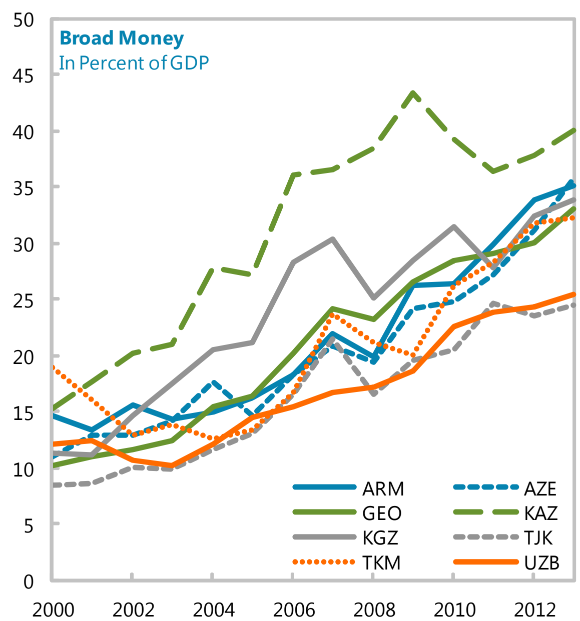
Inflation in the region has come down significantly…



… so have interest rates …

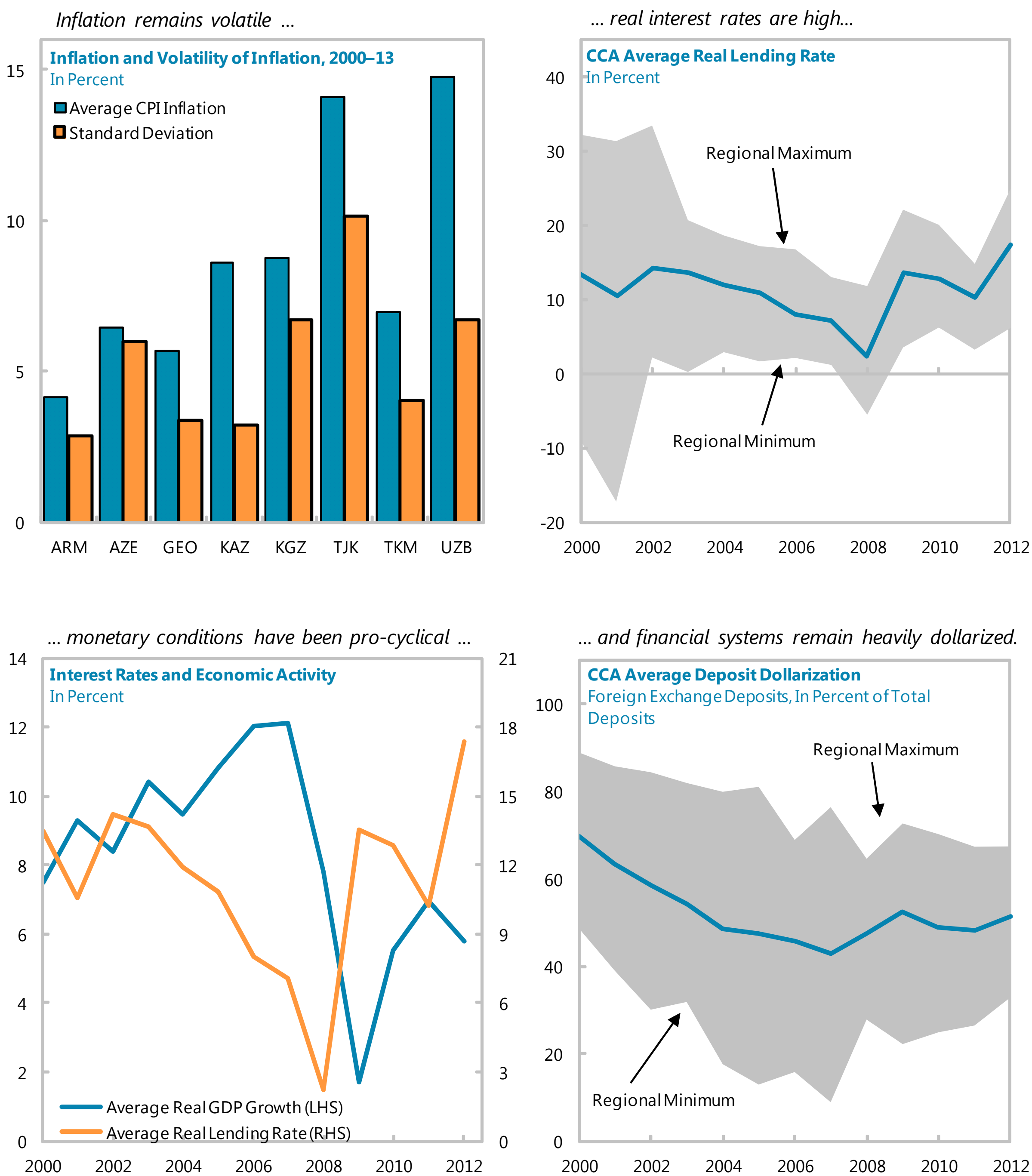


… and financial sectors are now much deeper.



Source: National Authorities; IMF WEO; IMF IFS; and IMF staff estimates.

Figure 2. CCA Monetary Policy – Challenges



Source: National Authorities; IMF WEO; IMF IFS; and IMF staff estimates.

3. Looking ahead, CCA countries need to articulate a vision for monetary policy—consolidating stability, enhancing flexibility, and supporting medium-term growth

Over the next ten years, the region should strive for a monetary policy framework in line with best practice in advanced emerging markets. Three goals stand out:

- **Stability -** Consolidate the gains in terms of inflation reduction, so that price stability becomes engrained in the expectations of economic agents.

- **Flexibility –** Help the economy respond to external shocks—such as commodity prices—but also to domestic cycles. For this, it is important to have the capacity to run countercyclical monetary policy. Also, it is important to reduce the dollarization of the financial system, so that exchange rate movements do not produce large 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 allocation of credit across the economy (including through having access to foreign financing).

Design of the framework will vary according to country characteristics and how advanced each of them is in terms of these objectives.

4. Attaining the Vision

For all of our CCA countries:

- We need to improve data quality and our forecasting models – otherwise monetary policy is flying blind.

- We need to strengthen the transmission of monetary policy – by introducing monetary instruments, by strengthening the use of local currency, by reducing the influence of the dollar in our economies.

- We should strengthen central bank independence. Many of our countries have independence by law but are less independent in practice, facing political pressure, over exchange rate policy, to be lenient when regulating banks, or to be blamed if the central bank were to run losses.

