

CENTRAL ASIA

Subregional growth was better than expected in the first half of 2002 largely due to rapid growth in investment and production. Higher oil and gas prices in the second half of the year will benefit the energy exporters of Azerbaijan, Kazakhstan, and Turkmenistan. Some slower growth might be expected in the latter part of the year as the economy of the Russian Federation weakens, the effects of the heavy rains on the cotton crop in the early part of the year are felt, and non-oil commodity prices stabilize.

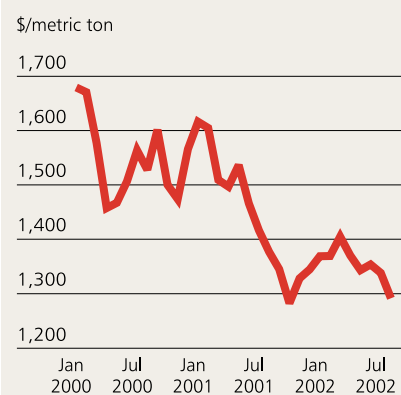
MACROECONOMIC ASSESSMENT

The global economic slowdown in 2001 weakened demand and exerted downward pressure on international prices of several of the subregion's major export commodities including cotton, oil, and nonferrous metals. The attacks in the US in September 2001 also created additional uncertainties in the countries neighboring Afghanistan. Despite these unfavorable external circumstances, the majority of countries continued the process of economic recovery that had been under way for the 3 preceding years. Weighted average GDP growth in the subregion was 8.7% in 2000 and 10.7% in 2001. Preliminary figures indicate that real GDP grew by a weighted average of 8.4% in the first quarter of 2002, just slightly lower than the year earlier figure of 8.6%.

The impact of softening commodity prices in 2001 (except for gold) was offset to varying degrees in different countries through increases in production. The oil sector, which is still in a phase of investment-led expansion, is the main engine of economic growth in both Kazakhstan—the subregion's largest economy—and Azerbaijan. In Kazakhstan, real GDP continued to expand at a double-digit rate—10.7% in the first quarter of 2002—fueled by a high level of investment in the oil sector and by rising oil export volumes. Growth was more modest in Azerbaijan (4.7% compared to 8.2% a year earlier) due to various capacity constraints. In Turkmenistan, real GDP growth was 10.8% for the first quarter of the year, owing to strong performance in both the industry and agriculture sectors. Industrial performance is dominated by the gas sector, in which production increased sharply as new fields came on stream. Cotton export revenue in Turkmenistan increased despite weak international prices, as processed cotton exports rose substantially from the level of a year earlier. The subregion experienced heavy rains in early 2002, putting an end to a 3-year drought. As a result, agricultural production started to recover slowly. At the same time, increased production of processed cotton benefited Tajikistan and Uzbekistan, which registered GDP growth of 9.3% and 3.1%, respectively, during January–March 2002 (up from 7.9% and 2.8% in the same period a year earlier).

A marked deterioration in current account balances is partly due to a fall in commodity prices ...

**Aluminum Prices,
January 2000–August 2002**



Sources: CEIC Data Company Ltd.

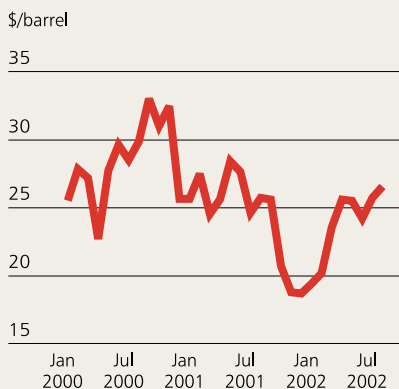
Selected Economic Indicators, Central Asia, 1999–2003

