3. Caucasus and Central Asia: Need to Increase Resilience and Accelerate Reforms to Become Emerging Markets

Growth in the CCA is expected to remain robust in the near term, though subject to downside risks. The recovery in oil and gas production and other extractive industries has been supporting economic activity. Remittances inflows have also held up well, despite a marked economic slowdown in Russia, the main destination for labor migrants from the region. Nonetheless, lower-than-anticipated growth in key emerging market economies and a tightening of external financing conditions present risks to the outlook. The CCA countries should take advantage of the current conditions to enhance their resilience to shocks by increasing fiscal and financial buffers where they are low, and accelerating economic reforms to increase long-term growth potential. Better governance and stronger policy frameworks are essential to set in motion an accelerated and comprehensive structural transformation by which the CCA countries can become dynamic emerging market economies.

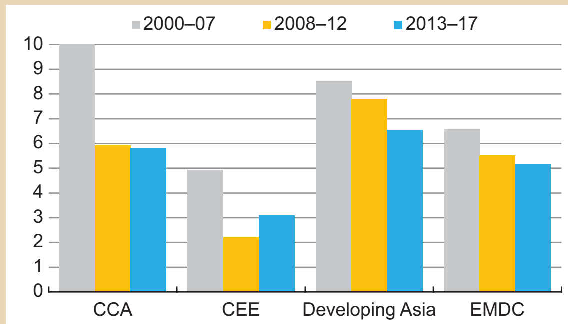
Commodities, Remittances Support Rapid Economic Expansion

Economic activity in the CCA region continues to expand at a fast clip, about 6 percent per year. Although slowing from the even higher rates experienced in the decade before the global financial crisis, the CCA region remains among the fastest growing in the world (Figure 3.1). This growth reflects, in part, a continued catching up from low average income levels (though there is considerable variation in per capita income in the region; Figure 3.2). As in the recent past, growth also continues to be supported by an expansion of productive capacity in extractive sectors and a stable inflow of remittances, mostly from neighboring Russia.

- Growth in the CCA oil-exporting economies is picking up slightly, to about 6 percent in 2013, underpinned by a recovery in Kazakhstan's oil and gas production and an increase in exports of Turkmenistan's gas to China as new capacity comes on line (Figure 3.3). Nonhydrocarbon growth also remains steady, supported by agriculture and construction (Figure 3.4). These trends are

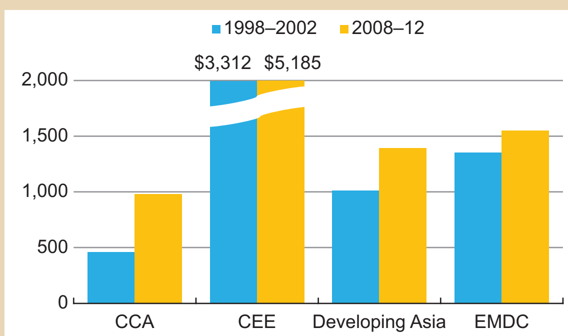
Prepared by Sami Ben Naceur, with inputs from Jonathan Dunn, Mark Horton, and country teams; and research assistance by Jaime Espinosa-Bowen.

Figure 3.1
Real GDP Growth Rates
(Percent, period average)



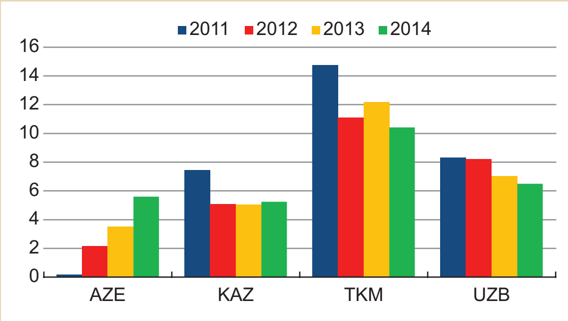
Sources: National authorities; and IMF staff estimates.
Note: CEE = Central and Eastern Europe; EMDC = emerging market and developing countries.

Figure 3.2
Median Real GDP Per Capita in U.S. Dollars
(Period average)



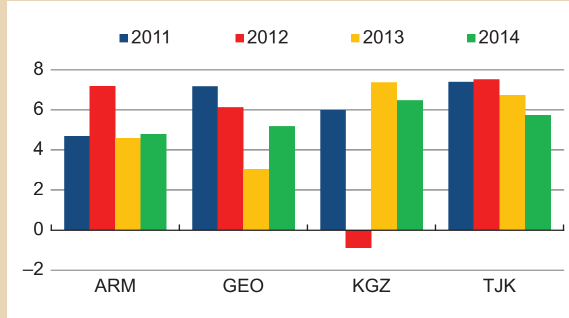
Sources: National authorities; and IMF staff estimates.
Note: CEE = Central and Eastern Europe; EMDC = emerging market and developing countries.