Countries with more Flexible Exchange Rates

Have made significant progress in their monetary policy frameworks and monetary operations. This includes developing complex forecasting models to inform policy decisions, and better control of monetary policy tools. But further work is needed to realize the vision:

- It is important to continue improving price statistics, including improvement in inflation series and data on inflation expectations.
- Forecasting models should be further improved, including customizing them to capture local conditions.
- Further strengthening of the central bank's communication strategy (via press conferences, detailed inflation reports, etc) will improve accountability and monetary policy credibility.
- Improve the transmission mechanism of monetary policy through further deepening of financial sectors and be de-dollarizing the economy (to give the exchange rate channel more freedom to work)

De-dollarization can be encouraged by:

- Improving 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)
- Encouraging banks to issue long term certificate of deposits (in local currency), to increase the stability of local currency funding
- Higher reserve requirements on FX funding
- Higher risk weighting of FX loans (for capital requirements computation)
- Higher liquidity ratio for FX assets/liabilities

Central banks need to clarify their objectives, and be more open in coming to terms with their "fear of floating":

- If choosing "pure" inflation targeting, countries need to strengthen their commitment to exchange rate flexibility (and this is needed in order to achieve the price objective)

- When choosing “flexible” inflation targeting, for example if keeping also an exchange rate objective (which can be done when integration within international capital markets is not full), central banks need to be upfront about it. Acting on such objectives, while denying them, causes confusion and undermines the success of the central bank.

Challenges for Countries with More Managed Exchange Rates

All of the region’s oil and gas exporters maintain some form of managed exchange rate. These countries share some challenges with the region’s energy importers, particularly in improving data and forecasting capacity and improving the transmission channel for monetary policy.

Yet, these countries also have some unique challenges arising from their exchange rate regime and reliance on natural resources:

- Resource exporters with managed exchange rates are prone to unique distortions that require enhanced management of liquidity under fiscal and BOP dominance and especially close coordination between monetary and fiscal authorities.

- Given the reliance of energy exporters’ spending on resource revenues, monetary policy faces greater challenges. Balance of payments surpluses and the transfer of oil export receipts to the budget result in large liquidity surpluses in Azerbaijan and Kazakhstan, which are difficult to sterilize.

Central banks should make clear the trade-offs between the conflicting goals that their monetary policy faces: ensuring price stability, supporting the nominal exchange rate and contributing to the competitiveness of non-energy exporters and promote diversification. Kazakhstan balances the objectives of an inflation goal of 6-8 percent while maintaining the Tenge/USD rate within a tight band. Azerbaijan also targets price stability while ensuring a near fixed parity between the Manat and USD. Central banks should be clear on how these objectives are traded off if they come into conflict.

Countries should prepare for possible greater exchange rate flexibility. Laying the ground work now, including by building capacity, can improve the effectiveness of monetary policy, deepen the financial sector, and give the authorities options to adjust their exchange rate policy in the future, if needed.

DRAFT 5/15/2013

2013 Caucasus and Central Asia (CCA) Conference: Note on CCA Financial Sector

Financial intermediation in the CCA countries has deepened since independence. Most notable reforms took place in the first decade, when the pillars of a modern financial system were put in place. Over the next 10 years CCA countries should aspire to reach dynamic emerging market status and aim to develop a competitive banking sector and create non-bank financial institutions that support private-sector-led growth. The financial system should follow international standards of regulation and supervision to strengthen financial intermediation and increase contribution to economic growth.

After Twenty Years of Transition

The financial sector of CCA countries, mostly dominated by banks, has registered some notable achievements since independence, with most progress made in the first decade. A commercial banking system has been instituted and main supervisory framework put in place. Modern retail payment systems have been created and Real Time Gross Settlement (RTGS) systems have become operational in most countries. International Financial Reporting Standards (IFRS) have become mandatory. Reforms on accounting and auditing standards supported the development of financial sector. Foundational elements of regulation and supervision of capital markets, investment funds, insurance sector, and private pension funds, including the responsibility for setting accounting and auditing standards, were also put in place. The framework for microfinance has been improved and the number of microfinance institutions and credit unions has grown rapidly. In some countries, stock exchanges and non-bank financial institutions are important players in the money markets. Anti-Money Laundering and Combating Financing Terrorism (AML/CFT) legislation has been adopted and implementation started. Reform momentum was lost, however, in 2000s, after the regional financial crisis in 1998.

Table 1. Deepening of Banking Intermediation in the CCA, 1996–2012

	1996	2002	2012
	as a share of GDP		
M2	9.6	14.1	26.4
Credit to Private Sector	4.3	9.8	20.7
Deposits *	4.6	6.4	19.4

Sources: WDI, IFS, authorities data, staff calculations.
* data for 1997 and selected CCA countries.

After initial reforms, less has been achieved in recent years, and financial sector development and intermediation remain relatively limited.

- The progress in banking sector in the CCA region has been slow relative to its peers. EBRD transition indicators imply uniformly weak progress in many aspects of financial sector reforms: development of banking and non-banking services; capital market; private equity; and access to financing (Figure 2).
- The financial systems are shallow and credit intermediation to the private sector is low compared with other transition economies (Figure 3).
- Significant footprint of the state in the banking sector remains, as government ownership in banks is wide-spread and practices of direct lending to preferred borrowers continue to prevail. This limits adequate access to financing for stimulating private-sector-led growth.
- Bank assets and foreign participation in CCA banks are also low.
- The system is still functioning through a large informal economy with strong preference for holding cash and dollar assets. (Table 3).

Figure 2. State of Financial Sector Reforms

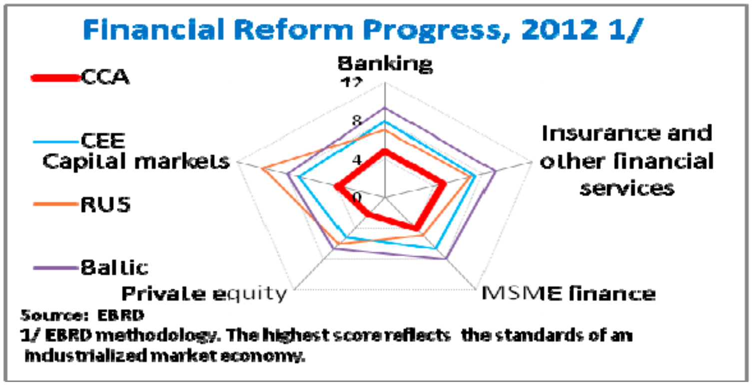


Figure 3. Shallow Financial Intermediation

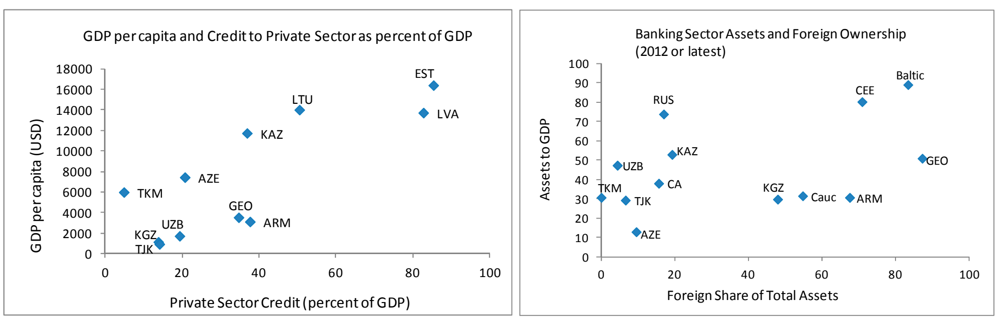


Table 3. Financial Intermediation: CCA and Other Groups of Countries

(in percent)

