ASIAN DEVELOPMENT

# Outlook 2002

**ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA**

## Central Asian Republics

Azerbaijan
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

# AZERBAIJAN

With improved performance in the non-oil sector, the economy maintained strong momentum in 2001, but overall GDP growth fell slightly as world oil prices declined. Growth prospects remain positive for 2002–2003 as major investments in the oil and gas sector are expected. Policy commitment to developing the non-oil sector through deepening structural reforms remains key to achieving sustained growth and poverty reduction.

## MACROECONOMIC ASSESSMENT

GDP growth for 2001 is estimated at about 9.9%, a slight decrease from the 11.1% in 2000 (Figure 2.21). Agriculture increased by around 11% because of higher grain production resulting from an expansion in the area under cultivation. The oil and gas sector, the most important part of the economy and accounting for almost 30% of GDP, continued to grow only slowly, due mainly to a sluggish rise in  production.

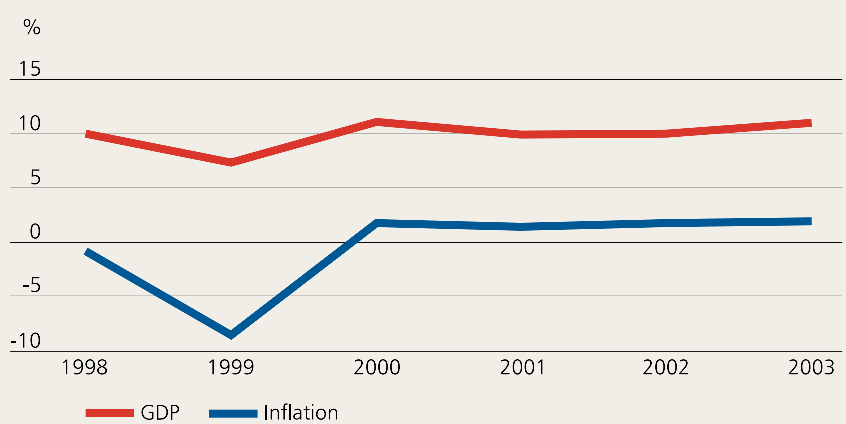
Domestic investment recovered in 2001. Preliminary data point to improved foreign investment. Foreign investment inflows (primarily in the oil and gas sector), which currently account for 56% of total gross domestic investment, are estimated to have climbed to about $700 million, or 13% of GDP, during the year. Despite strong economic growth and improved investment, there is no indication of improvement in the employment situation: unemployment is now estimated to have risen to 18%, because much of the economic growth has been in capital-intensive areas that create few jobs.

Government revenues (excluding the State Oil Fund), which rose in nominal terms on account of the strong GDP growth, still fell short of budget targets. As a result, revenues relative to GDP declined to 18% in 2001 from 18.6% in the previous year. Although government expenditures rose by 10% in nominal terms, the expenditure-to-GDP ratio fell to 20.1% from 20.8% in 2000. As a result, the fiscal deficit slightly improved from 2.2% of GDP in 2000 to 2.1% in 2001. Foreign capital remained the major source of deficit financing.

Broad money supply increased by 9.7% in 2001. Much of the increase was due to financial deepening, as total money supply, including foreign currency deposits, is currently only 12% of GDP. Annual inflation, measured by the consumer price index, remained modest at 1.5%. The exchange rate depreciated by 4.4% against the dollar to AZM4,748 by the end of the year.

Exports strengthened by 7.9% in 2001, lifted by strong oil exports. With falling imports, this resulted in an improved trade balance and a surplus equivalent to 9.6% of GDP. As a result, the current account deficit narrowed to 2.3% of GDP from 3.4%, despite

FIGURE 2.21 **GDP Growth and Inflation, Azerbaijan, 1998-2003**




*Sources*: Asian Development Bank *Country Strategy and Program Update (2002-2004)*; State Statistical Committee.

TABLE 2.19 Major Economic Indicators, Azerbaijan, 1999–2003 (%)

| Item | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| GDP growth | 7.4 | 11.1 | 9.9 | 10.0 | 11.0 |
| Inflation rate (consumer price index) | -8.5 | 1.8 | 1.5 | 1.8 | 2.0 |
| Money supply (M2) growth | 15.2 | 18.3 | 9.7 | — | — |
| Fiscal balance/GDP | -4.5 | -2.2 | -2.1 | -2.0 | -2.0 |
| Merchandise export growth | 51.5 | 83.6 | 7.9 | — | — |
| Merchandise import growth | -16.6 | 7.5 | -5.4 | — | — |
| Current account balance/GDP | -13.1 | -3.4 | -2.3 | -3.0 | -5.0 |

— Not available.

*Sources:* Asian Development Bank, *Country Strategy and Program Update (2002–2004)*; State Statistical Committee.

**The Government has demonstrated a renewed commitment to structural and institutional reform.**

the growing deficit on the nonmerchandise account.

On the capital account, gross foreign investment recovered, mainly in the form of FDI in the oil and gas sector. Despite rising debt repayments and growing funds in the State Oil Fund, gross international reserves improved from $680 million in 2000 to $744 million at the end of 2001, or equivalent to about 5 months of non-oil imports of goods and services. Total public and public-guaranteed external debt rose from $1.16 billion in 2000 to about $1.27 billion in 2001, but as a proportion of GDP remained stable at 22%.

## POLICY DEVELOPMENTS

A mix of a tight fiscal policy and a looser monetary stance was pursued in 2001. In view of the growing accumulation of spending arrears and worse than expected revenue performance, the fiscal deficit target of 2% of GDP was not met. The loosening of the monetary stance reflected the policy intention of supporting the development of the non-oil sector. But credit availability in this sector remained limited because of the underdeveloped banking sector and poor financial intermediation. The Government continued with its flexible exchange rate policy with the objective of maintaining currency stability and of supporting the non-oil sector.

The Government demonstrated a renewed commitment to structural and institutional reform, including the launching of a new privatization program and the streamlining of governnment organization. Preparation of a national program for poverty reduction, which emphasizes non-oil sector development, also began.

A new reform program—introduced with the assistance of IMF—aimed at deepening trade liberalization; promoting good governance, especially financial discipline in the energy sector; and improving the legal and regulatory environment for private sector development.

## OUTLOOK FOR 2002–2003

The growth prospects for 2002–2003 are positive, provided that, as expected, oil investments increase and the world economy begins to recover in the second half of 2002. With agricultural performance likely to be stable, overall economic growth is forecast at around 10% in 2002 and 11% in 2003. Some major investment activities are expected to begin in 2002, which will help boost economic activity. They include the start of phase one of the full development of the Azeri-Chirag-Guneshi oil field and the construction of the Baku-Tbilisi-Erzurum gas pipeline. The inflation rate is expected to be fairly stable at 1.8% and 2.0% in 2002 and 2003, respectively.

The Government's current tight fiscal and looser monetary policy mix is expected to continue. However, a challenge for the Government is to increase much-needed social expenditures while keeping the fiscal deficit under control. Higher investment, which is closely associated with oil equipment imports, is expected to increase pressure on the current account, which is projected to swing to a deficit of 3% of GDP in 2002 and to 5% of GDP in 2003. To promote non-oil trade activities, the Government will likely allow a quicker depreciation of the manat. Debt service is expected to rise, reaching about 8.5% of exports of goods and services in 2003.

# KAZAKHSTAN

Economic growth improved in 2001 to over 13%. Manufacturing performed well while production and exports of oil and other minerals were buoyed by high prices in the first three quarters of the year. However, the economy, dependent on a narrow range of exports, remains vulnerable to external factors. The medium-term outlook hinges on the pace of structural reform, economic diversification, and commodity prices, particularly those of oil.