Figure 3.3
Oil and Gas Exporters: GDP Growth by Country
(Percent)



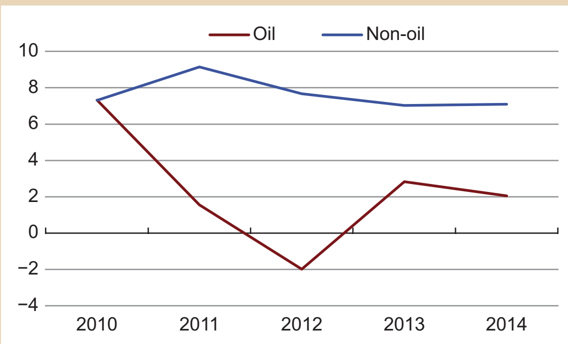
Sources: National authorities; and IMF staff estimates.

Figure 3.5
Oil and Gas Importers: GDP Growth by Country
(Percent)



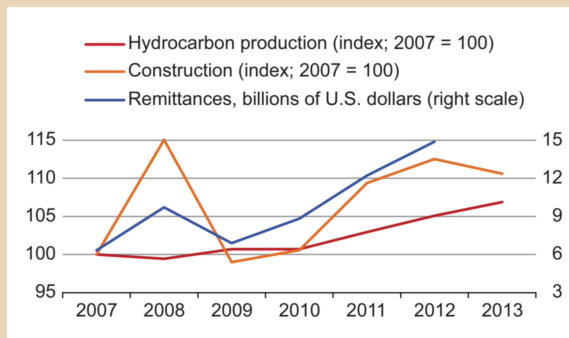
Sources: National authorities; and IMF staff estimates.

Figure 3.4
Oil Exporters: Non-Oil and Oil GDP Growth
(Percent)



Sources: National authorities; and IMF staff estimates.

Figure 3.6
Russia: Remittances Outflows to CCA Countries, Construction, and Hydrocarbon Production



Sources: Central Bank of Russia; national authorities; and IMF staff calculations.

expected to continue into 2014, despite the projected softening in commodity prices. Hydrocarbon production in particular will be bolstered by an expected recovery from recent disruptions in Azerbaijan.

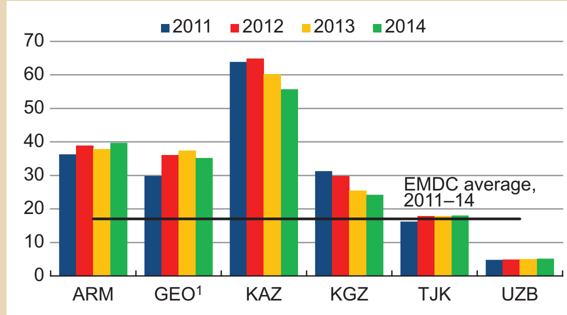
- Economic activity in the CCA oil and gas importers is set to slow to about 5 percent in 2013, reflecting weaker external demand, slower private investment, and, in Armenia and Georgia, budget underspending (Figure 3.5). Private consumption growth remained steady, supported by remittances inflows from migrants working in Russia's construction and oil sectors, which have held up well despite the overall slowing of activity in Russia (Figure 3.6). Growth is expected to pick up in 2014 in all countries except the Kyrgyz Republic and Tajikistan, and could reach, on average, about 5½ percent, supported by higher private investment and external demand, provided that planned policy actions are fully implemented. Continued recovery from earlier disruptions in the gold sector in the Kyrgyz Republic and a more normal pace of government spending in Georgia and Armenia will also contribute to the recovery.

Risks to the Near-Term Outlook Are Tilted to the Downside

Headwinds are likely to come from external sources. A lower-than-anticipated growth rate in major emerging markets, including Brazil, China, India, and Russia, would lower commodity prices further and cause economic activity in the region's oil and gas exporters to weaken. Those countries with low public debt will be able to draw on their reserves to sustain aggregate demand (Annexes 1 and 2). Lower-than-anticipated growth in emerging markets would also reduce growth in the region's oil-importing countries because it would weaken exports and bilateral official project lending. Russia's slowdown, in particular, is an important source of risk for the region's oil importers in light of close linkages. Remittances from migrants working in Russia have so far remained strong, but a marked slowdown in Russia could still adversely affect them in the period ahead. A slowdown in the euro area would also be felt by the CCA economies, both directly and, more important, because of the likely consequent weaker economic activity in Russia (Annex 2). On the domestic side, delays in improving the health of the banking systems may weigh on domestic credit growth and economic activity in some cases (for example, Kazakhstan).

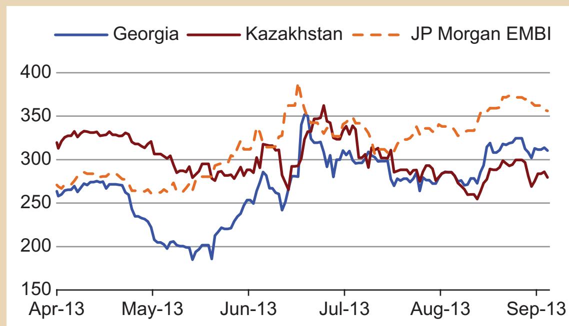
The impact from a greater-than-expected tightening of global financial conditions is expected to be manageable for the CCA economies (Annex 2). The CCA oil and gas importers fund their current account deficits mainly through concessional borrowing and foreign direct investment (FDI); however, Georgia's vulnerability to a decline or reversal of capital flows increased following a rise in its external liabilities. Rollover risks are generally not an issue for the CCA oil and gas exporters, except Kazakhstan, for which external debt is still high and future pricing and rollover rates of private sector debt may be affected (Figures 3.7 and 3.8).