	1999	2000	2001	2002		2003	
				ADO 2002	Update	ADO 2002	Update
GDP Growth (%)							
Average	5.1	8.7	10.7	5.7	6.2	6.4	5.7
Azerbaijan	9.5	11.1	9.9	10.0	9.1	11.0	8.5
Kazakhstan	2.7	9.8	13.2	7.0	7.5	6.0	6.0
Kyrgyz Republic	3.7	5.4	5.3	4.5	4.4	4.5	4.2
Tajikistan	3.7	8.3	10.3	6.0	8.0	5.0	6.0
Turkmenistan	16.0	17.6	20.5	11.0	11.0	11.0	11.0
Uzbekistan	4.4	4.0	4.5	4.0	2.0	5.0	3.0
Inflation (%)							
Average	15.5	17.0	13.6	10.0	10.8	5.6	8.2
Azerbaijan	-8.5	1.8	1.5	1.8	2.5	2.0	2.5
Kazakhstan	8.3	13.2	8.4	6.6	5.6	5.6	5.9
Kyrgyz Republic	35.9	18.7	6.9	7.5	4.1	5.5	4.7
Tajikistan	27.5	32.9	38.6	8.9	13.0	7.6	11.0
Turkmenistan	23.5	7.4	5.6	8.5	8.5	7.5	7.5
Uzbekistan	26.0	28.2	26.4	18.0	22.5	—	13.5
Current Account Balance (% of GDP)							
Average	-4.3	-0.5	-4.2	-4.5	-4.1	-4.9	-4.4
Azerbaijan	-13.1	-3.2	-0.9	-3.0	-6.0	-5.0	-9.7
Kazakhstan	-1.4	2.3	-7.8	-4.5	-6.6	-4.7	-6.0
Kyrgyz Republic	-14.4	-5.6	-0.9	-6.3	-3.8	-6.5	-5.4
Tajikistan	-3.4	-6.6	-7.0	-6.2	-4.2	-5.5	-4.5
Turkmenistan	-18.0	-13.9	-1.5	—	—	—	—
Uzbekistan	-1.0	1.4	-0.6	—	-1.2	—	-2.0

— Not forecast.

Sources: ADO database; staff estimates.

... notably crude oil, from a Brent average of \$28.30 a barrel in 2000 to \$24.40 in 2001.

Crude Oil Prices, January 2000–August 2002

Sources: CEIC Data Company Ltd.

The Kyrgyz Republic is the only notable exception to the GDP pattern, with real GDP declining by 4.9% in the first half of 2002, prompted mostly by a sharp decline in gold production after record levels were seen in 2001. Although, in the past, the agriculture sector has generally helped alleviate the country's heavy dependence on gold, the sector grew only moderately in the first quarter of 2002 because of late sowing due to climatic and seasonal factors.

Fiscal balances have continued to strengthen in the subregion, helped by improved revenue collection due to higher tax revenues from commodity exports and to prudent expenditure management. Azerbaijan, Kazakhstan, and Tajikistan have so far reported budget surpluses equivalent to 3.3%, 3.7%, and 2.8% of GDP, respectively, for the first quarter of 2002. In Turkmenistan and Uzbekistan, according to official reports, the state budget is close to balance. However, the true state of the fiscal balance remains unclear, as many fiscal transactions are conducted through off-budget funds. The Kyrgyz Republic is again the exception, with a budget deficit equivalent to 5.6% of GDP for the first quarter of 2002. The sharp slowdown in GDP has dampened revenue collection, while the Government has little scope to reduce social spending given high and widespread poverty levels.¹

¹In addition, the budget figures for the Kyrgyz Republic include the Public Investment Program, but not for other countries. Hence, the figures are not strictly comparable.

Inflation, though varying greatly across the subregion, improved in the first quarter of 2002 from a year earlier. This was mainly the result of stronger fiscal positions and tight monetary stances. However, it remains a matter of concern in Tajikistan and Uzbekistan, with annual inflation reaching 26.2% and 24.5%, respectively, in the first quarter of the year. Among the main factors pushing up consumer prices are high food prices owing to shortages caused by earlier droughts in Tajikistan, and rising utility prices in Uzbekistan. The other economies of the subregion experienced much lower inflation rates, ranging from 1.9% in Azerbaijan to 5.6% in Kazakhstan, over the same period.

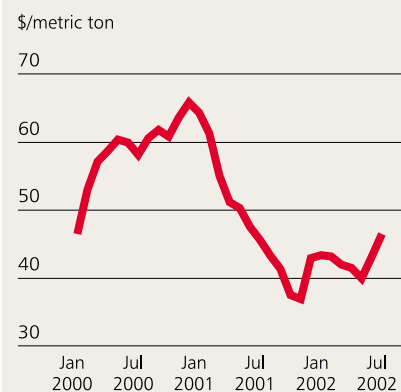
Exchange rate stability was maintained in the first quarter of 2002. The currencies of Kazakhstan and the Kyrgyz Republic remained stable, while those of Azerbaijan and Tajikistan experienced marginal depreciation. In Turkmenistan, large hard currency inflows from gas exports enabled the Government to maintain the official exchange rate and stabilize the spread between the official and black market rates, which, however, remains extremely wide. In Uzbekistan, as part of an IMF staff monitored program, the Government has promised to narrow the rate between the official and black market rates. While the commercial rate (the rate at which the public can buy dollars through licensed exchange bureaus) has been substantially depreciated and is now almost equivalent to the curb market rate, progress in the depreciation of the official rate has been gradual and there is still considerable uncertainty over the possible reunification of official and market rates this year.