## MACROECONOMIC ASSESSMENT

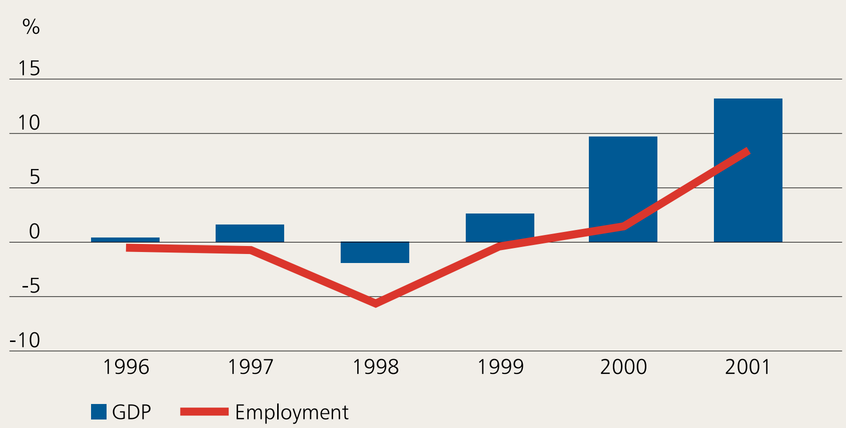
Economic performance in 2001 remained strong, with real GDP growth accelerating to 13.2% from 9.8% in 2000. Continued rapid growth was driven by buoyant world oil and other mineral prices (until the fourth quarter of 2001), robust regional demand for exports, and strong investment. The pace of growth, however, slowed to 11.7% in the fourth quarter from 16.6% in the second due to the softening of prices for oil and other minerals and uncertainty following the September 11th attacks in the US.

The easing of these prices was largely responsible for a slight deceleration in industrial output growth to 13.5% in 2001 from 15.5% in 2000. Manufacturing output rose by 14.8%, benefiting from strong regional demand for Kazakhstan's machinery, textile, leather, and chemical products. Agricultural output grew by 16.9%, compared with a contraction of 3.3% in 2000. Aided by good weather and an extension of the sown area, grain production increased by 37% to 15.9 million tons from 11.6 million tons in 2000. Cotton production rose by 45% in 2001, also partly because of an extension of the sown area. The services sector accelerated to 13.6% growth in 2001 from 9.3% in the previous year as private sector activities in wholesale and retail trade, hotels, restaurants, and housing continued to expand.

Capital investment remained strong, rising by 21%. More than half the total capital investment went to the oil and gas sector, followed by manufacturing, transport and communications, and construction. Major sources of capital investment were private domestic and foreign investment, which accounted for 58% and 30% of the total, respectively, while public investment made up the balance.

Rapid economic growth contributed to an improvement in the population's standard of living. Per capita income rose by over 10% relative to 2000. Average nominal monthly wages in 2001 were T17,258 (equivalent to $117), a 25.4% rise over the 2000 level. In real terms, average monthly wages went up by 9.5%. As a result, the share of the population living below the subsistence minimum of T4,637 (equivalent to $31 a month at the end of 2001) declined from

FIGURE 2.22 **Change in GDP and Employment, Kazakhstan, 1996-2001**




*Source*: Staff estimates.

TABLE 2.20 Major Economic Indicators, Kazakhstan, 1999–2003 (%)

| Item | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| GDP growth | 2.7 | 9.8 | 13.2 | 7.0 | 6.0 |
| Gross domestic investment/GDP | 17.8 | 17.9 | 23.0 | 16.9 | 16.8 |
| Gross domestic savings/GDP | 16.0 | 22.9 | 22.3 | 23.5 | 24.7 |
| Inflation rate (consumer price index) | 8.3 | 13.2 | 8.4 | 6.6 | 5.6 |
| Money supply (M2) growth | 84.4 | 44.9 | 40.2 | 27.0 | 22.4 |
| Fiscal balance/GDP[b] | -3.5 | -0.1 | -0.6 | -2.3 | -2.0 |
| Merchandise export growth | 2.0 | 60.6 | -3.5 | 11.6 | 5.2 |
| Merchandise import growth | -15.3 | 21.3 | 23.5 | 11.7 | 15.3 |
| Current account balance/GDP | -1.4 | 4.1 | -4.6 | -4.5 | -4.7 |

[a] Annual average. [b] Fiscal balance for 2001–2003 includes transfers to the National Fund.

*Source:* Asian Development Bank Kazakhstan Resident Mission datafile.

**The fiscal position remained stable, supported by continued growth as well as by enhanced tax collection and the expansion of the tax base.**

31.8% in 2000 to 28% in 2001. The actual unemployment rate fell to 10.4% from 12.8% in 2000, but despite the decline, unemployment is still a major problem in rural areas and among women (Figure 2.22).

The fiscal position remained stable, supported by continued growth as well as by enhanced tax collection and the expansion of the tax base. Total government revenues rose to 24.2% of GDP from 22.6% in 2000, as a result of strong receipts from income and social insurance taxes and from VAT. Nontax revenues, accounting for roughly 10% of the total, rose by 88%, largely due to the rent paid by the Russian Federation for use of the Baikonur space complex. In contrast, capital revenues amounted to only 49% of the target due to slow progress in privatization. In line with total revenues, government expenditures increased to 24.7% of GDP from 23.1% in 2000. The Government raised spending for the social sectors and capital investment, which accounted for 46.4% and 11.5%, respectively, of total government expenditures. Overall, the budget deficit widened to 0.6% of GDP in 2001 from 0.1% in 2000, due to the sharp expansion of public spending and budgetary transfers to the National Fund. The transfers totalled 3% of GDP in 2001, and the Fund had accumulated nearly $1.24 billion by the end of 2001 (equivalent to 6% of GDP). The Fund was established in May 2001, both to reduce the volatility of budgetary revenues caused by fluctuations in world oil prices and to consolidate savings for future generations. Budgetary contributions to the Fund are made if the price of Kazakhstan oil exceeds $19 a barrel (or $23 a barrel for Brent crude).

The central bank followed a somewhat expansionary monetary policy, keeping pace with the liquidity demand of a rapidly expanding economy. The refinancing rate was reduced from 14% in 2000 to 9% in 2001, the lowest level since independence in 1991. This led to a cut of the average weighted interest for the corporate sector from 18.8% in 2000 to 16.3% at the end of 2001, and consequently a rise in commercial bank lending by 77.3% compared with the previous year. A capital amnesty, announced by the central bank in 2001 to encourage money illegally transferred to foreign banks to return to the country tax free, brought over $500 million back into the banking sector. As a result, money supply grew by 40.2% over the course of 2001, but the sterilization efforts of the central bank, continued monetization of the economy, and increased productivity helped keep inflation under control. Slower increases in the prices of nonfoodstuffs and services (4.5% and 3.5%, respectively) and a 15.5% decline in the price of gasoline contributed to lower inflation, which, as measured by the consumer price index, fell to 8.4% in 2001 from 13.2% in 2000. The tenge remained fairly stable in 2001, with a depreciation of 3.2% against the dollar in nominal terms.