Figure 3.7
External Private Debt
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.
Note: EMDC = emerging market and developing countries.
[1]Excludes intercompany loans.

Figure 3.8
Sovereign Bond Spreads
(Basis points, April 25 to September 10, 2013)



Source: Bloomberg, L.P.

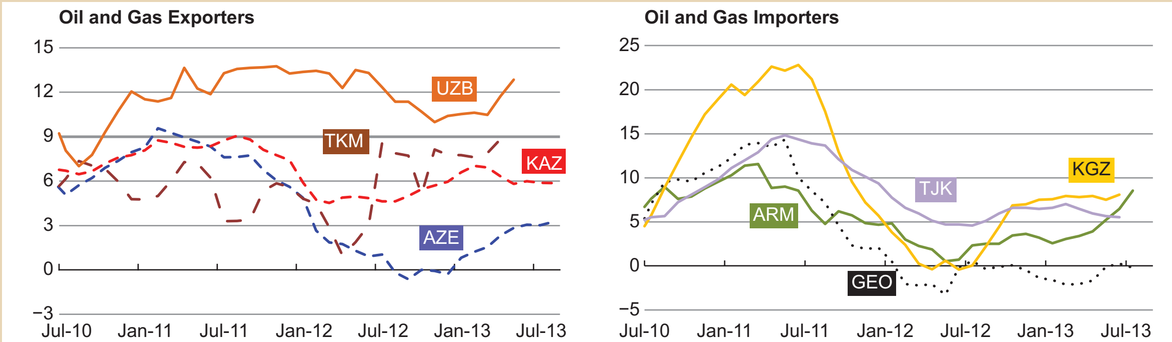
Inflation Stays Largely within a Comfortable Range

Administered price increases in several CCA countries will push headline inflation upward in the near term, but underlying pressures remain contained. After declining to 5.3 percent as economic activity slowed in 2012, average annual consumer price inflation is set to rise by about 2 percentage points in 2013–14, in part because of increases in energy and administered utility prices, for example, in Kazakhstan. Second-round effects from these increases are expected to be small, given spare capacity, declining international food and fuel prices,

Figure 3.9

Headline Consumer Price Index Inflation

(12-month change; percent)



Sources: National authorities; and IMF staff estimates.

and contained inflation expectations. Inflation is expected to stay largely within central banks' explicit or implicit comfort zones, and monetary policy may remain on hold in most countries. Inflation volatility is likely to remain high, however, given the large share of food prices in the consumption basket, reliance on food imports, and weaknesses in the monetary transmission mechanism.

Two countries depart from these general trends. In Uzbekistan, inflation will stay in double digits because of continuing exchange rate depreciation, higher local food and administered prices, and wage increases (Figure 3.9). Further monetary policy tightening is needed to rein in inflation and hold back second-round effects from administered price increases. By contrast, Georgia has experienced deflation since early 2012 as a result of lagged effects of exchange rate appreciation, declining food and administered energy prices, and subdued domestic demand. In response, the central bank has been reducing the policy rate, but inflation is still about 6 percentage points below the medium-term target.

Slowly Recuperating Financial Sector Needs Strong Oversight

Gradually recovering from the legacy of past banking crises, the financial sector in the CCA region remains shallow. The profitability of banks, which dominate the financial sector, has generally recovered from the crisis troughs but has not yet returned to precrisis levels. Banks appear to be well capitalized and liquid. However, capital adequacy ratios well above 20 percent may, in part, mask problems in asset classification (Table 3.1). Risk management practices remain below international standards in many cases, casting doubt on the banking sector's ability to withstand large unanticipated shocks. Private credit has accelerated in Azerbaijan, and consumer lending is picking up in Kazakhstan, and although growth is taking place from a low base (see Box 1.2), these lending developments underscore the need to ensure strong forward-looking supervision. Nonperforming loans remain elevated in Kazakhstan and Tajikistan (Figure 3.10), weighing on credit growth and efficient resource intermediation, thus calling for a

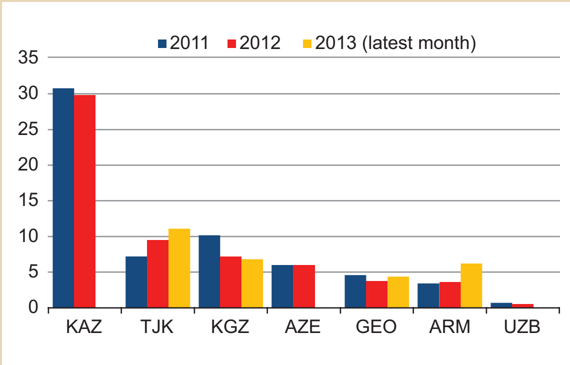
Table 3.1. Financial Sector Indicators

(June 2013, or latest available data)

	Capital adequacy ratio *(Percent of risk-weighted assets)*	Return on assets *(Percent of total assets)*
Armenia	16.3	0.9
Azerbaijan	15.7	1.0
Georgia	26.5	2.2
Kazakhstan	18.7	–0.1
Kyrgyz Republic	27.7	2.5
Tajikistan	21.5	2.1
Turkmenistan	14.9	2.9
Uzbekistan	24.3	1.9

Source: National authorities.

