

Azerbaijan

Set against impressive economic growth, which will continue as large oil sector investments begin production, rising inflation highlighted the underlying sensitivity of the macroeconomic environment. The Government should, though, take advantage of this prosperity to institute the necessary structural changes that will sustain strong performance and enhance welfare over the longer term.

Macroeconomic assessment of 2004

In line with the 10.7% average annual growth of the past 5 years, GDP grew by 10.2% in 2004. Progress in foreign capital investments in the oil and gas sector—namely the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, the Azeri-Chirag-Gunashli (ACG) oil fields, and the Shah-Deniz gas field and pipeline—provided the stimulus for the overall outcome. Industry, up by 12.2%, accounted for 62% of the GDP increase, with construction expanding by nearly 42%. Construction has benefited from the oil sector investments, as well as from a building boom in the capital and from foreign-funded infrastructure projects, and has more than quadrupled in size during the last 3 years. Despite agriculture's importance as an employer—accounting for nearly 40% of total employment—its 4.6% rise contributed only 5.9% to total GDP growth. Services expanded by 7.7%, reflecting mainly an upsurge in communications and trade.

Official unemployment remained low in 2004 at 1.5%, but this figure includes only individuals registered for unemployment assistance. The State Statistical Committee carried out a labor force survey in 2003 (following international standards), showing unemployment at 10.7%, with the urban rate double that of rural areas (14.0% versus 7.0%). Women suffered higher rates than men (12.2% versus 9.6%).

According to the latest figures from the 2002 household budget survey, nearly half of the popu-

lation is living in poverty, based on monthly minimum consumption needs of food and nonfood items of AZM175,000 (\$36) per person. Urban areas suffered somewhat higher rates than rural areas; this atypical outcome stems from the fact that the camps of internally displaced persons are located in urban areas.

In 2004, the Government continued to pursue a prudent fiscal policy. Revenues and grants were 25.0% of GDP, with VAT the main source of funds. Government spending reached 27.0% of GDP, partly stemming from increases in wages and energy subsidies. The overall deficit at 2.0% of GDP was somewhat less than in 2003. While small deficits have kept national debt levels low, the limited supply of treasury bills has created difficulties in managing the money supply.

Although high world oil prices in 2004 had a beneficial impact on growth and fiscal performance, price stability suffered. The efforts of the National Bank of Azerbaijan (NBAR) to avoid a nominal appreciation of the exchange rate, coupled with the thin treasury bill market, led to an unsterilized accumulation of foreign assets and a rapid expansion of the money supply. Although NBAR began in August to issue its own bonds to absorb liquidity, broad money still jumped by 47.5% over the year. Moreover, increases in some administered prices—notably retail prices for fuel—further aggravated inflation. By December, consumer prices were 10.5% higher than at end-2003, and average annual inflation for 2004 reached 6.7% (Figure 2.21). Although NBAR's

intervention efforts succeeded, with the average exchange rate against the dollar remaining essentially unchanged over the year, the real exchange rate appreciated somewhat because of the inflation differential.

Buoyant oil sector developments were reflected in the balance of payments as well. Exports grew by 31.5%, triggered by high world oil prices, such that the level of exports was nearly \$3.5 billion, or 40.5% of GDP. Investment activities led to a rapid 25.2% expansion of imports, with the result that the level of imports was on a par with exports at 40% of GDP. While the trade account was virtually balanced, an increase in the large net services and income deficit (primarily associated with the oil sector) widened the current account deficit to 30.7% of GDP in 2004 from 28.3% a year earlier. As in recent years, net capital inflows, mainly FDI, exceeded the current account deficit and international reserves (including the oil fund) climbed by \$284 million.