Lower prices of oil and other minerals in the international markets, together with rapidly increasing imports, reduced the size of the trade surplus, which shrank to about 4% of GDP from 15.2% in 2000. Exports—almost 90% of which were oil and other minerals—declined by 3.5% in 2001 from the prior year level, while imports surged by 23.5%, mainly due to rising capital goods imports. As a result, the balance of payments suffered, with the current account recording a deficit equivalent to 4.6% of GDP. Nevertheless, the heavy presence of oil multinationals in the country ensured a steady inflow of FDI to cover the current account deficit. The sharp rise in gross FDI to $3.6 billion in 2001, contributed to an increase in the capital account surplus, from 5.6% of GDP to about 7% over the same period. International reserves of the central bank rose by 22% to $2.56 billion, while gross official reserves (including the National Fund) soared by 79% to $3.75 billion (equivalent to 4.2 months of imports of goods and services). Total public external debt continued to fall, from $4 billion (21.9% of GDP) in 2000 to $3.4 billion (16.6% of GDP) in 2001 due to limited new borrowing by the Government and its continued repayments of the outstanding external debt. The public debt service ratio declined to 17.3% from 24.6% in 2000.

## POLICY DEVELOPMENTS

The Government continued its efforts in 2001 toward fiscal sustainability. A new tax code designed to broaden the tax base was approved by Parliament in June 2001 and became effective on 1 January 2002. A number of tax exemptions were abolished and fiscal stimulus was provided through a lowering of the social insurance tax and VAT rates. In April and November 2001, the Government revised the state budget and increased revenues and expenditures: revenues mainly as a result of improved tax collection and buoyant prices for the country's major exports; expenditures because of the Government's decision to clear wage and pension arrears accumulated from previous years.

As budget revenues remain sensitive to oil and other mineral prices, the Government needs to restore fiscal balance in the coming years by expanding the tax base through diversifying the economy and accelerating privatization. Despite the adoption of a new tax code, it needs to strengthen the tax and customs administration by introducing simplified declarations and completing the computerization of the system. In addition, it needs to enhance the administration of transfer pricing, rationalize public spending, and prioritize capital expenditures.

Monetary policy developments were encouraging in 2001. A decline in inflation allowed the central bank to cut the refinancing rate to 9%, below its target of 11%. As a result, the primary lending rates by commercial banks were reduced to the lowest level since independence. Because of sterilization of capital inflows, the central bank was able to maintain a relatively stable exchange rate and to avoid an overappreciation of the tenge, which could have had an adverse effect on the non-oil sector.

Finance sector reform continued, with a focus on strengthening the banking sector. A sound regulatory system and a fairly stable national currency are contributing to the stability of the banking system, while the deposit insurance system, banking secrecy, and confidentiality of the capital amnesty all helped increase household confidence in the system. As a result, public deposits rose to T185.5 billion (or $1,223 million), as against the 2001 target of T135 billion (or $890 million).

To provide long-term financing to the corporate sector, including SMEs, the Government established the Kazakhstan Development Bank in July 2001. The development of nonbank financial intermediaries continued, since pension funds account for almost 6% of GDP. However, little progress was made in relaxing strict regulations on pension fund investments and diversifying investment instruments. In view of the weak domestic stock market, investment regulations should be amended, allowing pension funds to invest some of their assets abroad.

The Government maintained its liberal trade policy, as accession to WTO remains a priority. Selected customs tariffs were abolished, and further simplification of the tariff system is expected.

**As budget revenues remain sensitive to oil and other mineral prices, the Government needs to expand the tax base through diversifying the economy.**

## OUTLOOK FOR 2002–2003

The economic prospects for 2002–2003 remain positive, though GDP growth is expected to slow to 7% in 2002 and to 6% in 2003, mainly due to moderate world prices for oil and other minerals. However, the impact of low oil prices will be mitigated by the expected growth of oil production due to the recent opening of the Caspian Consortium Pipeline. In addition, a new pipeline linking the North Caspian oil field to this pipeline is to be completed by 2005. Therefore, the oil sector and continued FDI inflows to the development and exploitation of hydrocarbon resources will con-

**Greater efforts are needed to raise the competitiveness of industry through accelerating privatization, restructuring or closing nonperforming enterprises, and improving the legal and business environment.**

tinue to drive medium-term growth. Projected strong regional demand is also likely to boost GDP growth as the other economies in the Commonwealth of Independent States increase their imports of manufactured goods, including machinery, textile, and leather products.

A deterioration of the fiscal situation is expected in 2002–2003 as the Government will raise its budgetary spending to ensure a 25% increase in public sector wages and large external debt repayments in 2002 (mainly due to a $350 million eurobond redemption). Under the assumption that the oil price for Brent crude stays at $23 a barrel, the budget deficit is projected at 2.3% of GDP in 2002 and 2% of GDP in 2003. Nonetheless, if oil prices decline further, the National Fund will be able to provide some offset and support for the fiscal position. In 2002–2003, monetary policy should be expansionary in support of continued robust economic growth. The central bank has announced a medium-term monetary policy that focuses on inflation targeting rather than currency devaluation. It is likely to pursue a reserve money management regime to keep inflation in the 4–6% range in 2002–2003. Interest rates are expected to decline in line with the fall in inflation.

The trade balance is likely to remain positive over the next 2 years as oil production increases. Exports are expected to rise, reflecting an anticipated moderate global economic recovery in the second half of 2002. The current account deficit is projected to increase to about 5% of GDP in 2002–2003, as imports are likely to grow faster than exports. However, the expected increase in FDI inflows in the near term will likely cover the current account deficit. External public debt is projected to decrease, in view of the fact that the Government is committed to repaying its outstanding external debt and to limiting new external borrowing.

Despite recent achievements, the economy faces some major development challenges on two main fronts. On the first, limited economic diversification and high dependence on oil and other minerals make the country vulnerable to volatility in prices of these commodities. In addition, structural reforms have been very slow because privatization and restructuring of the corporate sector have been at a virtual standstill. Economic diversification is important for sustainable development. Equally, greater efforts are needed to raise the competitiveness of industry through accelerating the privatization process, restructuring or closing nonperforming enterprises, improving the legal and business environment, and building a system of good corporate governance. These measures will encourage greater investment in the non-extractive sector. On the second front, while projected strong growth is likely to further improve living standards, the Government needs to ensure that it benefits the whole population.

The Government is giving high priority to poverty reduction, and a comprehensive medium-term poverty reduction program for 2003–2007 will be developed by May this year. The realization of the Government's commitments to increase public sector wages and to introduce a mandatory social insurance system in 2003 will also contribute to enhanced living standards. However, additional efforts need to be made in addressing regional inequality, particularly in rural areas where poverty is more prevalent.

# KYRGYZ REPUBLIC

The macroeconomic situation stabilized in 2001 as the Government pursued prudent fiscal and monetary policies and implemented key structural reforms. The recently concluded Paris Club meeting has addressed the short-term problems of debt burden and bunching of debt service payments. Long-term prospects depend on further debt rescheduling by bilateral creditors in 2004.