Figure 3.10
Nonperforming Loans
(Overdue by 90 days or more, percent of total loans)



Source: National authorities.

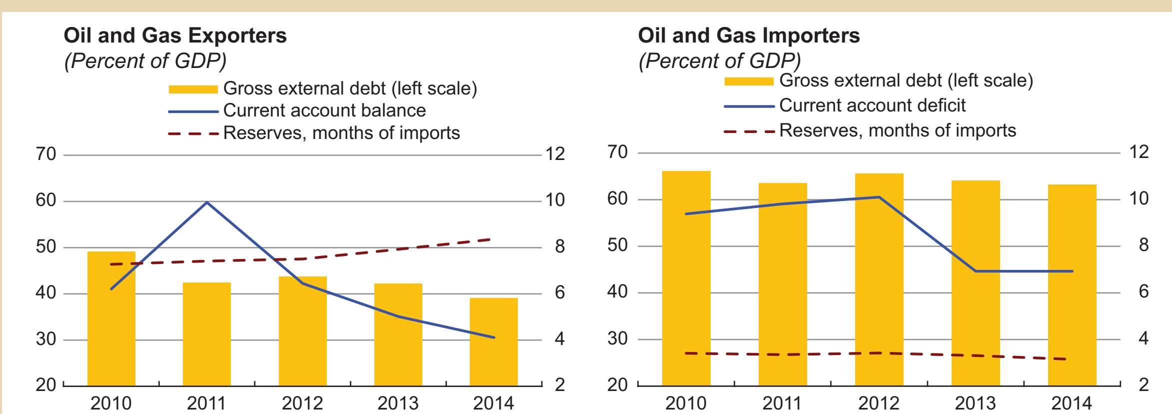
tightening of regulatory standards related to loan classification and credit management. Another factor aggravating financial sector vulnerabilities is widespread dollarization, which not only weakens the monetary transmission mechanism but also makes the banking systems vulnerable to possible large movements in exchange rates.

To improve the efficiency and soundness of the financial sector, many countries are taking measures to strengthen prudential regulation and supervision. Kazakhstan recently introduced a framework providing options for banks to resolve high nonperforming loans, and is now considering measures to further strengthen this framework. Some CCA countries are taking new macroprudential measures to discourage nonresident deposits and dollarization, such as higher liquidity requirements for banks with a high fraction of nonresident deposits in Georgia, and foreign exchange liquidity requirements and lower reserve requirements for deposits in domestic currency in Armenia.

External Positions Call for More Exchange Rate Flexibility

Lower external demand and falling oil and gas prices are putting pressure on the external positions of some CCA countries. The overall current account surplus for the CCA region is projected to decline from about 4¾ percent of GDP in 2012 to about 3 percent in 2014, because of shrinking surpluses in the oil- and gas-exporting countries, particularly Azerbaijan and Kazakhstan (Figure 3.11, left panel). Current account deficits in the CCA oil and gas importers are narrowing (except in Tajikistan) because of import compression amid subdued domestic demand, but remain above 7 percent of GDP (Figure 3.11, right panel). Export growth in the oil and gas importers has been supported by good harvests and recent exchange rate depreciation (in Armenia), and a recovery in gold production in the Kyrgyz Republic. However, overvalued

Figure 3.11
External Positions
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

exchange rates constrain export growth in some cases, suggesting the need for more exchange rate flexibility. Although the oil and gas importers are financing their current account deficits mostly through FDI and concessional borrowing, their international reserves remain barely above three months of imports.

