Retrospective of the Last Ten Years in Caucasus and Central Asia Countries[1]

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Ten years ago this month I attended a conference here in Bishkek to celebrate the tenth anniversary of the introduction of the som. Later in the same year, I attended a conference in Armenia to celebrate the tenth anniversary of the introduction of the dram in Armenia. (It was also the 110th anniversary of the establishment of the State Bank in Armenia.) I also spoke about the challenges of economic reform at the American University in Bishkek a little over ten years ago. Today I would like to revisit some of the things I said on those three occasions, assess them in the light of the last ten year's experience, and draw lessons for the future.

Remonetisation and inflation

In 2003 I noted the good progress that had been made in reducing inflation and managing the remonetisation (ie financial deepening) of the economy in CCA countries while keeping inflation under control. I pointed out that the rate of remonetisation was unpredictable and it would be important not to overestimate it and, as a result, allow excessive monetary growth and inflation. The task for central banks was further complicated by the strong foreign exchange inflows in some of the countries. I suggested that an important instrument for dealing with this situation would be exchange rate appreciation. This would help to restrict monetary and credit growth to levels compatible with the low inflation target, and to limit risks to banks arising from rapid credit growth. Of course, appreciation would not normally be the correct policy in countries without strong foreign exchange inflows.

Looking back, we can see that monetization continued at a rapid pace during the last ten years. [Chart 1] The broad money to GDP ratio roughly doubled in all countries except Tajikistan, and dollarization has remained at a high level. At the same time, inflation was kept under reasonable control in most countries. [Chart 2] It did, however, remain higher than in emerging market and developing countries as a whole, although less so in recent years than in the 2000s. On the other hand, with the exception of Tajikistan and Uzbekistan, inflation was lower than in Russia. It is especially interesting to note that Armenia and Georgia, which had the lowest inflation rates, were also the only two oil-importing countries that allowed their exchange rates to appreciate, as I recommended ten years ago. [Chart 3] The appreciation occurred entirely in the first half of the period when foreign exchange inflows were strong. Since then the dram and lari have depreciated as inflows weakened following the crisis. I conclude that monetary and exchange rate policies were reasonably successful, though Central Asian countries in particular could have done better.

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[1] Presented at the conference on "The Transition Road and the Journey Ahead in Caucasus and Central Asia (CCA) Countries", Bishkek, May 19-21 2013.

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Tax ratio

In 2003 I noted the need to raise the tax ratio from very low levels so that the government could improve public services and the infrastructure without accumulating excessive debt. Looking now just at the oil-importing countries – insufficient tax revenues are not generally a problem in the oil-exporters – we see that there has been considerable progress. [Chart 4] The tax ratio in these countries is now of the same broad order of magnitude as in emerging market and developing economies as a whole. However, the tax system in most countries is still inefficient and unpredictable, and does not contribute to a sound business environment. There also remains a need for major reforms of the public services to improve value for money.

Growth and reforms

Ten years ago I noted that growth in the previous few years, that is after the Russia crisis of 1998, had been good, thanks to structural reforms and a rise in capacity utilization. I argued that better growth in future would depend increasingly on new investment which in turn would require development of the financial sector, improvements to the business climate, more competition, hard budget constraints, better governance and a reduced role for the state. In my talk in Armenia I argued that the government sector had hindered rather than supported the development of the private sector that held the key to sustained long term growth. Much remained to be done to transform the government sector. On the one hand it should improve the things government should be doing, including providing strong and independent judiciary bodies and regulatory agencies, ensuring a competitive business environment with level playing fields, providing a fair and predictable tax system and efficient public services and ensuring that public servants behave honestly and accountably. [Chart 5] On the other hand it should stop doing things that are harmful to growth, such as interfering in private sector decisions and the work of the judiciary and regulatory agencies, using the tax or regulatory system to favour or threaten specific enterprises, and tolerating corruption, whether low level or high level corruption.

In practice, there has not been as much improvement in all these areas as I had hoped. There has been very little development of the financial sector. EBRD Transition Indicators for the banking sector, although definitions have changed, are little different from those ten years ago. [Chart 6] In most countries the EBRD reckons that there are major transition gaps to be crossed before the standards of a market economy are reached. The story is similar in other parts of the financial sector where the transition gap is larger still.

There has been little or no change in many other EBRD Transition Indicators. For example, those for Enterprise Governance and Restructuring, and Competition Policy, were virtually the same in 2012 as in 2002. [Chart 7] There were small improvements in Armenia, Georgia and Tajikistan, and deteriorations in Azerbaijan and Uzbekistan. But all eight CCA countries continue to score only 2 (including 2- and 2+), implying major transition gaps in these sectors.