## MACROECONOMIC ASSESSMENT

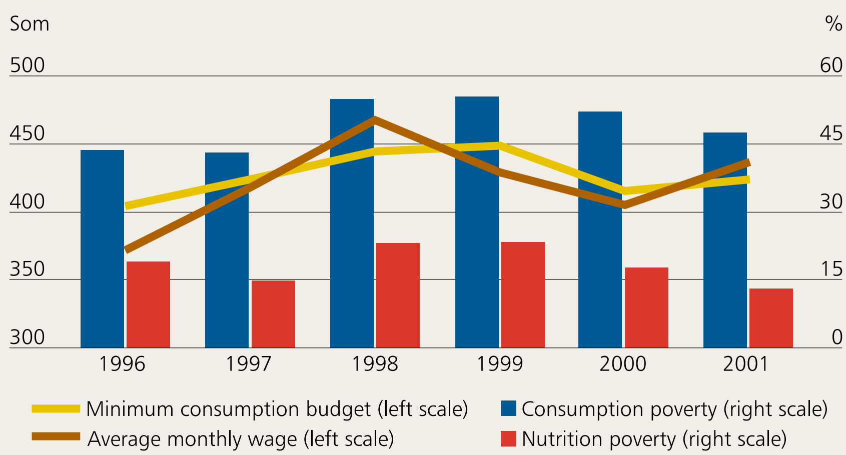
In 2001, GDP grew by 5.3%, a rate slightly lower than in the previous year. In agriculture, which expanded by a healthy 6.8%, productivity growth and an expansion in the area under cultivation generated a large food grain harvest of 1.8 million tons. This was 16.3% higher than 2001's output and 12% more than the previous peak. However, the output of animal husbandry, important for the poorer mountainous regions, rose by only 2.2%. Though the industry sector grew by 5.4%, growth was uneven and masks the decline in the output of several subsectors. Excluding the metallurgical sector, whose gross production increased by 13.8%, industrial output fell by 1.6% in 2001 due to a significant decline in the output of power generation, agroprocessing, oil refining, and pharmaceuticals. A sharp drop in transport services restricted growth in the services sector to a modest 2.4%, reflecting the decline in both industrial and foreign trade activity.

Gross domestic investment fell from 18% of GDP in 1999 to about 16% in 2000 due to a fall in the Public Investment Program (PIP), from 9% of GDP to 7% over this period. In 2001, the rate of investment declined further, by about 35%. A heavy external debt repayment burden, caused by the bunching of debt service requirements, pulled down the PIP to 4.4% of GDP in 2001.

The unemployment rate increased from 5.9% of the labor force in 1998 to 7.5% in 2000. The level of unemployment is not officially available, but on the basis of estimates of the registered unemployed, it seems that there has been very little reduction in unemployment in spite of robust growth in the last 2 years. However, poverty incidence has dropped, from 52% at the end of 2000 to 47.4% in September 2001, as a result of higher agricultural growth and stable food prices (Figure 2.23). This suggests that the insensitivity of the unemployment rate to significant growth may be the result of an increase in labor force participation rates.

Under IMF's new Poverty Reduction and Growth Facility (PRGF) program, the Government embarked on an ambitious fiscal compression program,

FIGURE 2.23 **Real Wages and Poverty Incidence, Kyrgyz Republic, 1996-2001**




*Source*: National Statistical Committee.

TABLE 2.21 Major Economic Indicators, Kyrgyz Republic, 1999–2003 (%)

| Item | 1999 | 2000 | 2001[a] | 2002 | 2003 |
|---|---|---|---|---|---|
| GDP growth | 3.7 | 5.4 | 5.3 | 4.5 | 4.5 |
| Gross domestic investment/GDP | 18.0 | 16.0 | — | 16.1 | 15.8 |
| Inflation rate (consumer price index) | 35.9 | 18.7 | 6.9 | 7.5 | 5.5 |
| Money supply (M2) growth | 33.9 | 12.4 | 11.3 | 13.5 | — |
| Fiscal balance/GDP | -12.7 | -10.0 | -4.0 | -4.9 | 4.3 |
| Merchandise export growth | -13.5 | 10.4 | -6.0 | 2.8 | 3.4 |
| Merchandise import growth | -27.6 | -8.2 | -14.4 | 4.8 | 5.9 |
| Current account balance/GDP | -14.4 | -5.6 | -0.7 | -6.3 | -6.5 |
| Debt service ratio | 26 | 25.7 | 29.4 | 30.7 | 31.0 |

— Not available.
[a] Preliminary data.

*Sources:* National Statistics Committee; National Bank of the Kyrgyz Republic; Ministry of Finance; International Monetary Fund (for 2002–2003).

**A high burden of public debt prevented the Government from devoting more resources to consumption and investment expenditures.**

cutting its fiscal deficit from 10% of GDP in 2000 to 4.4% in 2001. Current revenues increased by 1.2 percentage points of GDP while public spending fell by 4.3 percentage points, and the PIP recorded a sharp fall. Parliament reviewed the budget in the middle of the year and amended certain tax measures to enhance the revenue-to-GDP ratio. It also increased user charges on many paid services to improve nontax revenues.

Continuing a policy begun in 2000, the central bank restricted monetary growth to 10–12%. However, it relaxed the reserve requirements of the commercial banks in June, resulting in an easing of the banking sector's liquidity position. Tight monetary policy and solid performance of the agriculture sector sharply reduced the monthly average rate of consumer price inflation to 6.9% in 2001 from 18.7% in 2000, while the year-on-year rate of inflation fell sharply to 3.6% from 9.6% in the previous year. Increases in the administered prices of utilities and in user charges represented the main source of inflation, as nonfood consumer goods prices registered a modest increase of 1.4% and food prices did not rise at all.

The foreign sector contracted in 2001. Exports fell by 6% due mainly to lower exports of power, food products, and nonprecious metals, while imports shrank by 14.4% due to a fall in public investment. This resulted in a positive trade balance of $50.5 million, which helped limit the current account deficit to about 0.7% of GDP. The som depreciated by about 1.5% against the dollar in 2001.

## POLICY DEVELOPMENTS

Under IMF's PRGF, the Government will adopt a three-pronged approach to mitigate the medium-term risks to the economy and to improve economic performance. The PRGF takes into account some of the important structural adjustment reform programs of ADB and the World Bank. The key components of the program are: implementation of a credible debt strategy, continued pursuit of prudent fiscal and monetary policies to maintain macroeconomic stability, and implementation of structural reforms.

The high burden of public debt prevented the Government from devoting more resources to consumption and investment expenditures. Total external debt was estimated to be about $1.7 billion (112% of GDP) at the end of 2001, of which 55% was multilateral and 29% bilateral (owed mainly to Japan, the Russian Federation, and Turkey), and the rest commercial debt. The debt service burden is high at around 30% of exports of goods and services, and until recently, the Government had to face the looming problem of bunching of debt over 2002–2004. A large part of the nonconcessional debt (representing about one fifth of the total) was due for repayment, with grace periods for many concessional loans coming to an end. However, in March this year, agreement was reached at the Paris Club whereby debt servicing during 2002–2004 was rescheduled favorably with the possibility of debt stock restructuring in 2004, provided that the ongoing PRGF is implemented successfully. In addition, the Government has adopted a debt reduction strategy that, among other things, stipulates lowering the PIP to 3% of GDP by 2005.

The main objective of the fiscal stance for 2001–2004 is to achieve a turnaround in the budget, securing budgetary savings of 2% of GDP by 2004 from dissavings of 2.5% in 2000. This requires an increase in fiscal revenues of about 3.5% of GDP and rationalization of government consumption expenditures. The Government proposes to cut direct tax rates in 2002. Several measures have been put in place to compensate for the potential short-term loss of tax revenues. Further reforms to customs; VAT; and turnover, property, and land taxes are envisaged to improve revenues, and a 10% tax on interest incomes is to be introduced. Tax administration will be modernized and streamlined with a special focus on the customs department. On the expenditure side, the burden of fiscal adjustment will fall mainly on the PIP.

The Government undertook several structural reform measures in 2001 in an attempt to create a conducive environment for the private sector to function efficiently and to improve public sector governance. In the finance sector, it took steps to liquidate four nonviable banks. It also purchased the largest commercial bank—Kairat—from the central bank, augmented its capital, and has taken steps to improve its management with a view to eventual privatization. The regulatory capacity and powers of the central bank are being strengthened further. The Government has also initiated measures to strengthen the legal framework for the debt restructuring agency. Other notable structural reform measures include the introduction of international accounting standards, preparation of a blueprint and a time-bound implementation plan for judicial reform, and steps to facilitate rapid implementation of public enterprise reforms.