Fiscal Consolidation Is Needed to Increase Buffers and Stabilize Debt

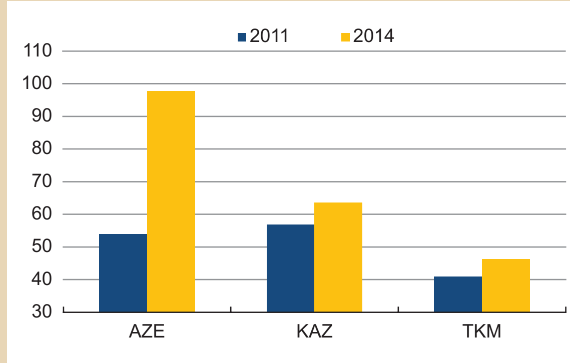
Like the external positions, fiscal balances in the CCA oil- and gas-exporting countries are projected to weaken sharply in the near term (Figure 3.12). General government balances are set to decline from about 5½ percent of GDP in 2012 to 1 percent of GDP in 2014, driven by declines in hydrocarbon revenues, especially in Azerbaijan. Fiscal breakeven prices for the oil and gas exporters range from about $43 per barrel for Turkmenistan to $90 per barrel for Azerbaijan at present, providing them with a sufficient cushion to absorb moderate fluctuations in oil prices (Figure 3.13). However, fiscal breakeven prices have been rising in most countries since 2011, suggesting that fiscal buffers are declining. Long-term fiscal sustainability analyses and other frameworks for fiscal management in resource-rich countries also suggest that the CCA oil and gas exporters are not saving enough for future generations (Annex 4). In a prudent response to these trends, nonhydrocarbon fiscal balances in the CCA oil and gas exporters have been improving, supported by expenditure restraint.

The region's oil and gas importers have had mixed success in reducing their fiscal vulnerabilities. Public debt remains below 40 percent of GDP, but it is rising and has not returned to the precrisis lows (Figure 3.14). The region's fiscal deficits have come down from the crisis highs but are projected to deteriorate by almost a full percentage point in 2013

Figure 3.13

Oil and Gas Exporters: Breakeven Oil Prices

(Fiscal breakeven oil prices, U.S. dollars per barrel)

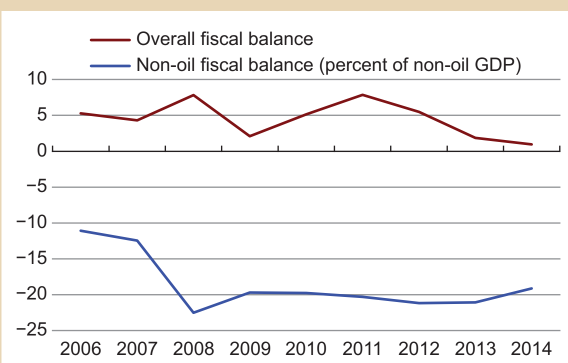


Sources: National authorities; and IMF staff estimates.

Figure 3.12

Oil and Gas Exporters: Fiscal Balances

(Percent of GDP)

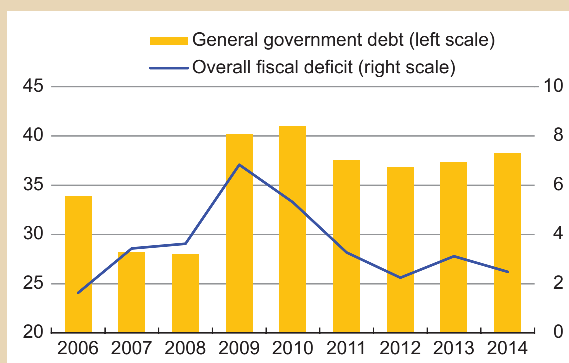


Sources: National authorities; and IMF staff estimates.

Figure 3.14

Oil and Gas Importers: Fiscal Balance and Debt

(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

to about 3 percent of GDP. This mainly reflects an increase in budgetary spending in a number of countries, including Armenia and Tajikistan. Fiscal balances are expected to consolidate next year on account of planned containment of expenditures, particularly in the Kyrgyz Republic and Tajikistan. Nonetheless, on current projections, many countries also have limited fiscal space to accommodate large unanticipated shocks.

The CCA countries should take advantage of their continued strong expansion to strengthen low or declining fiscal buffers and improve intergenerational equity. More fiscal room can come from broadening tax bases, increasing low rates of indirect taxes, and strengthening tax administration. Expenditure measures are also important; for example, scaling down energy subsidies in Turkmenistan and Uzbekistan and ensuring the sustainability of pension systems in Azerbaijan and the Kyrgyz Republic. To minimize the impact on economic growth and enhance equity, some of these savings should be allocated to more investment in education and better-targeted social safety nets (Annex 3). In oil-exporting countries, fiscal policy requires a framework to delink spending decisions from short-term fluctuations in oil prices, avoid procyclical fiscal policy, and ensure that medium-term fiscal targets provide for intergenerational equity (Annex 4). In all countries, improved fiscal coverage can help monitor and manage fiscal risks (see Box 2.4).

Toward Becoming Vibrant Emerging Markets[1]

The CCA countries have recorded significant economic achievements during the two decades since independence. These countries have grown more rapidly than 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 started to deepen, as evidenced by higher deposits and lending. Fiscal policies were broadly successful in building buffers before the global crisis, and many CCA countries used those buffers effectively to support growth and protect the most vulnerable as the crisis washed across the region.

There remain, however, continued need and ample room to strengthen these economic outcomes. Growth in CCA countries has been volatile and has relied heavily on energy resources, other commodities, and remittances (Figure 3.15). Like economic growth, inflation has been volatile, and real interest rates generally remain high, discouraging financial intermediation. Central banks in the region often lack independence, monetary policy has been procyclical, and high rates of dollarization reflect continued weak confidence in many CCA countries. Progress has been uneven in restoring postcrisis fiscal positions and rebuilding fiscal buffers. Non-oil revenue remains low in resource-rich CCA countries, social and capital spending needs are generally high, and quasi-fiscal activities—supported by directed lending—are widespread.