Turning to the role of government, which ten years ago I identified as a major problem, only Georgia has since shown a strong improvement in the Worldwide Governance Indicators for Regulatory Quality, Rule of Law and Control of Corruption. [Chart 8] There were small improvements in Regulatory Quality in Azerbaijan, Kazakhstan and Tajikistan, but a decrease in Corruption Control in Kyrgyzstan, Turkmenistan and Uzbekistan. Otherwise, there were no significant trends in these three key indicators of the role of government.

Growth in the Last Ten Years

I am not saying anything very new. The latest EBRD *Transition Report*, for example, noted that there had been no sign of the major reform drive that was needed to boost growth rates towards long-term potential. But we need to acknowledge that, despite this, the growth performance of CCA countries over the last ten years has actually been quite respectable. Leaving aside the special circumstances of the oil and gas exporters, growth in the other four countries averaged 6% a year from 2003 to 2012, with three of them (Armenia, Georgia and Tajikistan) growing at 6% or 7% and only Kyrgyzstan, which has experienced major disruptions due to political conflicts and problems at Kumtor, growing more slowly, at 4%. [Chart 9] Of course, growth has been slower since 2008, but it was still respectable, except in Armenia which was the only one of the four oil importers to grow more slowly than Russia.

This good growth record was not what I expected ten years ago when 5% a year seemed an ambitious target. For example, in my talk at the American University in 2002 I said that the pace of structural reforms in Kyrgyzstan needed to be accelerated if the country was to grow at an average rate of 5% for the rest of the decade.

I hope that today's conference will give a convincing explanation of why good growth rates have been achieved despite the poor reform record. My own view is that there was more spare capacity at the beginning than we had realized, and the early liberalization and privatization reforms produced a bigger boost. Moreover, demand was strong, thanks to growth in Russia and other major partners, high commodity prices and emigrants' remittances. I do not accept the argument that the good performance is attributable to the active role of the state. On the contrary, I believe that interference by the state and the dominance of oligarchic structures prevented a more spectacular outcome. I hope that this conference will counter the argument that state and oligarchy led development, which has been successful in some Asian countries for a time, is the best strategy for CCA countries. I stick to my position of ten years ago that better growth in the long term will depend on new investment as well as financial sector development, improvements to the business climate and reforms in governance and the government sector. In the short term, however, there can be growth without reform, as we have seen. And the short term can last a long time, even decades, as the Soviet Union and other countries have shown. This complicates the task of convincing political leaders that major reforms are needed to generate sustained higher growth rates.

Political Economy

Let me add a comment on political economy. In my talk in Armenia ten years ago I suggested that progress with democratic reforms would contribute to the transformation of government. Entrenched regimes that are not exposed to free and fair elections are more likely than regimes that depend on the popular vote to promote cronyism, support vested interests, encourage oligarchy, interfere with the independence of the judiciary, tolerate corruption and avoid transparency and accountability. There is, indeed, a clear correlation between measures of democracy, such as Freedom House's indicator of political rights and civil liberties, and governance indicators. [Chart 10] Most CCA countries have continued to limit genuine democracy and I am therefore not surprised that there has been minimal change in the role of government and governance more widely. This is a fundamental feature of the situation that we need to keep in mind in our deliberations today.

Conclusion

The experience of the last ten years suggests the rather pessimistic conclusion that major reform drives and improvements in governance are unlikely. But change *does* occur: in the short term because of changes in government, as in Georgia in 2003 and Kyrgyzstan more recently; and in the longer term because of the growing strength of a property-owning middle class that presses for reforms, better governance and the rule of law. When such changes *do* take place, the policies for improving the situation to be discussed today will have a better chance of success.

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Charts to accompany the presentation by John Odling-Smee at the conference on "The Transition Road and the Journey Ahead in Caucasus and Central Asia (CCA) Countries", Bishkek, May 19-21 2013

Chart 1

Monetization
(broad money/GDP ratio, %)

	2003	2012
Armenia	14.4	27.6
Azerbaijan	20.4	55.6
Georgia	12.4	30.0
Kazakhstan	21.1	36.6
Kyrgyzstan	17.3	32.2
Tajikistan	25.1	25.1
Uzbekistan	10.3	24.4
Russia	29.9	59.6

Note: The denominator in the case of Azerbaijan is non-oil GDP.