Trade balances in the subregion generally worsened in the first quarter of 2002 compared to a year earlier. Export earnings remained stagnant or decreased slightly as a result of weaker commodity prices. Imports increased significantly, specifically in Azerbaijan and Kazakhstan where oil sector developments pushed up import volumes (primarily capital technology and services imports). Turkmenistan is a notable exception with a sharp increase in its trade surplus for the first quarter of the year, owing to a robust year-on-year rise in both export volume and prices, as Turkmenistan was able to negotiate a slightly higher price for its gas exports to two key markets: the Russian Federation and Ukraine. The Commonwealth of Independent States (CIS) countries, in particular the Russian Federation, remain the main trading partners for nearly all the countries in the subregion.

In 2001, there was a marked deterioration of the current account balance in the subregion. This was caused by a combination of a fall in commodity prices (most notably crude oil, from a Brent average of \$28.30 a barrel in 2000 to an average of \$24.40 a barrel in 2001) and a sharp acceleration in import expenditure growth. The current account deficits are not a cause of concern for Azerbaijan and Kazakhstan as they can be easily covered by rising FDI inflows, mostly in the oil and gas sector. In other countries, however, FDI inflows remained very low, making their overall external position much weaker. Governments have to rely on credit from international financial institutions (IFIs) and bilateral donors to cover their external deficits. As a result, external debt stocks have risen rapidly, reaching 110% and 97% of GDP in the Kyrgyz Republic and Tajikistan, respectively, in 2001. The corresponding high level of debt service obligations is likely to put a serious strain on government budgets, thereby threatening prospects for growth and poverty reduction over the medium term. External debt management is therefore a key policy issue and both countries have been working closely with IMF to develop and implement a debt-reduction strategy. The Government of Tajikistan reduced its debt to the Russian Federation by about \$50 million in 2001, while the Government of the Kyrgyz Republic successfully concluded a debt rescheduling agreement with the Paris Club in March 2002, reducing its debt service burden for 2002–2004 from about \$100 million to \$5.5 million.

While cotton prices started to recover in early 2002 they are still off their recent highs.

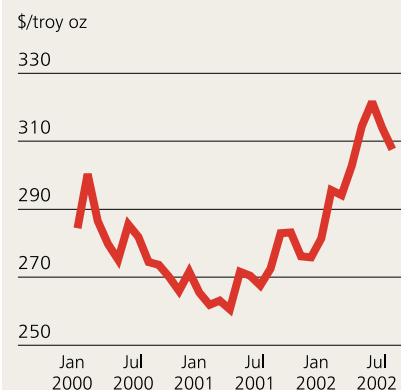
Cotton Prices, January 2000–July 2002



Sources: www.fao.org.

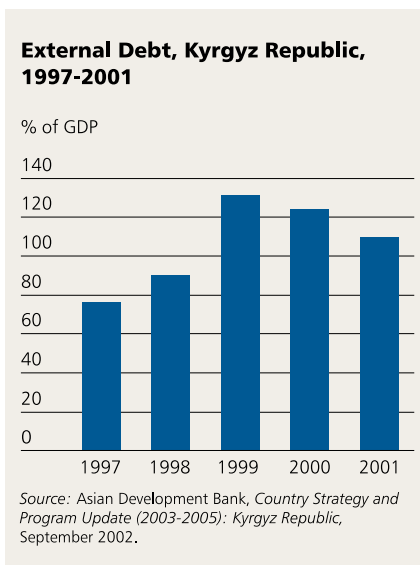
The notable exception to softening commodity prices is gold, the price of which has been steadily increasing since the first quarter of 2001.

Gold Prices, January 2000–August 2002



Sources: CEIC Data Company Ltd.

External debt stocks have risen to 110% of GDP in the Kyrgyz Republic ...



POLICY DEVELOPMENTS

The events of September 11, 2001 in the US and the ensuing campaign against terrorism have led to heightened international interest in the subregion. A number of reform measures encompassing both policy and structural elements have been implemented over the past year in most subregional countries as part of comprehensive programs sponsored by IFIs. In Azerbaijan, while an IMF poverty reduction and growth facility (PRGF) has been ongoing since the summer of 2001, the World Bank approved a second structural adjustment credit program worth \$60 million in March 2002. In Tajikistan, the Government is currently negotiating with IMF on a new PRGF, subject to the successful review of a six-month staff monitored program (January–June 2002). IMF also implemented a staff monitored program in Uzbekistan from January to June 2002. A final review is expected in September and, if successful, this may lead to the finalization of a regular program in the fourth quarter of the year. Even Turkmenistan, whose relations with IFIs have been extremely limited in recent years, has sought to revive its relations with them.