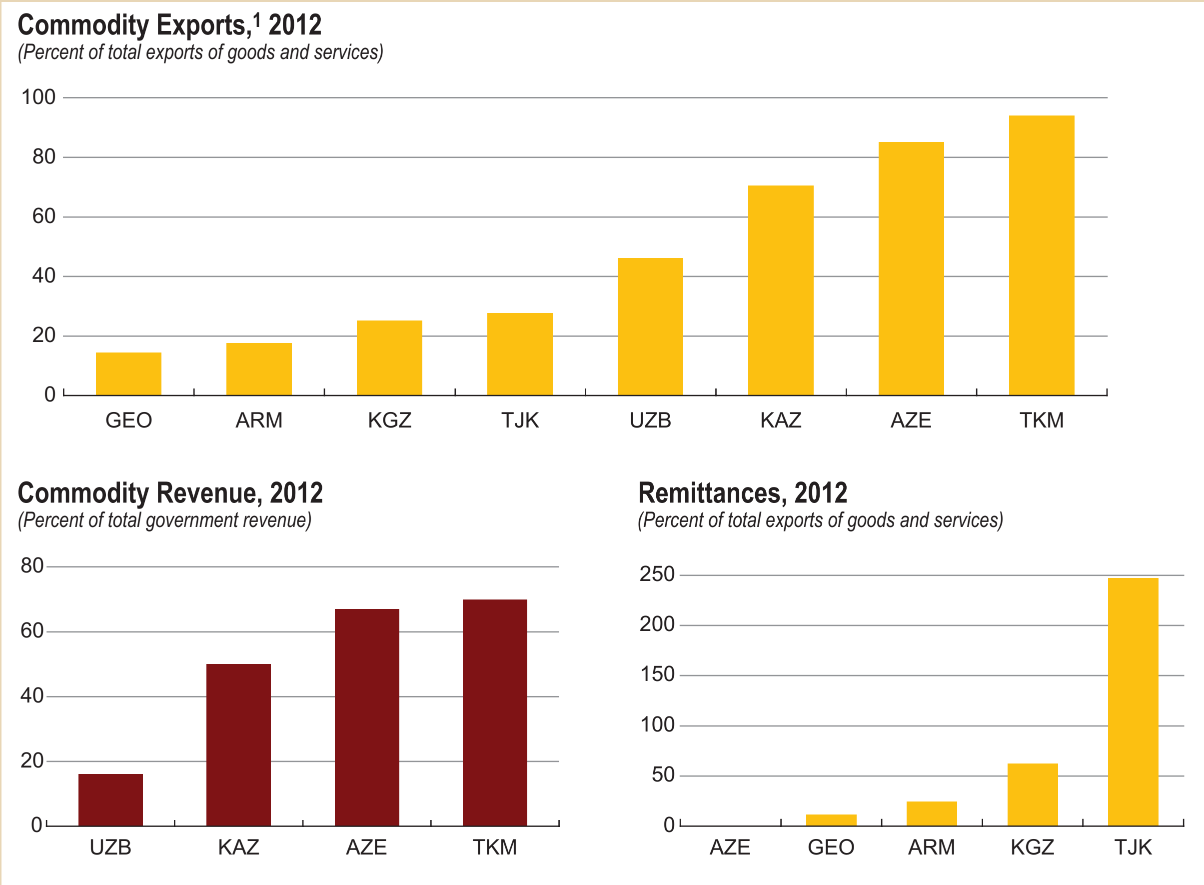
CCA countries can seize the opportunity afforded by strong commodity prices and remittances flows to pursue ambitious reforms and become emerging markets in the medium term. These reforms could target and remove key structural impediments, and could significantly strengthen fiscal, monetary, and financial sector policy frameworks, thereby creating the conditions for continued growth that is more rapid, stable, and inclusive. A recent analysis shows that if CCA countries can gradually move during the next decade to just the average of the global level of economic policy effectiveness,[2] they can

[1] Prepared with inputs from Jonathan Dunn and Mark Horton, based on a May 2013 conference in the Kyrgyz Republic on the lessons of the post-Soviet transition and future challenges for CCA countries (http://www.imf.org/external/np/seminars/eng/2013/cca/).

[2] Government effectiveness captures economic policy consistency and formal planning, quality of budgeting and financial management, and the quality of public administration.

Figure 3.15

Growth in the Region Has Not Been Diversified



Sources: National authorities; IMF World Economic Outlook; and IMF staff estimates.