Source: IMF, WEO database

Chart 2

Inflation (CPI)

	2003-2012 (annual average %)	2012
Armenia	5.0	2.5
Azerbaijan	8.6	1.1
Georgia	5.4	-0.9
Kazakhstan	8.7	5.1
Kyrgyzstan	9.0	2.8
Tajikistan	9.8	5.8
Turkmenistan	6.3	4.9
Uzbekistan	11.6	12.1
Russia	9.8	5.1
Emerging markets and developing countries	6.4	6.1

Source: IMF, WEO database and Country reports

Chart 3

Exchange rate appreciation(+)/depreciation(-)
(exchange rate against US$, % change 2003-12)

Armenia	+44
Azerbaijan	+24
Georgia	+30
Kazakhstan	+0.3
Kyrgyzstan	-7
Tajikistan	-35
Uzbekistan	-51
Russia	-0.5

Source: World Bank, World Development Indicators, and IMF, Country Reports

Chart 4

Tax ratio (%)
(general government revenue, except Armenia and Azerbaijan)

	2003	2012
Armenia (CG)	17.8	22.4
Azerbaijan (CG)	26.8	40.7
Georgia	16.0	28.7
Kazakhstan	25.4	27.9
Kyrgyzstan	22.5	34.5
Tajikistan	17.3	25.1
Turkmenistan	23.1	29.9
Uzbekistan	33.4	38.6
Russia	36.4	37.0

Source: IMF, WEO and Country reports

Chart 5

Government Do's and Do Not's

Governments should:

- Provide strong and independent judiciary bodies and regulatory agencies
- Ensure a competitive business environment with level playing fields
- Provide a fair and predictable tax system and efficient public services
- Ensure that public servants behave honestly and accountably

Governments should not:

- Interfere in private sector decisions and the judiciary and regulatory agencies
- Use the tax or regulatory system to favour or threaten specific enterprises
- Tolerate corruption

Source: John Odling-Smee, "The Next Ten Years: The Challenges Ahead", paper presented at the conference in Armenia to celebrate the tenth anniversary of the introduction of the dram, November 2003.

Chart 6

EBRD Transition Indicators: Banking

	2002 Banking Reform and interest rate liberalisation	2012 Banking
Armenia	2+	2+
Azerbaijan	2+	2
Georgia	2+	3-
Kazakhstan	3-	3-
Kyrgyzstan	2+	2
Tajikistan	2-	2
Turkmenistan	1	1
Uzbekistan	2-	1

Source: EBRD Transition Reports

Chart 7

EBRD Transition Indicators: Enterprises and Competition

	Enterprise Governance and Restructuring		Competition Policy	
	2002	2012	2002	2012
Armenia	2+	2+	2	2+
Azerbaijan	2	2	2	2-
Georgia	2	2+	2	2
Kazakhstan	2	2	2	2
Kyrgyzstan	2	2	2	2
Tajikistan	2-	2	2-	2-
Turkmenistan	1	1	1	1
Uzbekistan	2-	2-	2	2-

Source: EBRD Transition Reports

Chart 8

Quality of Governance

(Governance score -2.5 to +2.5)

	Regulatory Quality		Rule of Law		Control of Corruption	
	2002	2011	2002	2011	2002	2011
Armenia	+0.01	+0.26	-0.38	-0.41	-0.65	-0.62
Azerbaijan	-0.72	-0.40	-0.85	-0.87	-1.05	-1.13
Georgia	-0.81	+0.66	-1.17	-0.16	-1.14	-0.04
Kazakhstan	-0.73	-0.28	-1.12	-0.63	-1.06	-1.01
Kyrgyzstan	-0.15	-0.21	-0.76	-1.25	-0.86	-1.13
Tajikistan	-1.31	-0.97	-1.17	-1.21	-1.03	-1.13
Turkmenistan	-1.98	-2.05	-1.31	-1.41	-1.17	-1.46
Uzbekistan	-1.57	-1.59	-1.41	-1.39	-0.99	-1.34

Source: http://info.worldbank.org/governance/wgi

Chart 9

Growth of GDP
(annual average, %)

	2003-08	2008-12	2003-12
Armenia	11.6	-0.4	6.1
Azerbaijan	21.0	4.1	13.2
Georgia	7.8	3.9	6.1
Kazakhstan	8.4	5.2	7.0
Kyrgyzstan	5.1	1.8	3.7
Tajikistan	8.0	6.3	7.2
Uzbekistan	8.1	8.2	8.1
Russia	7.1	1.0	4.3
World	4.6	2.9	3.9

Source: IMF, WEO database

Chart 10

Democracy and Governance

	Freedom House indicators, 2013 (score 7 to 1)		Governance, 2011 (score -2.5 to + 2.5)
	Political Rights	Civil Liberties	
Armenia	5	4	-0.26
Azerbaijan	6	5	-0.80
Georgia	3	3	+0.15
Kazakhstan	6	5	-0.64
Kyrgyzstan	5	5	-0.86
Tajikistan	6	6	-1.07
Turkmenistan	7	7	-1.64
Uzbekistan	7	7	-1.44

Note: The Governance score is the average of the scores for the World Governance Indicators for Regulatory Quality, Rule of Law and Control of Corruption.

Source: http://www.freedomhouse.org/report/freedom-world/freedom-world-2013 and http://info.worldbank.org/governance/wgi