	CCA Average			Low Income	Middle Income	High Income
	2005	2010	2012	2009	2009	2009
Banking sector total assets/GDP	29.3	36.7	44.7	32.0	50.7	128.9
Banking sector total deposits/GDP	10.6	15.6	19.4	26.3	51.3	110.5
Bank Credit to private sector/GDP	12.4	17.4	20.7	19.6	40.6	117.3

Key Obstacles

Barriers to effective financial intermediation are high. First, 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 1998 financial crisis put a dent to market confidence (Figure 1). Many households and businesses (especially SMEs) avoid official financial systems. This has been compounded by excessive state intervention, lack of central bank independence, opaque ownership of local banks, and excessive connected lending. 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. Even with progress in supervision and regulation, banks continue to operate in an overly risky environment with inadequate protection of creditor rights, and tax authorities imposing improper functions on banks in some countries. These factors have contributed to continued lack of financial infrastructure and financial markets. The system remains largely closed to foreign direct invetsment, leaving unclear the possibility of sustainbable acceleration of financial sector in the CCA. Compounding this is insufficient provision of information and unsupportive legal environments.

Figure 1. Low Confidence in Financial System

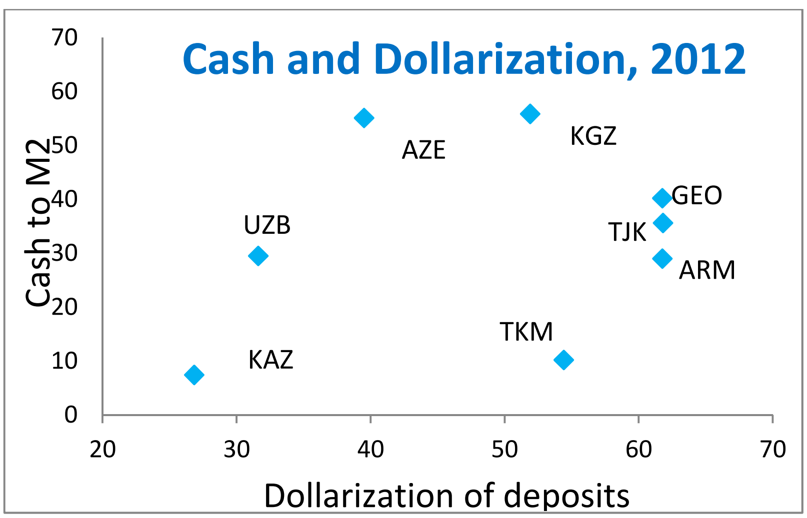


Table 2. Banking Risk Perception Remains High

	CCA Average		
	2005	2010	2012
Currency outside banks / M2	62.4	48.7	43.9
M2/GDP	13.4	23.0	26.4
Lending-deposit spread, domestic currency	11.0	12.5	14.6
Lending-deposit spread, foreign currency	10.8	10.5	13.2
Dollarization of deposits	63.1	51.1	41.4
Dollarization of loans	66.8	55.0	55.9
Average Inflation	7.3	6.9	4.0
Average real deposit rate, national currency	3.8	2.4	3.9
Policy rate	5.1	5.2	4.2

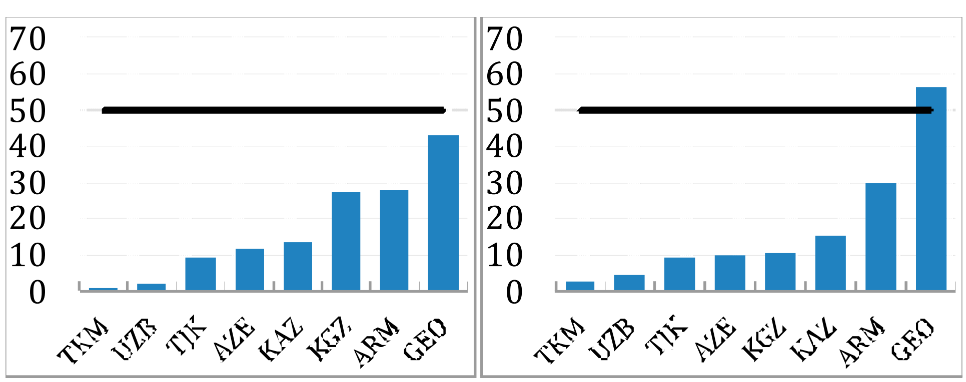
Sources: Country authorities, A Database on Financial Development and Structure, and II

Weak governance and reforms weigh on the pace of transition (Figure 4). With a few exceptions, non-transparent regulation, inadequate disclosure frameworks, weak protection of shareholder's rights, government intervention, and directed lending continue to limit investors' participation in the financial markets. Connected lending and opaque ownership have become particularly wide spread and hampering healthy development of banks. The development in the non-bank financial sector is also slow. Capital and private equity markets are underdeveloped in most countries, with insurance business picking up slowly. The absence of effective three-pillar pension systems further limits the demand for domestic debt and equities. Micro-finance is playing a growing role only in some economies.

Figure 4. Weak Institutions and Governance

Voice and Accountability | **Control and Corruption**

(Percentile Rank) | *(Percentile Rank)*



The Vision for the Next Decade

What financial policies need to be pursued to support the move to emerging market status? The priorities are the following:

- Reduce the role of state by limiting government intervention and ownership.

- Step up supervision by applying prudential norms uniformly, strengthening transparency and governance, and dealing with problem banks.

- Continue to build financial sector infrastructure, by promoting competition, developing capital and interbank markets, and stepping up legal and judicial reforms.

Achieving the status of dynamic emerging market economies will require CCA countries bolder reforms to transition to a market-based system.

- **Deeper banking intermediation should support private sector development**.
    - To achieve higher monetization (i.e. from current 26 percent of GDP to 50–70 percent of GDP) and higher deposit and credit to GDP (from current 20 percent to 50 percent), bold reforms are needed that would facilitate mobilization of deposits and capital, and allow better access to credit for a wider range of population.
    - To make holding of local currency assets more attractive, coordinated efforts are needed to ensure macroeconomic stability and strengthen the business environment. Financial sector measures include ensuring that banks prepare contingency plans to address systemic shocks and individual vulnerabilities and strengthening deposit insurance.

- **A variety of markets and products should facilitate capital market development and efficient allocation of long-term savings and investments.** In addition to the basic services, the system should be able to provide a range of institutions (pension funds) and instruments facilitating long and short-term savings and products allowing financial risk hedging (life insurance, unemployment insurance, forward contracts, etc.)

- In some countries, this would require strengthening the program of **issuance of government securities and developing public debt management strategy** and a legal framework for municipal bonds.