## OUTLOOK FOR 2002–2003

GDP is expected to grow at 4.5% in each of the next two years. This is lower than the 5% target set under the interim National Poverty Reduction Strategy (NPRS), which charts the development approach for the 3 years 2001–2003. The lowering of the growth target reflects the constraints imposed by a gradually declining public investment program and the difficulties in attracting private investment to fill the gap. Achieving even this lower growth target depends on several important factors: substantial easing of the debt repayment burden this year; continued pursuit of tight fiscal and monetary policies to maintain macroeconomic stability; prompt implementation of key structural reforms in a number of areas, particularly in banking, agriculture, energy, and infrastructure; public sector governance and adjudication processes; and a favorable external environment for the economy. Under these assumptions, consumer price inflation is expected to have fallen to 5.5% by 2003 (after reaching 7.5% in 2002). Although the current account deficit in 2001 fell sharply due to a trade surplus and a squeeze on public investment, it is expected to rise to over 6% of GDP in the next 2 years as investment activity reverts to normal levels.

The recent restructuring of external debt is likely to prove critical for ensuring sustainability of public finances and for maintaining even the gradually reduced levels of spending on the PIP.

**Recent developments indicate that the general business environment is still not supportive of the private sector.**

Recent developments, such as declining production in several industry subsectors including food processing, a fall in commercial credit in the banking sector, low levels of private investment, and subdued inflows of FDI indicate that the general business environment is still not supportive of the private sector.

Economic prospects depend to a large extent on the urgent implementation of structural reforms under a tight fiscal regime, limited implementation capacity, and political difficulties in implementing stringent measures to improve public sector governance. Fortunately, though, the aftermath of the events of September 11th and the conflict in Afghanistan did not have the feared major adverse impact. Nevertheless, political uncertainty in the region could make Central Asia a less attractive destination for FDI. Therefore, any deterioration in the political situation in Afghanistan could impede inflows of FDI and the long-term prospects for economic growth and poverty reduction in the Kyrgyz Republic.

# TAJIKISTAN

The economy in 2001 fared much better than forecast, with GDP growth reaching double digits, though this is expected to slow somewhat as capacity constraints are reached in aluminum smelting. External developments will also be critical, since exports, primarily cotton and aluminum, amount to about 70% of GDP. The situation in neighboring Afghanistan and developments in the Russian Federation, the country's major trading partner, will be particularly important to watch.

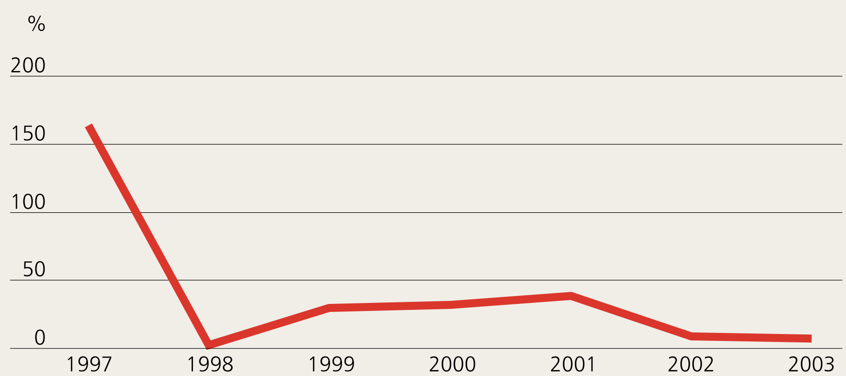
## MACROECONOMIC ASSESSMENT

With the conclusion of the peace process in 2000, Tajikistan embarked on rebuilding an economy ravaged by civil war. In 2001, contrary to all expectations, economic growth accelerated to 10%, up from 8.3% in the previous year. As in 2000, it was led by a substantial increase in aluminum production. However, other industry subsectors languished, so while overall industrial production rose by 14.1%, industrial output (excluding aluminum) shrank by 5%. The agriculture sector, which contributes around 20% of GDP and accounts for more than half total employment, performed very well. Despite continued drought, it recorded an 11% expansion, fueled mainly by a 35% increase in cotton production, which stemmed from an increase in both planted and irrigated areas and from the low-base effect of low output in 2000.

Economic growth, in which the driving force is rising capital-intensive aluminum production, has so far failed to have much of an impact on formal sector employment or the level of poverty. While the official unemployment rate fell to 2.8% in 2001 from 3.3% in 2000, unofficial estimates put the unemployment or underemployment rate much higher at over 30%. An estimated 200,000 people left the country in 2001, more than in the previous year, most of them to the Russian Federation in search of work. Some emigrated permanently, and some left for seasonal work. Further, about one third of the labor force is estimated to be working abroad. (Even during the Soviet era, Tajikistan was a major supplier of labor within the Soviet Union.) Such population movements should be seen against a background in which almost 80% of the population continue to live in poverty.

The Government derives its main revenues from sales taxes on cotton and aluminum (37% of the revenue base), as well as from excise and customs duties. The tax base of the private sector is very narrow, and neither personal nor corporate income tax yet plays a significant role. The budget deficit fell by half to 0.2% of GDP in 2001, and showed a primary surplus of 0.4% of GDP, a switch from a 0.3% deficit in 2000. This surplus was attained mainly by higher than expected revenue collections, but excludes

FIGURE 2.24 **Change in Consumer Price Index, Tajikistan, 1997-2003**




*Source*: Staff estimates.

TABLE 2.22 Major Economic Indicators, Tajikistan, 1999–2003 (%)

| Item | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| GDP growth | 3.7 | 8.3 | 10.0 | 6.0 | 5.0 |
| Inflation rate (consumer price index) | 30.1 | 32.9 | 38.5 | 8.9 | 7.6 |
| Fiscal balance/GDP | -2.3 | -0.4 | -0.2 | -1.0 | -1.0 |
| Merchandise export growth | 13.7 | 18.9 | 1.8 | 8.8 | 8.7 |
| Merchandise import growth | -5.2 | 21.1 | 8.0 | 4.5 | 6.8 |
| Current account balance/GDP | -3.2 | -5.9 | -7.7 | -6.2 | -5.5 |
| Debt service ratio | 5.1 | 10.0 | 18.0 | 43.0 | 38.0 |

*Sources:* International Monetary Fund; Government of Tajikistan; staff estimates.

the largely externally financed Public Investment Program, which accounted for 3% of GDP in 2000 and 4.1% in 2001. The greatest strain on, and danger to, the economy derive from the high levels of external debt repayments, both in terms of the principal and debt service. For 2001, over 1.7% of GDP was scheduled for servicing the external debt, up from 0.3% in 2000. Despite some successful bilateral negotiations, the grace period for some loans expired, and substantial repayments were due to IMF.

In 2000 and 2001, social spending accounted for 48% of government revenues and this has resulted in a squeeze on other essential expenditures, because of the Government's aim that over 40% of the budget should go to providing essential social services. Capital expenditures invariably suffered.

The Government continued its tight monetary stance in 2001. In the past, much of the inflationary pressure in the country was generated by exchange rate movements, the high costs of key imports from the Commonwealth of Independent States, and bad harvests that drove up food prices. Overall annual inflation was 38.5% in 2001, about 6 percentage points higher than in the previous year (Figure 2.24). The currency is stronger while the impact of the ongoing drought has diminished as a result of imports.