Reform measures have achieved some positive results, most notably in terms of the restoration and maintenance of macroeconomic and financial stability. However, the reform process is far from complete. Among the most important items remaining on the agenda are much-needed improvements in the investment and business climate and in external debt management, along with a further deepening of structural and social sector reforms. The lack of private sector development in the non-oil sector remains a source of concern in Azerbaijan and Kazakhstan, where poverty levels remain high despite robust GDP growth. Both countries have established state oil funds to better manage their increasing oil revenues, but their level of social sector spending seems inadequate to achieve their respective development objectives. Private sector involvement is even more limited in Turkmenistan and Uzbekistan, as both governments have largely preferred state-led development so far. The persistence of very restrictive exchange rate regimes in both countries has further dampened private sector growth.

OUTLOOK FOR 2002–2003

Economic growth in Central Asia has started to slow, following an impressive performance in 2000 and 2001. Real GDP growth for 2002 is currently projected at 6.2%, down from 10.7% in 2001, but somewhat higher than the *ADO 2002* growth forecast of 5.7%. Growth will continue to be driven by increases in commodity production and exports, particularly oil and gas. Higher commodity prices (most notably oil and nonferrous metals) contributed positively to growth in the first three quarters of 2001, but price declines in the fourth quarter had a dampening impact, which will continue to be felt in 2002. Some commodity prices, particularly oil, have started to recover since the beginning of 2002, and have contributed to the improved outlook in the first half of the year. Oil and gas prices are expected to rise further during the second half of the year, thus supporting growth in Azerbaijan, Kazakhstan, and Turkmenistan. However, an expected slowdown of the Russian Federation's economy in 2002 is likely to negatively impact growth performance, as the country is a key export market for the subregion. In addition, the heavy rains that hit the subregion at the start of the year are likely to have benefited the grain crop but to have damaged the cotton crop. This will negatively affect agriculture output growth in Uzbekistan in the latter part of 2002 and in early 2003, since most of the cotton harvest is processed the following year. The slowdown in agricultural output in Tajikistan and Turkmenistan (the other main cotton producers) should be offset by sustained industrial

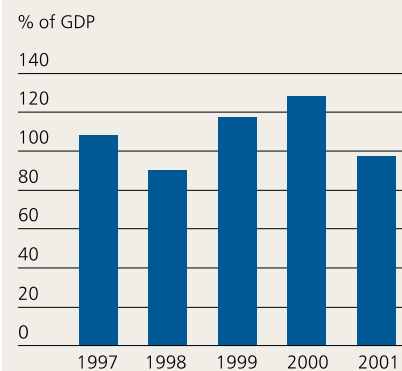
growth, driven mostly by aluminum production in the former and gas exports in the latter. As for the Kyrgyz Republic, gold production is not expected to rebound until 2003. As a result, growth will likely be driven mainly by agriculture in 2002 and is expected to slow to 4.4% (down from 5.3% in 2001 and an *ADO 2002* forecast of 4.5%), before picking up to around 4.2% in 2003 (against a forecast of 4.5% in *ADO 2002*).

Inflation in the subregion is likely to decrease further in 2002 and 2003, against the backdrop of a tight monetary stance. Average consumer price inflation is expected at 10.8% in 2002 (compared to 10% in *ADO 2002*) and 8.2% in 2003 (5.6% in *ADO 2002*). The fiscal stance remains generally fragile. The budget surpluses recorded for the first quarter of 2002 are misleading, as governments tend to be in arrears. Budget deficits ranging from 1% of GDP (Azerbaijan) to about 5% (for the Kyrgyz Republic) are expected in 2002. The tax base in most countries remains extremely narrow and, as a result, government budgets remain heavily dependent on a few commodities.

The deterioration of the subregional current account balance is set to continue in 2002–2003, albeit at a more moderate rate. Import expenditures (including services imports linked to oil and gas expansion) will continue to accelerate while export revenues will grow moderately, as oil prices firm somewhat in the second half of the year, barring any unexpected supply shock. Export revenues are expected to grow in 2002, albeit at a slower rate than anticipated in *ADO 2002*. Given the lack of improvement expected in the trade and current account positions, debt servicing is likely to become more difficult in already indebted countries such as the Kyrgyz Republic and Tajikistan.

... and 97% of GDP in Tajikistan.

External Debt, Tajikistan, 1997-2001



Source: Asian Development Bank, *Country Strategy and Program Update (2003-2005): Tajikistan*, September 2002.