- In **other countries,** steps to better reflect international regulatory developments and to tailor prudential and market conduct regulations are needed to establish the life insurance industry; eliminate the monopoly privileges of state-owned insurers on compulsory products; allow insurance companies to diversify their investments; and develop sound regulatory framework and enhance regulation capacity for private pension funds.

➢ **Improved implementation of regulatory and supervisory standards should help with better risk management.** Financial deepening should proceed in a sustainable way, ensuring good risk management and supervisory and regulatory practices, as provided in many FSAPs in the region.

- Some countries should follow through with **amending central bank law** to ensure legal protection of bank supervisors and strengthening the governance and autonomy of the central bank;

- Countries should move further toward a modern **risk-based approach to supervision** and effective corporate governance and risk management in banks, improve supervision of liquidity management; and ensure strict enforcement of prudential requirements for all banks;

- Most countries **need to improve legislation** to simplify and accelerate registration and execution of collateral and assigning a clear responsibility for banks to report any changes in operations that could have a material adverse impact on their balance sheet;

- Countries should also **improve enforcement** of judgments obtained by creditors against defaulting borrowers.

➢ **Advanced governance practices should boost confidence in the system.** The process should be supported by complementary governance reforms to ensure financial discipline and accountability which would help to create a business climate conducive for private sector development. Some measures in this direction include:

- **Enhancing central bank authority in corporate governance of banks** (legislating the authority to apply fit and proper criteria for owners, to determine the source of owners' capital; and to require changes in ownership);
- **Improving competition in financial sector** (provision of all banking services to the government via transparent competitive tenders);
- **Strengthening the framework for bank resolution and crisis management**, improve bank bankruptcy law, establish clearer and earlier triggers for a provisional administrator to conduct bank resolution.

➢ **Regional coordination on markets and supervision is essential for acceleration of financial markets.** In this regard improved consolidated supervision and cross-border supervision and cooperation are key. Amending regulations to apply prudential requirements on a consolidated basis and allow for sharing of information among domestic financial sector regulators and a transition to integrated supervision in the long-run would help create a supportive environment for expanding cross-border financial flows.

Policy Imperatives

Macroeconomic stability and transparency in financial operations are some necessary prerequisites to financial deepening. While macroeconomic outlook is generally favorable in the region, inflation is still volatile causing uncertainty among depositors and resulting most often in the flight to safety (cash hoarding and preference for foreign currency). Limiting state-intervention, directed lending, and improving governance in general, would help foster better business climate. Encouraging commercial principles of operations for financial institutions and ultimately elimination of financial repression through price liberalization and elimination of interest subsidies are crucial steps for enhancing market confidence and competitiveness.

Regular and timely communication, along with improved access to information may help boost confidence in the banking system. Increasing access to information and improving communication from monetary authorities about monetary policy stance, economic outlook, the health of banking system should help in rebuilding trust.

Strengthening financial market infrastructure and deepening financial integration would enable greater market efficiency and competition. Developing interbank and secondary markets for government papers and issuing government papers for monetary policy conduct is a first necessary step. Elimination of all regulatory weaknesses related to use of government papers as collateral (e.g., registry, etc) would facilitate transactions. Once these markets are developed, the market for private papers will follow.

Supervision practices have to be enhanced and brought in line with international standards. Sound supervision practices and strong independent supervisory agencies are the first certifications of soundness of banking sector. Compliance with most of Basel core principles across the region and improved communication on banking sector health would facilitate confidence. Practice of regulatory forbearance should be stopped and prudential norms should be applied equally across the banks. Also important in this regard is to strengthen the *de facto* independence of central banks.

Improving governance practices will be the key. Improving governance practices across the board, and in particular, in banking sector, with full disclosure of ownership schemes, compliance with AML/CFT legislation and applying international best practice will help increase transparency. Improved access to information (publishing all relevant information regularly on website and via other media) would also help strengthen the existing financial institutions.

Deepening financial integration may be more successful if regional approach is kept in mind. The individual markets in the CCA countries are small, and they may not always allow for scale and operation of certain institutions. Regional solutions and cross country cooperation on financial sector issues will enable greater synergies.

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2013 Caucasus and Central Asia (CCA) Conference:
Note on CCA Fiscal Policy and Fiscal Frameworks

The fiscal situation and fiscal institutions of CCA countries improved substantially over the last 20 years, although fiscal positions deteriorated following the global crisis. Over the next 10 years, CCA countries should aim at establishing governments focused on their core functions in a non-distortive, transparent, and accountable way. 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 (PFM) reforms aimed at promoting transparency and accountability and better fiscal policy outcomes.

Successes and challenges ahead

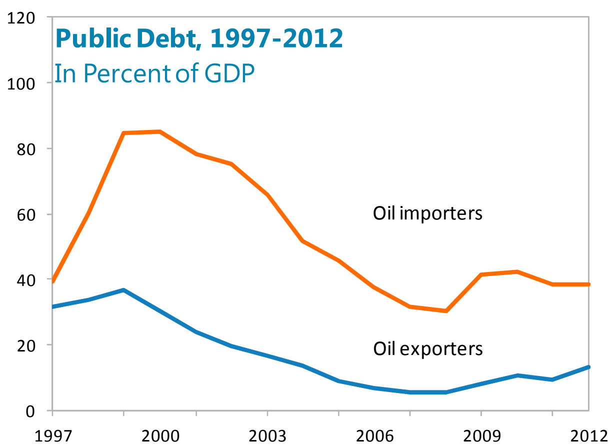
The fiscal situation and fiscal institutions of CCA countries improved substantially in the years prior to the crisis. *In particular:*

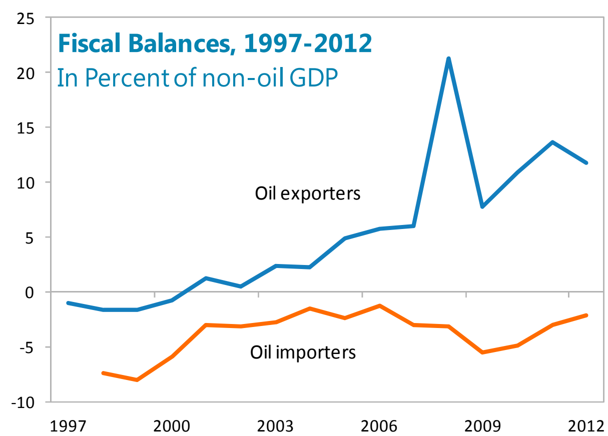
- Fiscal deficits declined significantly in oil importers and turned to large surpluses in oil exporters, aided by booming production (Azerbaijan, Kazakhstan) and high oil prices.
- Public debt fell sharply throughout the region, due to reduced primary deficits (or surpluses) as well as higher growth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

However, fiscal positions weakened following the 2008-09 global crisis, *owing both to the impact of automatic stabilizers on the revenue side and to discretionary stimulus policies. 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, but more is needed as the deficits are still above debt-reducing or debt-stabilizing levels and are undermining prospects of external consolidation.