Burdened by many nonperforming loans, mostly extended in the form of direct credits to SOEs, or privatized enterprises with strong state connections, the banking sector remains paralyzed. Lending to the private sector is at a virtual standstill. If banks extend loans at all, they are short term and intended for trade finance only. Indeed, the largest sources of credit to the private sector are the nonperforming loans of commercial banks that are rolled over.

The economy is highly dependent on foreign trade, with exports equivalent to 70% of GDP. Cotton and aluminum are responsible for over 80% of export earnings, rendering the economy extremely vulnerable to terms-of-trade shifts caused by fluctuations in international prices and, indeed, the prices of these two major exports deteriorated considerably in 2001: cotton, for example, fell by 35%. In addition, production of goods for export was severely hampered by a 2-month closure of the railway connection between Tajikistan and the Russian Federation—the country's major trading partner. Some conservative estimates put the loss of export earnings at about $8 million, approximately 1% of total exports. Imports increased, but at a slower rate than in 2000. Wheat and power imports rose as a result of the drought. Thus, the current account deficit widened from 5.9% of GDP in 2000 to 7.7% in 2001.

The balance of payments is shored up by international donors. In 2001, additional donor transfers increased reserves and resulted in import cover of 2.3 months at year-end, compared with 2.1 months 12 months earlier. External debt stood at 113% of GDP at the end of 2001.

**The greatest strain on the economy derives from the high levels of external debt repayments.**

## POLICY DEVELOPMENTS

The external debt burden is the most pressing economic problem that the Government will face over the next decade. It has therefore agreed to a debt reduction strategy with IMF, which includes making fiscal adjustments. To broaden the tax base, the Government now plans to strengthen

**The financial market is hampered by the public's lack of trust in the banking sector.**

the Large Taxpayers Inspectorate and to computerize the tax system. This is crucial, if it wants to offset the effects of the reduction to 5% in the cotton sales tax by end-2002. It also plans to earmark privatization proceeds for debt reduction, as well as to continue bilateral debt restructuring, for which purpose it is negotiating with the Russian Federation, its largest creditor. Although in 2001 the two governments agreed to reduce Tajikistan's debt stock by $49.5 million, the remaining discussions will be more controversial as both parties disagree on the exchange rate for valuing the remaining debt and on the question of debt-equity swaps. However, even the more optimistic debt scenarios conclude that the fiscal burden of servicing the debt will become unsustainable, and that debt rescheduling through an approach to the Paris Club in the near future will be necessary. The Government hopes to reschedule its debt under Naples terms (i.e., a debt reduction of two thirds of the net present value of eligible debt).

Since 2000, foreign exchange has been traded in the relatively competitive interbank currency market, and the authorities aim to intervene only to smooth out short-term volatility. The financial market itself is still undeveloped, hampered by an almost complete public lack of trust in the banking sector. This is reflected in the very low deposit-to-GDP ratio of below 5%. To revitalize the banking sector, the Government has embarked on a reform program. In 2000, the largest four commercial banks signed restructuring agreements, which include submitting business plans and undergoing financial audits. Two have already published audit results and the others are expected to follow soon. Five banks that did not comply with minimum capital requirements are now being liquidated. The Government is also working on changes to the legislative framework and tax system, including making loan losses 10% tax deductible.

Agriculture sector restructuring still presents a major hurdle to economic growth. The Government is undecided between safeguarding a minimum number of large-scale, industrialized, agricultural complexes to produce cash crops such as cotton, or allowing privatization and agricultural reform (to which it officially pledges its commitment). The process of privatization itself has been slowed by allegations of corruption and by a lack of the necessary skills in government to deal with such an ambitious undertaking. In addition, agriculture suffers from both a lack of credit in the noncotton sector and overindebtedness in that sector. It is thus crucial that the Government develop mechanisms to support the provision of rural finance for noncotton activities. This will decrease dependence on cotton and help diversify agriculture. Private farms are keen to expand production of high value-added crops, such as fruits and vegetables. In turn, this could stimulate growth in agroprocessing industries. Several international nongovernment organizations are providing microfinance services in rural regions, and beginning this year, the Government is planning to foster growth of viable microfinance institutions through creating a supportive regulatory framework.

## OUTLOOK FOR 2002–2003

After 5 consecutive years of economic growth, the outlook continues to improve, but significant risks remain. The main factors affecting stability are the high debt burden, the volatility of the external sector, the monolithic nature of industrial and agricultural production, and developments in Afghanistan. In addition, the price of aluminum will continue to weaken due to global oversupply. On the other hand, though, growth in the Russian Federation is expected to remain fairly constant and oil prices are projected to remain relatively stable.

Under these broad assumptions, GDP growth is expected to taper off. The only aluminum smelter is already operating close to full capacity and productivity gains of newly privatized farms will only be realized gradually. In monetary policy, the Government will keep a tight stance to reduce inflation to around 9% in 2002, and ensure fiscal discipline. The budget deficit is not expected to exceed 1% of GDP. The forecast for the debt service ratio has worsened in comparison with previous estimates made in 2001, as Tajikistan has to repay newly called-in government guarantees. However, the current account will likely improve as forecast increases in wheat and power production will reduce the need for such imports.

Whether economic growth finally succeeds in bringing down poverty levels depends crucially on the nature of that growth. There is an urgent need to diversify the economy and encourage manufacturing and small-scale enterprises. However, the Government's focus has so far remained on increasing power, cotton, and aluminum production, none of which is labor intensive.

# TURKMENISTAN

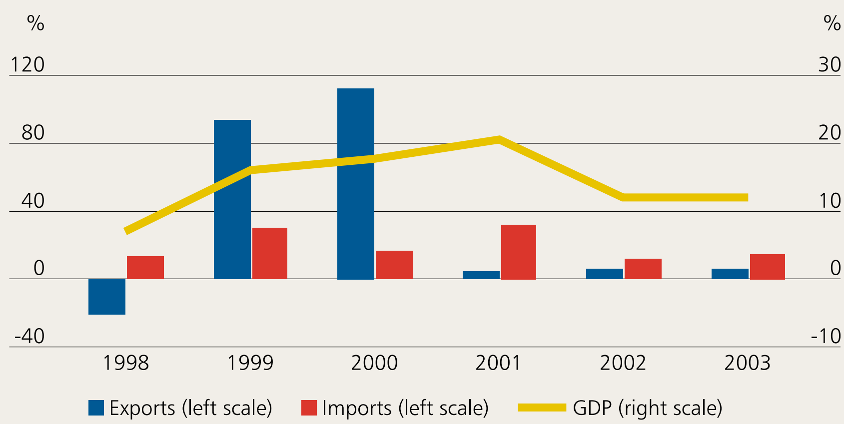
With a third successive year of around 20% rates of growth, GDP in 2001 recovered to above pre-independence levels. Economic prospects, however, remain strongly linked to export earnings from natural gas, oil, and cotton. While industrial and agricultural diversification policies have had some success, policy distortions in the foreign exchange regime discourage private sector growth and inflows of FDI.

## MACROECONOMIC ASSESSMENT

With GDP growth in 2001 officially reported at 20.5%, the economy registered the third year in a row of around 20% expansion. Turkmenistan has benefited from positive developments in external circumstances, which, to a large extent, determine the economic performance and prospects of its export-dependent economy. The continued economic upturn in the Russian Federation and the Ukraine, which together absorbed 88% of total natural gas exports, and in other Commonwealth of Independent States (CIS) economies sustained export demand. Natural gas exports rose because of fuller capacity utilization of a new pipeline to Iran and a larger offtake by the Ukraine and other CIS importers via the Russian Federation. Nearly 7 billion cubic meters (bcm) of gas were exported in 2001 through the pipeline. Natural gas production increased to 51.3 bcm, a rise of 9% over the 2000 level. Of this, 37.3 bcm were exported, 11% more than in the previous year. Oil production also rose, by 12%. The value of industrial output, which consists mainly of oil and gas production, registered an impressive growth rate of 27%. However, transport bottlenecks continued to impose a binding constraint on further expansion of energy product exports.