Macroeconomic policy developments

In November 2004, Parliament approved the 2005 budget, the first budget to be consistent with the Government's new long-term strategy on the management of oil revenues. This strategy appropriately provides for annual limits on the change in the non-oil deficit to guide fiscal policy. The budget targets a fiscal deficit of AZM579 billion (1.2% of GDP), using a projected world oil price of \$25 per barrel in its calculations. Even accounting for the discount on the price of Azerbaijan's oil relative to Brent crude, on the assumption of higher prices it is likely that the budget deficit will be smaller than targeted, regardless of whether retail prices are adjusted to restrict the increase in the budgeted cost of domestic oil subsidies.

NBAR's stated policy target is inflation, but exchange rate management dominated actions in 2004. Remonetization of the economy has enabled the rapid money supply growth of recent years to be absorbed without it putting excessive pressure on the price level, but the reemergence of inflation in 2004 clearly shows that there are limits to this "inflation-free" monetary expansion. Since success in achieving inflation targets affects people's willingness to hold the local currency, the introduction of central bank bills gives NBAR a valuable tool

Table 2.19 Major economic indicators, Azerbaijan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	10.2	14.5	19.0	22.0
GDI/GDP	40.0	35.0	30.0	30.0
Inflation (CPI)	6.7	5.5	4.5	4.0
Money supply (M2) growth	47.5	31.0	35.0	38.0
Fiscal balance/GDP	-2.0	-1.1	-1.0	-1.0
Merchandise export growth	31.5	24.5	50.5	45.0
Merchandise import growth	25.2	7.5	-2.5	-5.0
Current account/GDP	-30.7	-20.0	-6.0	4.5

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Ministry of Finance; National Bank of Azerbaijan; State Statistical Committee of Azerbaijan Republic; International Monetary Fund; staff estimates.

to maintain price stability. Managing large foreign exchange inflows generated by the oil sector is a key policy challenge over the medium term.

The Government took several important steps in reforming the financial sector. In January 2004, it adopted the Banking System Law that is consistent with the Basle Core Principles, thereby fostering better corporate governance at commercial banks. Moreover, the law creates a level playing field by applying prudential requirements consistently across all financial institutions. In December 2004, the National Bank Law was enacted. This gives NBAR considerable independence to pursue monetary policy, but also holds it accountable for results. It also includes measures to improve the transparency of NBAR's operations.

Outlook for 2005–2007 and medium-term trends

The medium-term outlook for the economy is very positive, with the main driving force switching from investments in the oil sector to resultant production and export. The BTC pipeline should become operational by September 2005. The first phase of the ACG oil fields began production during the first quarter of 2005. Although the BTC investment is winding down, the Shah-Deniz gas field and its pipeline, plus further development of the ACG oil fields, will ensure that investment and construction remain dynamic. Additionally,

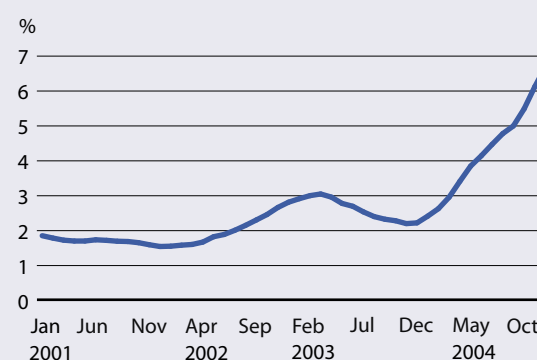
the Government has announced its intention to rehabilitate completely the east-west and north-south road corridors in the coming years. Moreover, NBAR will continue to resist undue real exchange rate appreciation to assist development of the non-oil sector, so as to avoid the deleterious effects of “Dutch disease.” Accordingly, the outlook is for GDP growth to accelerate to 14.5% in 2005, rising further to 19.0% in 2006 and 22.0% in 2007.

