

Central Asia

High world prices for the subregion's major commodity exports and rising FDI in oil- and gas-exporting economies are helping sustain subregional economic growth, at 7.5%, in 2003. This impressive figure, however, disguises large variations within the subregion. It also masks the persistent poverty, environmental challenges, and structural weaknesses that need addressing to make growth sustainable and less vulnerable to external circumstances.

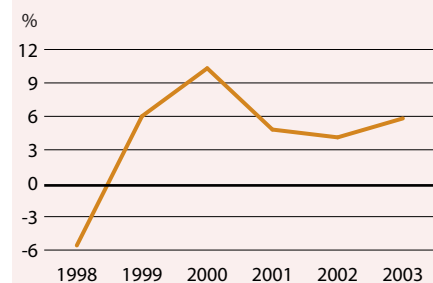
Macroeconomic Assessment

GDP Growth

High world prices for the subregion's major commodity exports, combined with continued strength of the Russian Federation's economy, contributed to a strong economic performance by the Central Asian republics (CARs) in the first half of 2003. Oil prices reached a high of \$31 per barrel in the first quarter of 2003 and remained at relatively high levels in the second and third quarters. Natural gas prices have been rising since the last quarter of 2002, primarily as a result of low stock levels in the US. There has been a strong recovery in cotton fiber prices in the last 15 months and the continued global demand for gold has kept prices at high levels. The Russian Federation's economy, the CARs' largest trading partner, grew by 4.3% in 2002 and by 7.2% in the first 6 months of 2003. Strong FDI inflows in the oil and gas sector in the subregion's hydrocarbon-exporting countries and better agricultural performance in some CARs strengthened subregional domestic demand. As a result of these positive developments, subregional economic growth in the first half of 2003 was estimated at about 8% and for 2003 as a whole it is forecast at 7.5%. The *ADO 2003* forecast made in April this year anticipated that subregional growth in 2003 would slow to 5.8%, mainly because of an expected moderation in investment and production activities in the oil and gas sector.

The average subregional figure, however, masks large variations across countries.¹ The three main oil and gas exporters (Azerbaijan, Kazakhstan, and Turkmenistan), benefiting from higher oil and gas prices and increased investment activity, achieved double-digit GDP growth rates in the first half of 2003 while Tajikistan also recorded high growth of 8.6%. In contrast, the Kyrgyz Republic reported only 2.3% GDP growth in January–June 2003, having suffered from a decline in agricultural output due to adverse weather conditions. Uzbekistan, while benefiting from

GDP Growth, Russian Federation



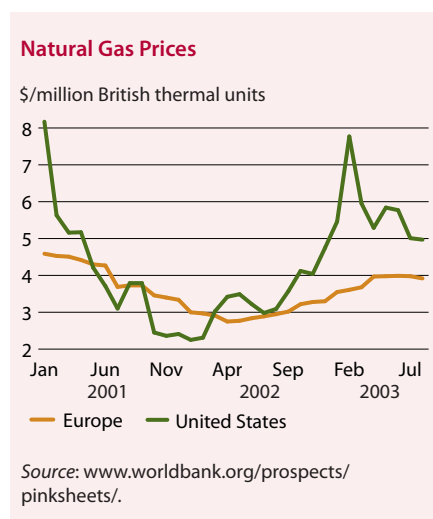
Source: www.eiu.com.