Cotton exports, the other major revenue earner for the economy, also increased, in their case by 7%, and were helped by a 10% larger harvest than in 2001 (according to official figures). The superior quality of Turkmenistan's cotton fiber and the higher share of processed and value-added cotton exports partly mitigated the impact of a fairly sharp decline in average international cotton prices. Aided by favorable weather conditions and continued policy support, wheat production registered growth of 18% and contributed to a 23% rise in agricultural output. The emergence of a small export surplus in cereals testified to the success of the Government's policies to diversify agriculture away from a cotton monoculture and to generate self-sufficiency in grain production. The services sector has lagged behind industry and agriculture, as a result of weak development in private financial and retail trade activities. Transport and construction, which

FIGURE 2.25 **Change in GDP and Merchandise Trade, Turkmenistan, 1998-2003**




*Sources*: Asian Development Bank, 2001, *Economic Report and Interim Operational Strategy for Turkmenistan*, December; National Institute of Statistics datafile.

TABLE 2.23 Major Economic Indicators, Turkmenistan, 1999–2003 (%)

| Item | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| GDP growth | 16.0 | 17.6 | 20.5 | 11.0 | 11.0 |
| Inflation rate (consumer price index) | 23.5 | 7.4 | 6.0[a] | 8.5 | 7.5 |
| Fiscal balance/GDP | 0.9 | 0.3 | — | — | — |
| Merchandise export growth | 93.3 | 111.7 | 5.0 | 6.0 | 6.0 |
| Merchandise import growth | 30.0 | 16.6 | 32.0 | 12.0 | 15.0 |
| Current account balance/GDP | -18.0 | -13.0 | — | — | — |

— Not available.
[a] January to June.

*Sources:* Asian Development Bank, 2001, *Economic Report and Interim Operational Strategy for Turkmenistan,* December; National Institute of State Statistics and Information of Turkmenistan datafile; staff estimates.

**Turkmenistan has benefited from positive developments in external circumstances.**

remain largely in government hands, showed growth of 4% and 7%, respectively, during January–October 2001, compared with the same period in 2000.

A tight monetary policy stance brought down inflation further to about 6% during the first 6 months of 2001, from an average level of 7.4% in 2000. The banking sector, dominated by public sector banks and government control over all foreign exchange transactions, remains underdeveloped. Essentially, the Government is operating a directed banking sector with public sector commercial banks having very limited autonomy and scope for credit management. The differential between the market and official exchange rates was unchanged over the year, with the market rate depreciating by less than 1% (to 21,500 manat to the dollar) and the official rate remaining pegged at 5,200 manat to the dollar. The huge differential between the two rates has generated widespread rent seeking and distortions that effectively discourage private sector growth.

The state budget recorded a deficit of 291 billion manat (1.2% of GDP) during January–October 2001. Revenues, at TMM5.37 trillion, were 14% short of the annual target and expenditures were 15% below target at TMM5.66 trillion. The true state of the fiscal balance, however, remains unclear because of the large number of off-budget accounts, including the foreign exchange reserve fund, which is managed directly by the President's office and which absorbs a substantial share of foreign exchange revenues from exports.

Foreign trade turnover, equivalent to nearly 80% of GDP, increased by 16% from the 2000 level and was estimated at $4.49 billion. Despite a 32% rise in imports—a result of capital goods imports for the Turkmenbashi oil refinery and other projects in the petrochemical and textile sectors—compared with only a 5% rise in exports, the trade balance still generated a small surplus of $275 million. While details of invisible trade flows are not available, there are significant outflows of foreign exchange on this account, leaving the external current account with only a marginal surplus.

Poverty incidence in Turkmenistan is perhaps the lowest among the transition economies of Central Asia. Extensive subsidies—the sustainability of which, however, remains questionable—in the provisioning of basic goods and services for the entire population have helped shelter people from price increases. Nearly 80% of total annual public expenditures are directed toward social and public services. The high GDP growth rates achieved in the last 3 years, combined with the Government's scheme for subsidized availability of basic commodities and services, has brought down the level of absolute poverty to negligible levels. Relative poverty, defined as the proportion of the population living on less than 50% of the country's average per capita income, is estimated at 15.9%.

## POLICY DEVELOPMENTS

The Government has adopted a three-pronged overall economic policy framework: a transition strategy that accords to the state the leading role in economic development, a gradual approach to economic liberalization and privatization, and a special emphasis on minimizing social costs by subsidizing the provision of basic necessities and services. Within this framework, the Government is also pursuing the twin goals of industrial diversification and self-sufficiency in food and other basic goods.

As part of the diversification strategy, some public sector investment and foreign exchange earnings have been used for establishing textile and garment manufacturing plants, often in collaboration with Turkish partners. These joint ventures are now exporting to the US and Europe. As a result, the share of the textile sector in total industrial production increased from 10.4% to 26% during 1995–2000 while the share of cotton processed domestically in total cotton fiber production rose from 3% to 35% over the same period. However, given the multiple exchange rates and hidden subsidies available to these firms, their financial and economic viability cannot easily be ascertained.

The Government is also attempting to raise the output of processed oil and petrochemical products, and thus achieve higher value-added exports. In pursuit of this, it is undertaking a $1.5 billion upgrade of the Turkmenbashi refinery and developing an associated petrochemicals complex, which is expected to come into operation later in 2002. Another smaller refining and processing facility is being built near Atamurat, in Lebap province, to supply neighboring countries such as Afghanistan and Uzbekistan.

## OUTLOOK FOR 2002–2003

The economic outlook over the next few years remains strongly linked to the export prospects for natural gas, cotton, and—to an increasing extent—crude oil and refined oil products. The country currently produces 51 bcm of gas, representing the utilization of only half its installed production capacity. In 2002, the production target for gas is 72 bcm, a near 40% increase over 2001's level. Similarly, with expanded capacity coming onstream at the Turkmenbashi oil refinery in 2002, a marked increase in production and exports of refined oil products can be expected. Moreover, exports of natural gas, oil, and other basic commodities to the northern and western regions of Afghanistan, which border Turkmenistan, are likely to strengthen over the medium term.

**The economic outlook over the next few years remains strongly linked to export prospects.**

Based on these outcomes, GDP growth is expected to be around 11% in both 2002 and 2003 (Figure 2.25). The official target for GDP growth in 2002 is 18%, which could be achieved if some of the more ambitious (but less likely) export contracts for natural gas materialize, and if exports of textiles and garments are substantially larger than in 2001. On the other hand, there is a risk that, because of the Government's inflexible policy stance with respect to the dominant role of the state in the economy and its maintenance of an extensive system of regulations and controls over trade and industrial activity, the economy may become increasingly isolated from global trade, investment, and financial flows. This could pull down future rates of economic growth.

The risk of an externally induced significant economic downturn, however, may be quite weak, for several reasons. These include the dependence of some CIS economies on energy supplies from Turkmenistan; the emergence of import demand from reconstruction activity in neighboring Afghanistan (the two countries already have extensive trade and commercial links); and the ready market for the country's high-quality cotton fiber in industrial economies, with which strong export links have been established since independence.