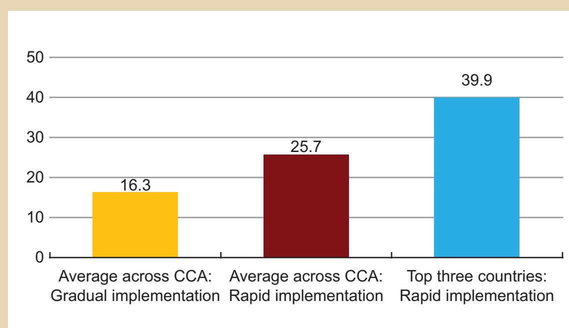
[1]Includes oil, gas, precious metals, aluminum, copper, other metals, metal byproducts, and cotton.

achieve considerably higher per capita GDP (Figure 3.16). Moreover, the more rapidly these reforms are implemented, the larger that income gain would be.[3] Yet reform implementation has slowed across the CCA in the past decade as the result of political economy constraints arising from vested interests and state capture, which may continue to stand in the way of ambitious reforms.

Figure 3.16

Relative Gains by 2023

(Percent of GDP per capita in 2023 under existing policies)



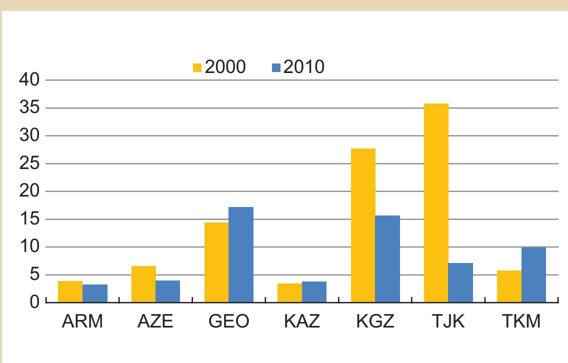
Sources: National authorities; and IMF staff estimates.

[3] These results are consistent with earlier IMF analysis (*Regional Economic Outlook: Middle East and Central Asia*, November 2012) that showed that higher growth in emerging markets and developing countries since 1990 is mostly tied to improvements in policymaking and the building of policy space.

Important elements of an ambitious reform agenda to help the CCA countries achieve the emerging market vision of higher, sustainable, less volatile, and more inclusive growth are the following:

- *Enhancing structural reforms and regional cooperation.* Many CCA countries are lagging in reforms that would deepen and sustain competitive markets, and greater regional cooperation could help drive and diversify growth. Governance and business climates can be strengthened to leverage FDI and domestic investment into nonresource sectors in a number of ways, including regulatory streamlining, better bankruptcy and collateral frameworks, improved domestic competition environments, and enhanced financial reporting and management structures. Performance and prospects may also be enhanced through education reforms to reduce skills mismatches and by stronger health care systems. Intraregional trade has actually declined significantly (as a share of total trade) in most CCA countries during the past decade (Figure 3.17); improved regional cooperation could increase the quality and spread of growth- and trade-facilitating infrastructure and transit facilities, and address concerns about energy and water security.

Figure 3.17
Trade with CCA
(Percent of total trade)



Sources: World Integrated Trade Solutions (WITS); and IMF staff calculations.

- *Strengthening fiscal frameworks.* Improved fiscal frameworks can support fiscal sustainability and help rebuild the buffers needed to manage shocks and volatility of growth. For all CCA countries, fiscal frameworks could be extended to cover the medium term and to anchor policy through clear paths for key fiscal indicators. For CCA oil importers, this could be the debt-stabilizing deficit level; for CCA oil exporters, this could involve price- and savings-based fiscal rules. Energy exporters could strengthen their frameworks further by ensuring that spending from resource savings goes through the budget, rather than through extrabudgetary or quasi-fiscal channels. All CCA countries could enhance transparency and accountability by broadening the definition of the public sector to include the operations of state enterprises, reporting quasi-fiscal activities in budget documents, strengthening public sector statistics, and establishing one-stop and e-government services.

- *Improving the effectiveness of monetary policy.* Stronger monetary frameworks would allow CCA countries to consolidate gains from price stability, increase the resilience of their economies to external and domestic shocks, and support growth. Although some countries have made progress in implementing inflation targeting in recent years (Armenia, Georgia), all eight CCA countries should further improve the quality and timeliness of data, central bank communications strategies, and inflation forecasting. Central banks in the region should progressively shift from policy based on monetary aggregates to open-market operations that rely on liquidity forecasting to strengthen these frameworks. Moving toward exchange rate flexibility in the medium term would also be important for de-dollarization and greater effectiveness of monetary policy, along with development of deeper securities markets to support open-market operations.

- *Fostering financial sector development*. Underdeveloped and often weakly regulated financial systems in CCA countries limit the effectiveness of monetary policy and hamper productive private investment and job-creating growth. CCA financial sectors can be strengthened in a number of ways. Constraining or eliminating directed lending and subsidized lending rates to state-owned enterprises will protect the health of banks and create more competition in the banking sector. Applying prudential and regulatory norms evenly and fully across all financial institutions, easing entry requirements for new banks, and fostering the consolidation or privatization of state-owned banks would also help. Access to finance for small and medium-sized enterprises and other small borrowers could be supported through the creation of private credit bureaus and stronger microfinance institutions. Deepening government debt markets and developing other capital markets are also important.