Table 2.4 Selected Economic Indicators, Central Asia, 2002–2004, %

Item	2002	2003		2004	
		ADO 2003	Update	ADO 2003	Update
GDP Growth					
Average	7.3	5.8	7.5	5.8	5.9
Azerbaijan	10.6	9.5	9.5	8.0	8.0
Kazakhstan	9.4	6.0	9.5	6.2	7.0
Kyrgyz Republic	-0.5	5.2	5.2	4.5	5.0
Tajikistan	9.1	7.1	6.0	5.0	4.0
Turkmenistan	8.6	7.5	10.0	7.5	7.5
Uzbekistan	3.2	3.5	3.2	4.0	3.0
Inflation Rate (CPI)					
Average	11.3	13.9	10.4	14.2	9.8
Azerbaijan	2.8	3.2	3.0	2.9	2.7
Kazakhstan	5.9	5.9	6.4	5.4	5.4
Kyrgyz Republic	2.0	-	3.5	-	3.5
Tajikistan	12.2	10.0	14.5	6.0	5.0
Turkmenistan	8.8	-	-	-	-
Uzbekistan	24.2	30.0	19.5	32.0	20.0
Current Account Balance/GDP					
Average	-1.3	-4.2	-1.5	-5.1	-2.4
Azerbaijan	-12.6	-15.0	-19.5	-18.0	-21.0
Kazakhstan	-1.8	-1.5	1.5	-1.8	0.4
Kyrgyz Republic	-2.0	-3.4	-3.4	-5.6	-4.8
Tajikistan	-2.7	-4.0	-5.3	-4.0	-5.7
Turkmenistan	2.1	-	5.0	-	4.6
Uzbekistan	2.8	-	-1.0	-	-1.4

- = data not available; CPI = consumer price index; GDP = gross domestic product.

Sources: ADO database; staff estimates.



higher gold and cotton prices and a reportedly good wheat harvest, still grew by only 3.8% in this period. This was due to a slowdown in industrial and retail trade activities, as both sectors are still suffering from stringent regulations and controls imposed by the Government since July 2002.

Moreover, the quality of economic expansion in Central Asia, in terms of its impact on poverty levels and lower vulnerability to external circumstances, continues to be of concern. Efforts at necessary diversification of the production structure, away from commodity production and toward growth in employment-generating manufacturing, light engineering, and services, have been limited and are still to yield substantial results.

The first 6 months of 2003 have seen significant activity in the oil and gas sector with a 25-year agreement for exports of up to 80 billion cubic meters of natural gas from Turkmenistan to the Russian Federation; a pickup in the construction of the Baku-Tbilisi-Ceyhan oil pipeline in Azerbaijan; the start of an ADB-supported feasibility study for the Turkmenistan-Afghanistan-Pakistan natural gas pipeline; and the Russian Federation's offer to rehabilitate and expand gas pipeline capacity in the Kyrgyz Republic and Uzbekistan. Kazakhstan has further expanded its oil production and exports in 2003 by increasing its use of the Caspian Sea pipeline. Also, there was news of active Russian and Iranian interest

in, and some movement on, financing of large hydroelectric projects in Tajikistan. These developments augur well for future investment activity in the subregion, diversification of export markets, and closer integration of the CARs with global markets. Appropriate policy support for private sector growth would stimulate private sector activity in the light engineering and services industries that are supportive of FDI in the hydrocarbon and energy-exporting sectors, as well as enhance prospects for inclusive economic growth.

Financial Policies and Prices

With fairly tight monetary and fiscal policy regimes in place across the subregion, inflationary pressures generally remained subdued (at about 3–5% annualized in Azerbaijan, Kazakhstan, and Kyrgyz Republic) in the first half of 2003; relative price stability is expected to be maintained in these countries through the end of the year. However in Tajikistan, where the Government had set a 7.0% target for the year-end, inflation was officially reported at 17% in the first 6 months and is likely to remain in double digits for the remaining months. According to official data, inflation in Uzbekistan remained at a moderate 4.2% in this period, though prices of basic goods and services are unofficially reported to have increased more sharply due to shortages that emerged from the tightening of border controls and severe import compression since the second half of 2002. In Turkmenistan, the Government's policy of free delivery of basic goods and services such as electricity, housing, and water, and heavy subsidies for basic necessities such as flour, salt, and petroleum have kept inflationary pressures repressed. While Kazakhstan's tight fiscal policy stance has helped keep inflation at bay, its very strong economic and financial fundamentals indicate that some loosening in policy may now be appropriate to address its critical infrastructure needs and employment generation.