- **Oil exporters** (Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan), have made less progress in bringing non-oil balances to pre-crisis levels, increasing risks of inflation pressures and vulnerability to oil price shocks. Fund engagement is through surveillance.



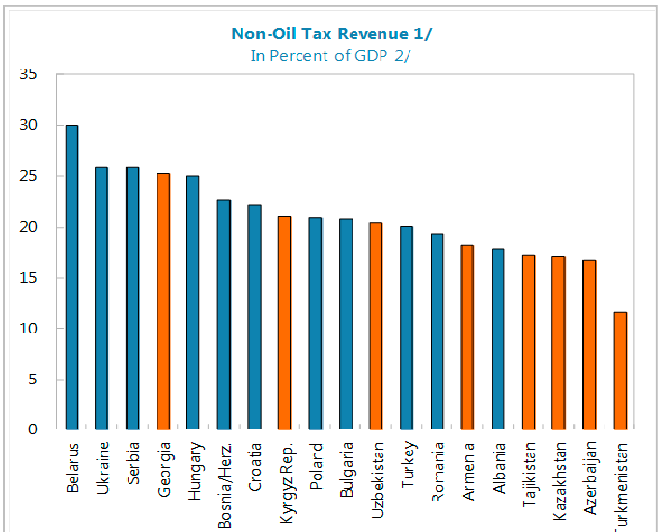


In addition, long-standing weaknesses in fiscal frameworks remain, including in the following three areas:

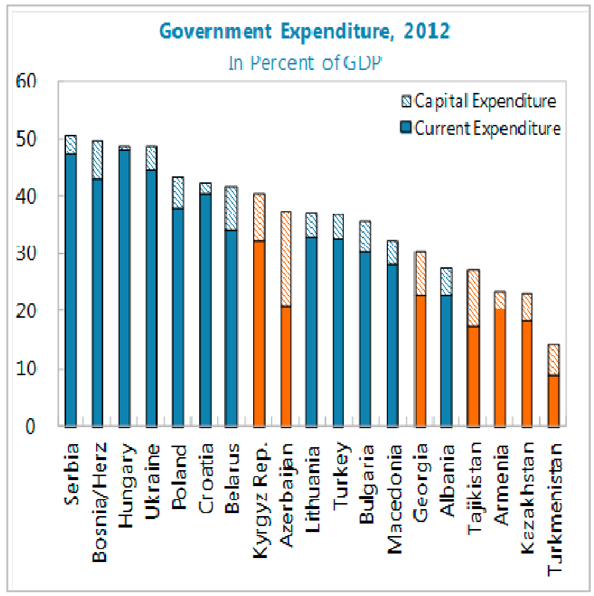
- **Tax revenue performance** is still an issue in most CCA countries. Tax revenue in oil importers and non-oil tax revenue in oil exporters remains low, both relative to comparable countries and relative to what would be necessary to finance the CCA countries' social and capital spending needs in a sustainable way. Tax policies and revenue administrations could be further strengthened to improve tax productivity and reduce distortions and business environment impediments.

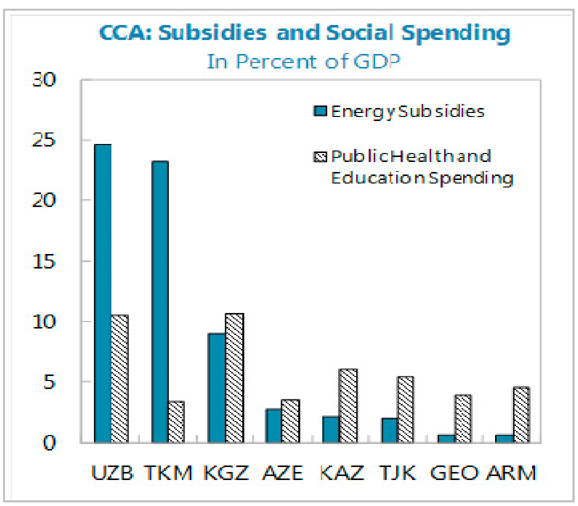
- **While CCA spending levels are moderate relative to comparable countries, inefficiencies in public spending are significant**, stemming in particular from large and poorly targeted subsidies, particularly in oil exporters, and/or weak systems for designing and managing public investment projects and procuring goods and services (as evidenced by the poor ranking in the joint World Bank/IMF public investment management index).

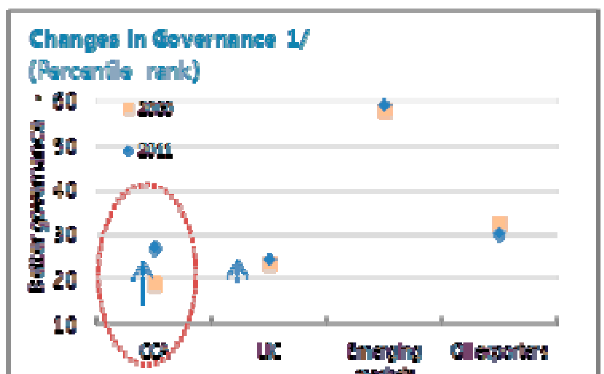
➢ **Fiscal control and fiscal transparency are still insufficient**, given undisclosed quasi-fiscal activities (QFA) by public financial and corporate institutions, and opportunities for corruption. This reflects weaknesses in PFM systems, including the unclear definition of the role of the state and a lack of well developed strategic medium-term plans. CCA countries are therefore exposed to considerable fiscal risks and are hampered in their ability to focus on core functions of addressing market failures and reducing poverty. These, in turn, undermine public and investor confidence.



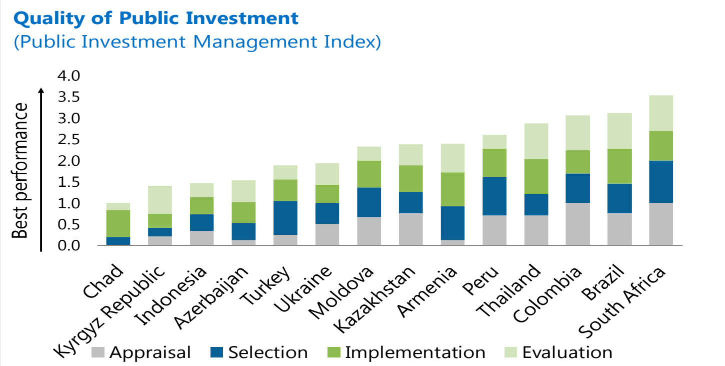
1/ Except UZB, for which non-oil data is not available.
2/ Non-oil GDP was used for AZE, KAZ, and TKM.







Sources: World Bank, Worldwide Governance Indicators (Government effectiveness, Regulatory quality, Rule of law and control of corruption); and Fund staff calculations.
1/ LIC: Low-income countries.



Source: Dabla-Norris et. al, 2011, "*Investing in Public Investment: An Index of Public Investment Efficiency*", IMF Working Paper/11/137.

The Vision for the Next Decade

Achieving the status of dynamic emerging market economies will require CCA **governments to focus on core government functions,** such as providing truly public goods and well-targeted social safety nets.