# UZBEKISTAN

GDP grew by 4.5% during 2001, despite soft international prices for the country's main exports and a second consecutive year of drought. For sustaining long-term growth with macroeconomic stability, the Government needs to persevere with the major economic and structural reforms that were initiated in 2001.

## MACROECONOMIC ASSESSMENT

GDP growth of 4.5% in 2001, marginally higher than in 2000, pushed national income to 3% above its pre-independence level in 1991 (Figure 2.26). This reflected reasonably strong growth in industrial output and in agriculture, despite continuing drought conditions. The agriculture sector, the largest employer and exporter, recovered after a poor performance in 2000, when the cotton crop was the lowest since independence. The sector registered an expansion of 4.5% in 2001, as cotton yields increased by nearly 10%.

Growth of industrial output accelerated to 8.1% in 2001 from 5.8% in 2000. Production of automobiles surged, mainly as a result of better capacity utilization at UzDaewooAuto, a joint venture. Production of natural gas and ferrous metals also rose, while output of oil and gas condensate decreased.

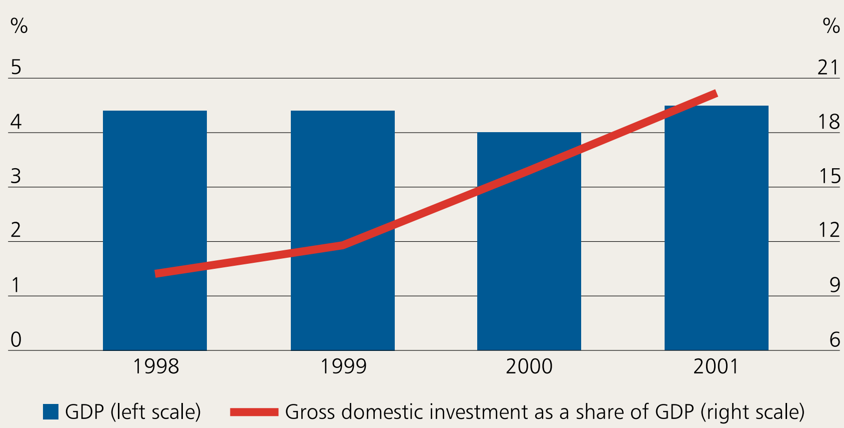
Due mainly to growing private activity, the services sector strengthened by 14.2% in 2001, marking a slight improvement on 13% in 2000. Retail trading, restaurants, and ICT have contributed noticeably to the expansion of the sector over the past few years as a result of small-scale privatization. This growth was achieved despite government restrictions on consumer goods imports.

A slump in international cotton and gold prices in 2001 hurt export earnings, exposing the vulnerability of the economy to fluctuations in commodity markets. The fall in commodity prices forced the Government to continue its policy of import compression and import substitution, to prevent external financing requirements from rising further. Despite these measures, a current account deficit of 0.5% of GDP emerged in 2001, compared with a surplus of 0.8% of GDP in 2000.

The fiscal deficit stayed at 1% of GDP in 2001. The shortfall was financed by central bank credits, the issuance of treasury bills, and proceeds from the sale of SOEs. The central bank's benchmark refinancing rate was 26.8% in 2000 and 2001 on an annual compound basis. The policy of keeping interest rates low can be attributed to the desire of the Government both to prevent its borrowing costs from increasing and to avoid bankruptcies among loss-incurring SOEs.

Consumer price inflation stood at 26.6% in 2001. However, IMF estimates put the inflation rate much higher, as the official data understate the true level of inflation, mainly because of shortcomings in the methodology by which consumer price data are collected.

FIGURE 2.26 **GDP Growth and Gross Domestic Investment Ratio, Uzbekistan, 1998-2001**




*Sources*: Government of Uzbekistan; staff estimates.

Exchange rate reforms and an effective depreciation of the commercial exchange rate, along with a rise in fuel prices and public sector wages, were the main sources of inflation in 2001. Despite the foreign exchange reforms, the market rate stayed at about 2.5 times that of the official rate at the end of 2001, about the same level as at the end of 2000. Exchange rate controls continued to stifle domestic investment activity and flows of FDI into the oil and gas sector.

Official statistics show that registered unemployment at end-2001 was the same as 12 months earlier, namely 0.4% of the workforce. Actual unemployment, however, is estimated to be much higher, and hidden unemployment in the rural sector has been rising.

## POLICY DEVELOPMENTS

With the objective of pursuing a tighter monetary policy and making real interest rates positive, the central bank raised its monthly refinancing rate to 2.5% on 1 January 2002, or to 34.5% on an annual compound basis; the rate in 2001 was 26.8%. This should help bring down inflation and enable the Government to achieve the macroeconomic targets established toward the end of 2001 under an IMF staff-monitored program. The central feature of the IMF reform package is the commitment to initially reduce the differential between the market and official exchange rates to less than 50% by end-March 2002 and to unify the exchange rates by July.

The banking sector and financial markets are still at an early stage of development. This is reflected in the low level of financial intermediation in the economy. Moreover, the banking sector is highly concentrated, with the larger banks remaining in the public sector and facing limited competition. There is a need to facilitate market-oriented reforms, dismantle administrative controls on bank operations including the removal of restrictions on withdrawals, and strengthen public confidence in the banking system. This would allow the banks to increase their deposit base, raise the level of financial intermediation in the economy, and improve the environment for private sector development by ensuring greater access to commercial bank credit.

The 2001 budget targeted a fiscal deficit of 1.5% of GDP, with revenues at 30.1% of GDP and expenditures at 31.6%, based on government growth forecasts. According to official figures, the deficit in 2001 stood at about 1% of GDP. However, this could understate the true figure somewhat because transfers to loss-incurring SOEs were made as directed credit from the banking sector, not as allocations from the budget.

## OUTLOOK FOR 2002–2003

Prospects for 2002 hinge on the policy stance of the Government. Exchange rate unification could dampen short-term growth prospects by restraining consumption and making imported capital goods more expensive. In the medium to long term, however, its positive effects will far outweigh any short-term negative impact. This necessary policy advance will significantly improve the investment climate in Uzbekistan.

**In the medium to long term, the positive effects of exchange rate unification will far outweigh any short-term negative impact.**

The Government envisages growth of 5.1% in 2002. This may not be realized given the global economic environment, continuing softness in international commodity prices, and the short-term impact of the policy changes. A GDP growth rate of 4% is more realistic. With the positive effects of policy measures likely to come through during 2002, higher GDP growth of 5% could be expected for 2003. Inflation by the end of 2002 is forecast to fall to 18%, but the actual figure may be higher because of upward pressure on prices due to exchange rate depreciation. Inflation will tend toward low double-digits in 2003 as the impact of depreciation works its way through the system and supply conditions improve.

Parliament has endorsed the 2002 state budget, which envisages a fiscal deficit of 2% of GDP, to be financed from privatization revenues, short-term government bonds, and credits from the central bank amounting to 0.5% of GDP. The budget includes social assistance to support vulnerable population groups that are likely to be affected by the liberalization measures.

The positive stimulus from exchange rate depreciation may encourage nontraditional exports and help the economy diversify its export base away from cotton and gold. However, a current account deficit of 1–2% of GDP is forecast for 2002–2003, as imports are likely to rise faster with investment activity picking up in response to an improved policy environment. The deficit is, however, likely to be fully financed by larger concessional and private foreign capital inflows, provided that the program of structural reforms is implemented in line with the Government's plans for exchange rate unification and for further liberalization of price and procurement policies in the cotton-growing sector.