External Sector Developments

The three major oil and gas exporters reported exceptionally strong export growth of 31%, 40%, and 25%, respectively, in the first 6 months of this year.² At the same time, these countries also saw their imports increase correspondingly with plant and equipment for the oil and gas sector accounting for the dominant share. Azerbaijan's current account deficit rose in the first quarter of 2003. Kazakhstan, however, ran a current account surplus of 4.0% of GDP and strengthened its international reserves by over \$1 billion to \$4.7 billion in the 6 months to June 2003.³

Uzbekistan, which is itself a major producer of natural gas and oil but not a large hydrocarbon exporter, officially reported export growth of 41% in the first half of 2003, based on an increase both in volumes and prices of its gold and cotton exports. Tajikistan's exports declined by 0.6% in this period despite higher volumes and prices for its cotton exports, which account for more than a fifth of its total exports. Revenue growth of aluminum exports, accounting for more than 55% of its total exports, was limited by continuing softness in global prices. Total trade turnover declined by 1.1% as a result of a 16% reduction in its trade with Confederation of Independent States countries. Tajikistan's external debt has improved with the favorable outcome of its negotiations with



the Russian Federation in December 2002. In the absence of any significant FDI inflows, the Kyrgyz Republic, which is one of the most heavily indebted CARs, again needed to borrow externally to finance its current account deficit. This increased its total external debt to \$1.7 billion in June 2003, about 108% of GDP. The Government hopes to secure an external debt write-off of about \$0.5 billion by the Paris Club members in the first quarter of 2004, based on successfully completing its current poverty reduction and growth facility program with IMF.

Exchange rates, which are generally market determined in the sub-region, remained broadly stable in the first half 2003. Even with strong revenue flows from oil and gas exports, Azerbaijan and Kazakhstan avoided a major appreciation in their real exchange rates as efforts to sterilize foreign exchange earnings in offshore funds, specially designated to receive oil revenues, were continued. In Uzbekistan, the long-standing spread between the official and market exchange rates virtually disappeared by end-June 2003, largely as a result of tight import restrictions and rising export earnings from higher cotton and gold prices. The Government has now committed to bring about current account convertibility by November 2003, thereby eliminating the dual exchange rate system. In Turkmenistan, however, there is still no indication that the multiple exchange rate system will be abolished, despite some appreciation in the market exchange rate, which reflects an apparent improvement in the balance of payments.

Policy Developments

Prospects for private sector growth in the CARs are quite positive in the engineering, raw-materials processing, and services sectors, either to support investments in oil and gas or to meet the demands of an expanding agriculture sector that is now being steadily privatized across the subregion. Some signs of emerging private sector activity in these three sectors are already visible, and this activity can be strengthened by well-designed policy support and by government recognition of the key role of public-private partnerships both in building a physical, social, and financial infrastructure and in putting in place incentives and regulatory mechanisms. The expansion of private small and medium enterprises in manufacturing and services will not only help achieve much-needed diversification of the production structure but also yield a more inclusive type of economic growth with a greater positive impact on employment and poverty reduction.

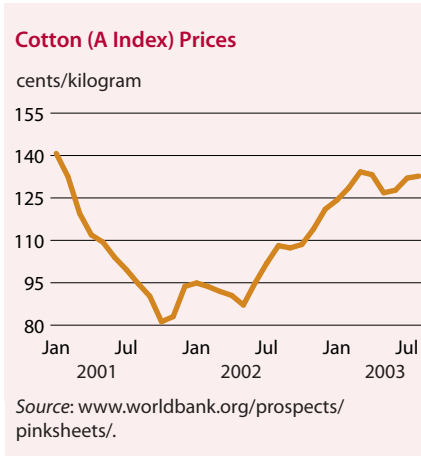
Significant policy advances have been made over the past decade in most countries of the subregion, as part of comprehensive economic programs sponsored by international finance institutions. However, the financial sector—more specifically commercial banking—which has an important role in fostering private sector growth, remains weak and underdeveloped in most CARs. In Tajikistan especially, but in the Kyrgyz Republic and Turkmenistan as well, confidence in the banking sector is generally lacking and deposits have been declining in real terms. Credit for new investments and for small and medium enterprises is still highly controlled and is far short of demand, except perhaps in Kazakhstan, which has recently adopted measures to improve the flow of credit for

these activities. Strengthening the financial sector in the CARs, particularly banking, while putting in place the required supervisory and regulatory capacity that will create greater confidence in the system, remains perhaps one of the more critical policy advances required for promoting private sector growth. A subregional initiative that avoids duplication in training capacities for central and commercial banking skills, that helps to standardize subregion-wide prudential norms and banking practices, and that creates a subregional clearing system supporting capital mobility and facilitating subregional trade, could make an effective contribution to achieving sustainable and inclusive growth.