The governments should deliver on these core functions **in a sustainable way**, avoiding sharp changes in revenue and spending, or in service provision, to support private sector-driven and inclusive growth. As a result, inefficient or counter-productive activities, such as the distribution of energy subsidies would be substantially reduced and replaced with well-targeted transfers.

In addition, CCA countries should **adhere to 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 strong PFM systems in place, strengthened medium-term budget frameworks, and quasi-fiscal activities and contingent liabilities reported in the budget.

Policy Requirements to Achieve the Vision Ahead

To meet this vision, CCA governments' efforts will need to focus on the following actions:

1. **Develop fiscal frameworks that anchor policies on clear paths for key fiscal indicators.** Clarity in the deficit, debt, or revenue paths, based on cautious growth projections and robust risk assessment, would help address fiscal sustainability

concerns, reduce potential risks of overheating, and explicitly build or rebuild buffers to withstand potential shocks.

- **For oil importers**, fiscal consolidation should aim at bringing the overall deficit to a sustainable level, 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 (further developed in the note on management of resource revenues).

2. **Pursue a growth-friendly strengthening of the fiscal position.** This entails adopting non-distortive revenue-enhancing measures (e.g. increases in indirect taxes on consumption such as value-added tax or excises) while improving the effectiveness and efficiency of public resources. In addition, some countries would need to balance the human capital and the infrastructure needs when deciding about the composition of public spending, given the pressing need to develop human capital in some countries:

- **Revenue Reform**
  - **Widening tax bases** by reducing tax incentives (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 exhaustibility (Azerbaijan)
  - **Increasing low rates in indirect taxes should be considered** in a few countries (Kazakhstan, Kyrgyz Republic, and Tajikistan)
  - **Strengthening tax administration** and ensure evenhandedness of taxpayers (most CCA countries).

- **Current spending reform**
  - **Expanding well-targeted social safety nets** (all CCA countries) to ensure that social transfer programs reach the neediest.
  - **Scaling down energy subsidies** (Uzbekistan and Turkmenistan)

- **Ensuring the financial sustainability of pension systems** (Azerbaijan and Kyrgyz Republic)

➢ **Increase the efficiency of capital spending**

- **Bringing large-scale domestic infrastructure projects** in most CCA countries in line with absorptive capacity constraints (particularly oil exporters, Azerbaijan, Kazakhstan, Turkmenistan) or with debt sustainability (Armenia, Georgia, Kyrgyz Republic, Tajikistan). Exploring scope for much greater regional cooperation on infrastructure projects. Sovereign Wealth Funds should also be fully integrated with the budget framework of oil exporters.

3. **Implement 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, public procurement

➢ Main QFA and contingent liabilities to be quantified/reported in the budget

➢ Strong public sector statistics to allow assessment of the public footprint on the economy and support decisions by policy makers

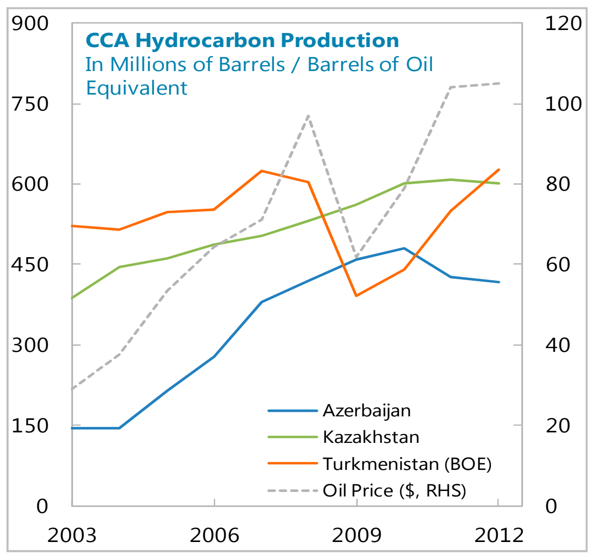
➢ Fiscal responsibility laws, endorsement of international standards (e.g., Extractive Industries Transparency Initiative) for oil exporters, or independent overseeing of the use of public resources (e.g. fiscal councils).

2013 Caucasus and Central Asia (CCA) Conference
Note on CCA Management of Energy Resources Wealth

Azerbaijan, Kazakhstan, and Turkmenistan, the energy rich CCA countries (RR-CCA) have achieved significant improvements in living standards with the use of energy wealth since the breakup of the Soviet Union. Over the next 10 years, the RR-CCA countries should aim at successfully leveraging their resource wealth to achieve diversification, reduce reliance on natural resources, and ensure sustained improvement in living standards, . To meet these objectives, governments will need to: establish fiscal anchors and a sound resource fund management; and support macro policies with decisive improvements on governance and business climate.

Successes and Challenges Ahead

Energy sectors in energy-rich CCA countries (RR-CCA), namely Azerbaijan, Kazakhstan, and Turkmenistan, have surged since the breakup of the Soviet Union.[1] *The surge reflects various factors:*



Source: 2013 WEO

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

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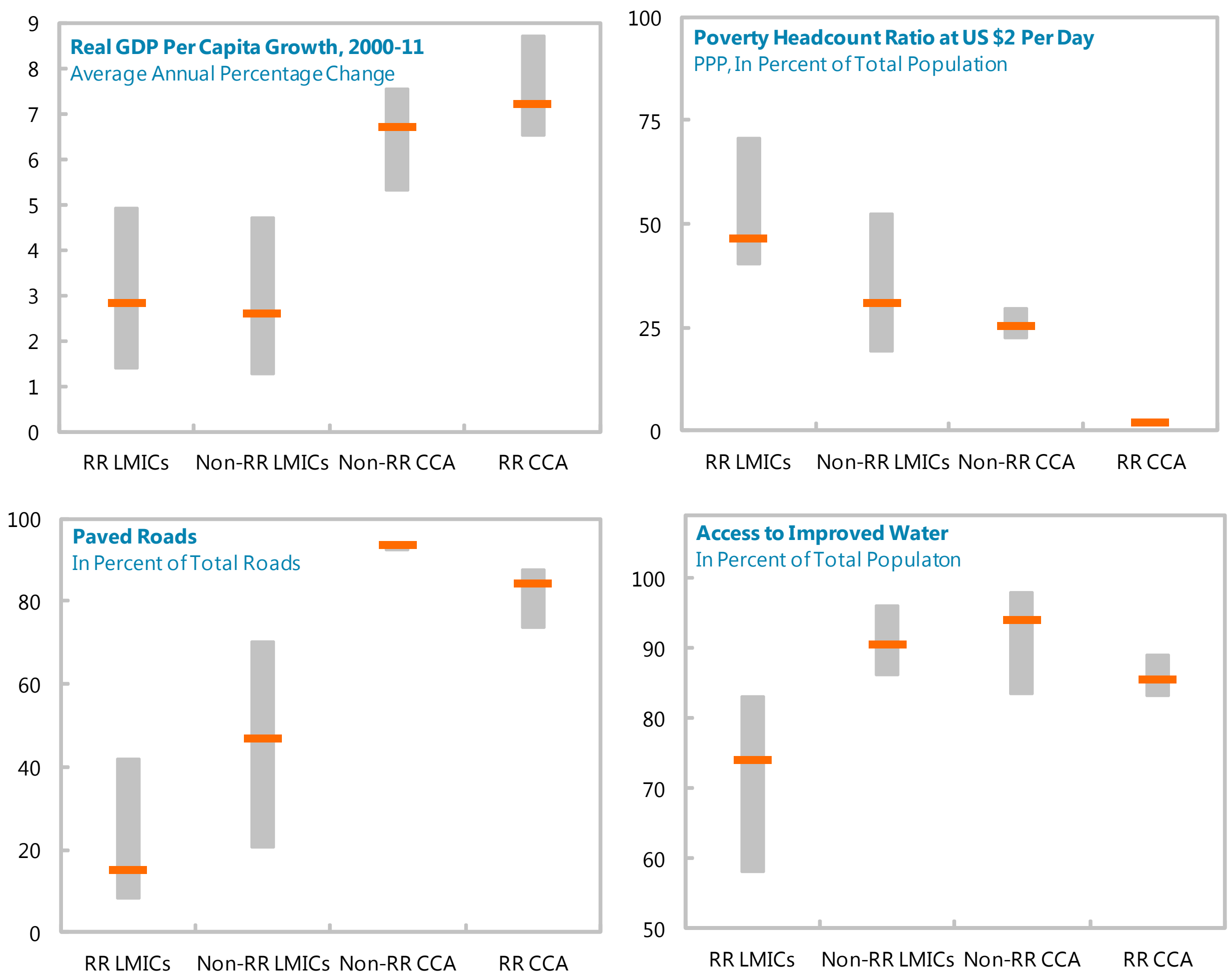
[1] This note focuses on Azerbaijan, Kazakhstan, and Turkmenistan and does not include Uzbekistan as energy resources play a considerably smaller role in Uzbekistan than in the other three natural resource rich countries of the CCA region.