CCA countries should take measures to move beyond the status quo in which several CCA countries face gradually weakening growth prospects and continuing vulnerability to shocks. Resolute actions to pursue structural reforms, enhance business environments and regional cooperation, and strengthen policy frameworks are likely to lead to greater investment and higher, more inclusive growth, moving these countries toward emerging market status. However, ambitious reforms will not be easy in the face of the political economy challenges in many CCA countries. These challenges include limited domestic political competition throughout the region, political uncertainties caused by lack of clear succession arrangements in several CCA countries, absence of independent judiciaries, and regional tensions. The strong position of well-connected businessmen (oligarchs) who lobby against policy changes is another constraint. If the CCA countries are able to mitigate or overcome these political economy constraints, there could be huge rewards for their populations.

CCA: Selected Economic Indicators

	Average 2000–07	2008	2009	2010	2011	2012	Projections 2013	2014
Real GDP Growth	**10.3**	**6.8**	**3.7**	**6.6**	**6.8**	**5.8**	**5.8**	**6.1**
(Annual change; percent)								
Armenia	12.0	6.9	–14.1	2.2	4.7	7.2	4.6	4.8
Azerbaijan	15.9	10.8	9.3	5.0	0.1	2.2	3.5	5.6
Georgia	7.6	2.3	–3.8	6.3	7.2	6.1	2.5	5.0
Kazakhstan	10.2	3.2	1.2	7.0	7.5	5.1	5.0	5.2
Kyrgyz Republic	4.5	7.6	2.9	–0.5	6.0	–0.9	7.4	6.5
Tajikistan	8.7	7.9	3.9	6.5	7.4	7.5	6.7	5.8
Turkmenistan	15.2	14.7	6.1	9.2	14.7	11.1	12.2	10.4
Uzbekistan	6.0	9.0	8.1	8.5	8.3	8.2	7.0	6.5
Consumer Price Inflation	**9.8**	**16.5**	**6.2**	**7.0**	**9.1**	**5.3**	**6.9**	**7.0**
(Year average; percent)								
Armenia	2.9	9.0	3.5	7.3	7.7	2.5	7.0	3.5
Azerbaijan	6.2	20.8	1.6	5.7	7.9	1.0	3.7	6.3
Georgia	6.4	10.0	1.7	7.1	8.5	–0.9	–0.3	4.0
Kazakhstan	8.5	17.1	7.3	7.1	8.3	5.1	6.3	6.3
Kyrgyz Republic	6.9	24.5	6.8	7.8	16.6	2.8	8.6	7.2
Tajikistan	17.2	20.4	6.5	6.5	12.4	5.8	7.5	7.2
Turkmenistan	8.1	14.5	–2.7	4.4	5.3	5.3	7.6	7.0
Uzbekistan	16.8	12.7	14.1	9.4	12.8	12.1	12.1	10.4
General Government Overall Fiscal Balance	**1.4**	**6.1**	**0.8**	**3.7**	**6.3**	**4.4**	**1.2**	**0.5**
(Percent of GDP)								
Armenia[1]	–2.5	–1.8	–7.7	–5.0	–2.9	–1.6	–2.2	–2.3
Azerbaijan[1]	0.5	20.3	7.0	14.6	13.3	4.1	–4.5	–6.7
Georgia	–1.8	–6.3	–9.2	–6.6	–3.6	–3.0	–3.3	–2.7
Kazakhstan	3.3	1.1	–1.4	1.4	5.9	4.5	4.8	4.1
Kyrgyz Republic	–4.5	0.0	–3.4	–6.3	–4.6	–5.4	–5.3	–4.2
Tajikistan	–2.8	–5.1	–5.2	–3.0	–2.1	0.5	–2.3	–1.3
Turkmenistan[2]	1.9	10.0	7.0	2.0	3.6	6.4	1.8	2.0
Uzbekistan	0.9	10.2	2.8	4.9	8.8	8.5	1.2	0.6
Current Account Balance	**–0.6**	**8.8**	**0.4**	**4.5**	**7.9**	**4.8**	**3.9**	**3.1**
(Percent of GDP)								
Armenia	–5.9	–11.8	–15.8	–14.8	–10.9	–11.3	–10.0	–8.6
Azerbaijan	–3.5	35.5	23.0	28.0	26.5	21.7	13.3	9.2
Georgia	–10.4	–22.0	–10.5	–10.2	–12.7	–11.5	–6.5	–7.8
Kazakhstan	–2.4	4.7	–3.6	0.9	6.5	3.8	4.3	3.1
Kyrgyz Republic	–1.2	–15.5	–2.5	–6.4	–6.5	–15.3	–9.6	–8.3
Tajikistan	–3.4	–7.6	–5.9	–1.2	–4.7	–1.3	–1.7	–2.2
Turkmenistan	7.0	16.5	–14.7	–10.6	2.0	0.0	0.2	3.8
Uzbekistan	4.9	8.7	2.2	6.2	5.8	0.7	0.2	1.1

Sources: National authorities; and IMF staff estimates and projections.
[1]Central government.
[2]State government.