The importance of subregional cooperation in raising growth rates, reducing poverty, and safeguarding the environment has been formally and repeatedly recognized by the political leadership in Central Asia. Many steps have been implemented in establishing subregional organizations and institutional mechanisms. Nevertheless, greater commitment is still needed to ensure that benefits from subregional cooperation accrue, especially in the areas of facilitating intrasubregional trade flows, strengthening transport infrastructure, and harnessing subregional energy resources. With average tariff levels in the CARs of 5–15% as a result of reforms already implemented, gains from further tariff reductions are unlikely to be large. However, growth prospects for smaller landlocked economies, such as the Kyrgyz Republic and Tajikistan, depend crucially on free and easy transit through neighboring countries for access to export markets. Thus, removing the host of nontariff barriers, border controls, and frequent transit stoppages by rent-seeking officials would yield substantial benefits. This issue could be very usefully addressed as part of a subregional cooperation agenda. It would be important, however, to demonstrate that this effort would result in a win-win outcome for all the CARs. Development of subregional physical infrastructure and energy capacities would require substantial investment that will be forthcoming only if the Central Asian governments demonstrate a willingness to enter into long-term subregional agreements that also involve some of their neighbors from outside the subregion.

Economic Outlook

Economic growth is expected to remain generally buoyant in the last few months of 2003 with an outturn of 7.5% for the year as a whole, in line with that achieved in 2002. With oil supplies forecast to remain relatively tight for the remaining months of this year and demand for natural gas showing no signs of weakening, the subregion will benefit from continued firmness in energy export prices in 2003. The Kyrgyz Republic is likely to improve on its first half performance with gold production, which had been seriously disrupted by a major accident at the Kumtor gold mine, expected to return to normal levels, thus pushing up industrial growth in the second half of the year. Uzbekistan can expect to benefit from a positive investor response if the Government adheres to its declared program of achieving current account convertibility by November, but failure to do so could result in strong negative sentiment that will push growth rates down and exacerbate both fiscal and external imbalances. Inflation in the subregion is expected to remain at the two-digit level in 2003. The



subregional current account balance is forecast to improve over the estimates presented in *ADO 2003*, mainly due to a movement to a surplus in Kazakhstan.

Oil prices are forecast to decline in 2004 to a range of \$24–26 per barrel, while capacity constraints in the existing pipeline systems will also begin to slow further increases in subregional exports of natural gas. Accordingly, GDP in the CARs is forecast to expand by 5.9% in 2004, which can be seen as a sustainable growth trend. This performance could be substantially improved if Uzbekistan actually undertakes its currency and trade reforms in 2003, if the Kyrgyz Republic improves its domestic resource mobilization, and if greater FDI flows are attracted to infrastructure sectors as a result of subregional cooperation efforts.

The risks to the 2004 economic performance arise from increasing political instability associated with presidential succession in Azerbaijan and electoral outcomes in Kazakhstan; continuing security concerns and border closures in Turkmenistan and Uzbekistan; and a worsening of the political and security situation in Afghanistan and Iraq, which could have a strong negative spillover impact on the subregion.

Endnotes

- ¹ The problem of reconciling officially reported data with estimates provided by other sources and of determining a plausible scenario of economic performance in some CARs is substantial. This issue continues to create significant difficulties, particularly in the case of Turkmenistan and Uzbekistan where official data are either unavailable or have often shown large variations from those reported by agencies such as IMF or the Economist Intelligence Unit. ADB estimates have been used in reaching subregional figures and these may not reconcile with officially reported data.
- ² Azerbaijan exports are for January–May.
- ³ Turkmenistan does not release current account figures or data on its foreign exchange reserves; information on Uzbekistan's balance of payments is also very limited.