The expansion of RR-CCA energy sectors has led to significant improvements in living standards, notwithstanding the modest progress in addressing infrastructure needs:

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

Development Indicators for Resource-Rich and Non-Resource-Rich Developing Countries

Median and Interquartile Range 1/

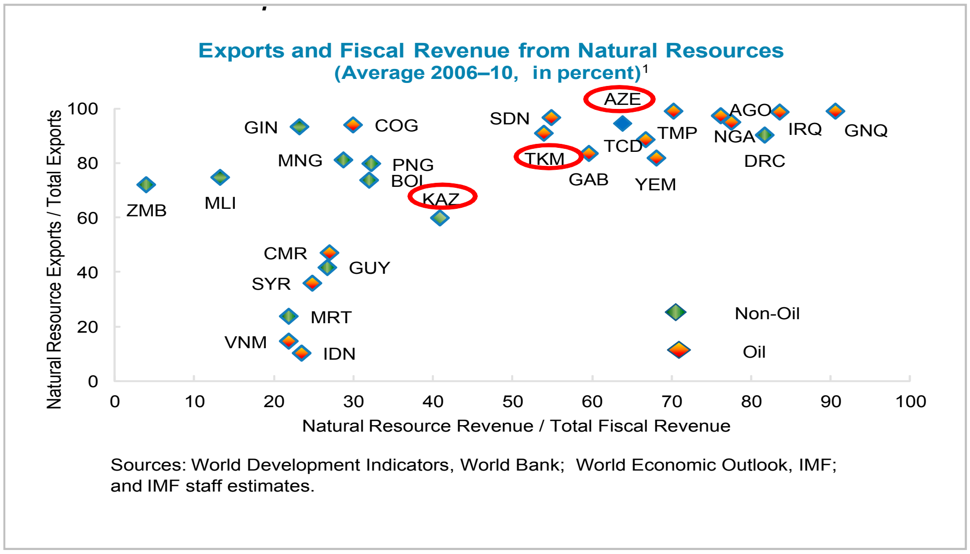


Source: World Bank; national authorities; and IMF staff estimates.

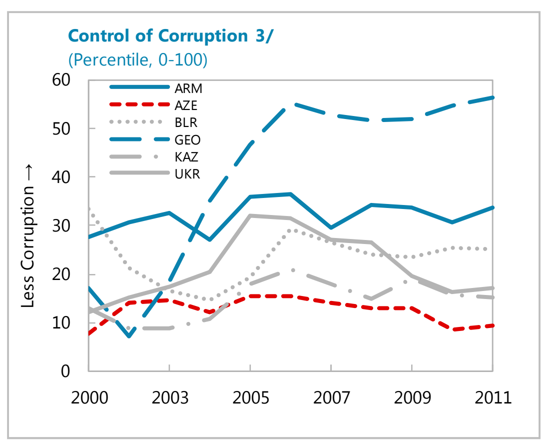
1/ Using latest available data since 2000. LMIC: Low-Middle Income Countries; RR: Resource-rich; Non-RR: Non-resource-rich.

Despite the benefits from large endowments, resource abundance poses two key challenges to the management of macro economic policy:

- **External and fiscal accounts have become heavily dependent on resource revenue,** exacerbating the vulnerability to volatility in the resource price and production.



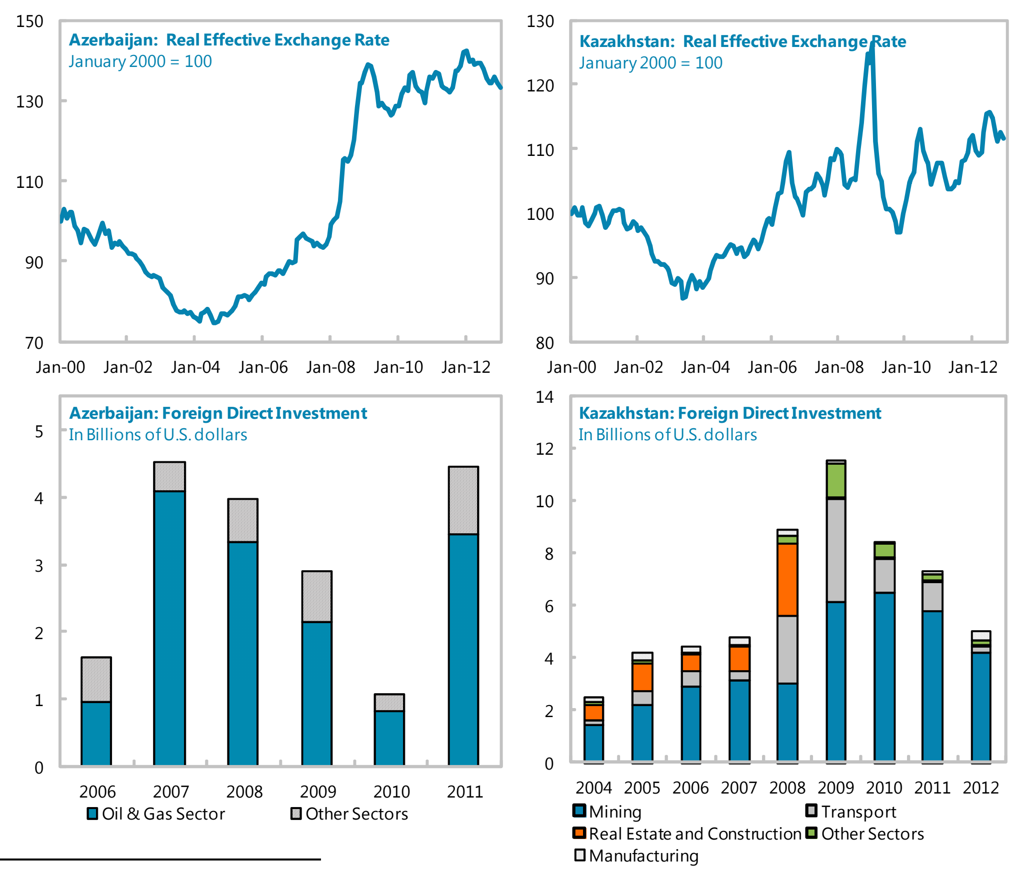
- **Transparency and efficiency of large public spending can be seriously undermined**, by the lack of mechanisms to address rent seeking and short-sighted policies in the use of resource wealth, even when resource funds are in place. This is evidenced by relatively high resource-financed public investment levels in RR-CCA with limited success on closing infrastructure gaps. This pattern is observed even in countries committed to full adherence of to international standards of revenue transparency such as the Extractive Industries Transparency Initiative.



"Natural resource curse", including Dutch Disease cannot be ruled out given the following warning signs:

- **Real exchange rates** have appreciated substantially, possibly as a result of the fast growth of non-tradables prices.[2]
- **Wages** have also increased faster than **productivity**.
- **Investment and** especially **FDI** have been highly concentrated in the energy sector with average shares of resource sector in investment and FDI over the last 5 years above 75 percent.
- **High energy subsidies**, via the provision of energy resources at low prices.

Real Effective Exchange Rates and Foreign Direct Investment



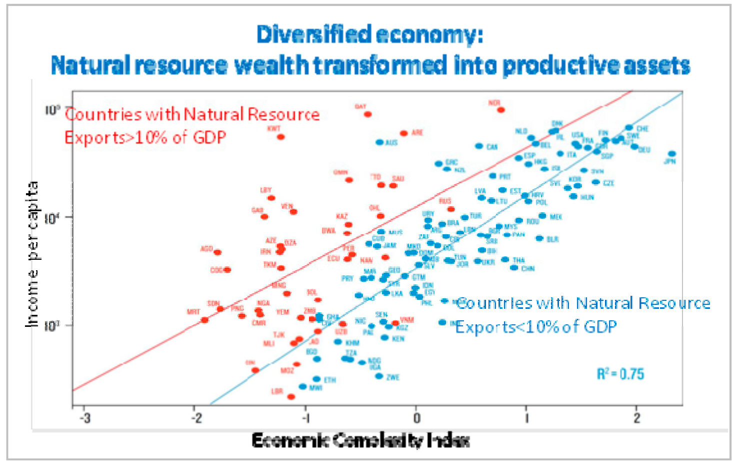
Sources: National authorities; and IMF stafff estimates.

[2] Turkmenistan 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..

The Vision for the Next Decade

Over the next decade the energy-rich countries of the CCA will need to **successfully leverage their resource wealth to become diversified emerging market economies**.

As diversification is strongly associated with sustained improvement in living standards, **policies in energy-rich countries of the CCA should facilitate transforming their resource wealth into productive assets** to foster diversification and ensure high living standards will be sustained even after the depletion of resource wealth.



Source: Hausmann, 2013

Policy Requirements to Achieve the Vision Ahead

To meet this vision, energy-rich CCA governments' efforts will need to focus on the following actions:

1. **Establishing fiscal anchors and sound resource fund management to help smooth spending and delink it from resource revenue volatility**. High macroeconomic volatility is a key channel for the growth-damaging "resource-curse," and volatile government spending is less effective and productive. Priorities :

   - **Adopting appropriate fiscal rules** to guide fiscal policy. Following recent IMF guidance PIH rules with focus on sustainability is important in Azerbaijan given the short depletion horizon. This would also help rebuild buffers to withstand potential shocks and address fiscal sustainability concerns. In Kazakhstan, management of oil revenues should be better integrated into broader macroeconomic policy frameworks (currently a fixed annual transfer from the resource fund to the budget). Price-based rules may be appropriate for Kazakhstan and Turkmenistan as sustainability is less of an issue and priority is short-term management of aggregate demand.

- **Ensuring sound management of resource-based funds** to support fiscal policy and intergenerational objectives. Funds should be transparently linked to the budget and ensure accumulation of fiscal buffers and intergenerational funds. Resource funds in the three countries have helped to secure saving from resource windfalls and delink spending from volatile revenue, though a clearer link of these funds with fiscal policy objectives is needed.

- **Reducing budget's reliance on resource revenues in the medium term.** This entails strengthening non-resource tax revenue (Azerbaijan, and Kazakhstan).

2. **Ensuring that resource revenue is well used and support transforming subsoil wealth into productive assets.** Most countries have ambitious plans of infrastructure investment and supporting 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.

    - **Governments need to realistically assess the tradeoff between the return on financial assets vs. net gain of resource financed public investment projects.** Use 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. Some frontloading of consumption though may be desirable, particularly in Turkmenistan.

    - Assessments of **different consumption-savings/investment strategies** have been discussed with Azerbaijan or will be discussed with Kazakhstan and Turkmenistan authorities, building up in recent IMF work on resource-rich countries and in the context of annual IMF Article IV consultations. Such analytical work help derive implications for fiscal policy and external sector assessments.

- **Advancing supportive fiscal reforms,** including improvements in fiscal transparency and PFM systems to get better handle of public resources and contingent liabilities. This would also facilitate more comprehensive assessments of macroeconomic impact of fiscal activities. In this direction, a priority is recognizing large and implicit energy subsidies in the RR-CCA, considered among the highest in the world in Turkmenistan. Reforming such subsidies will not be easy and will require disseminating its cost, which is significantly greater than public spending on health and education, and the distortions they create for the real economy, competitiveness, and growth.

3. **Advancing supportive reforms to speed up diversification and reduce reliance on natural resources**: Priority areas include:

- **Trade and competition reforms to encourage private sector investment on non-resource sectors and speed up integration with global markets**: This would entail accelerating plans for **WTO accession and new customs codes** to reduce informal and formal barriers to trade and competition. In addition, **streamlining of government red tape** will help sharply reduce non-oil companies' costs, particularly for SMEs, and opportunities for corruption.

- **Reforms to banking supervision and access to finance to non-resource sectors, including to SMEs.** Reducing directed lending is a priority in Turkmenistan and to lesser extent in Azerbaijan and Kazakhstan. Developing **capital markets**, including the legal framework, infrastructure, and instruments for savers and non-resource sector investors.