The authorities are expected to continue to pursue prudent fiscal and monetary policies over the medium term. Fiscal policy plans are consistent with the sustainable use of oil wealth, as laid out in the Government’s long-term strategy on the management of oil revenues. For 2005, the Government is targeting a non-oil deficit of 16.8% of non-oil GDP that will rise to 18.7% by 2007, and the *ADO 2005* budget projections assume that these targets will be attained. With no major declines in world oil prices expected, the projected overall deficits of less than 2% of GDP should be met, even accounting for wage and pension increases planned for 2005 and the ambitious public investment program.

With greater foreign exchange inflows from the oil sector, NBAR will face challenges in balancing price and exchange rate stability. NBAR is targeting an inflation rate of 5% in 2005 and 2–3% in 2006–2007, but this will be difficult to achieve without some appreciation of the exchange rate. *ADO 2005* forecasts a somewhat higher rate of 5.5% in 2005, slowing to 4.0% by 2007.

The changing pattern of investment and hydrocarbon production will be seen in balance-of-payments developments. Export growth will accelerate sharply in 2006, as the first two phases of the ACG oil fields begin production, and moderate only slightly in 2007. Import growth, in contrast, will decline in 2005 as investment in the BTC pipeline and much of the work on the ACG oil fields is completed. Gas production from the

Figure 2.21 12-month moving average inflation rate, Azerbaijan, January 2001–December 2004



Source: State Statistical Committee of Azerbaijan Republic.

Shah-Deniz field should begin in 2006, displacing some of the gas imports (and contributing to export growth). As incomes improve, growth in imports of consumer goods will offset part of the decline in capital goods imports, though total imports are projected to fall slightly in 2006–2007. Despite the fact that factor income outflows will rise as oil profits are repatriated, the current account will swing from a large deficit of 30.7% of GDP in 2004 to a surplus of 4.5% in 2007.

Growth in the non-oil sector hinges on progress in the structural reform agenda. Even though reform of the two state-owned commercial banks needs to be accelerated to create a truly competitive financial sector, policy changes in the sector mark a beginning—but more work is required to foster an economy with a diverse production base. Governance reforms, including enforcement of the anticorruption law passed in January 2004 and simplification of the bureaucratic requirements for businesses, are needed. Encouragingly, negotiations on the settlement of issues from the Nagorno-Karabakh conflict have shown some recent positive signs, and concrete progress would further enhance growth prospects.

Kazakhstan

Rapid economic growth continued in 2004, and the medium-term outlook is positive. The Government has maintained its prudent macroeconomic and reform policies, and has also adopted programs for economic diversification. Successful implementation of current development priorities and creation of a conducive environment for the private sector will ensure sustainable, broad-based growth.

Macroeconomic assessment of 2004

The brisk economic advance of recent years continued through 2004 with GDP rising by 9.4%. The boom was fueled by a combination of high world oil prices, expanded domestic production, buoyant investment, strong domestic consumption, and prudent macroeconomic policies. On the supply side, an 11.5% rise in oil production—aided by high world oil prices and greater capacity at the Karachaganak and Tengiz oil fields in western Kazakhstan—was the main factor in the rapid 10.1% advance in industrial output. Other industrial components were also buoyant: manufacturing grew by 8.9%, spurred by the engineering and chemical subsectors (up by 32.5% and 11.5%, respectively), while construction strengthened by 11.2%, reflecting significant investment in housing and infrastructure in the new capital, Astana. Based on the broad-based expansion in activity and incomes, the services sector increased by 10.8%, in part driven by vibrant banking and financial services activities. Meanwhile, the agriculture sector grew by only 0.1%, well below its historical average, mainly due to a poor harvest caused by bad weather conditions.

On the demand side, strong private consumption, generated primarily by large increases in real incomes and bank credit, was a major source of the economy's advance, as was (to a lesser extent) a surge in government

spending. Investment rose by 10.6%, mainly due to large private foreign investment in oil and gas, private domestic investment in housing, and public investment in manufacturing and transport. A 66% surge in net exports contributed 0.9 percentage point to GDP growth.

Continuing economic growth has resulted in higher living standards. According to official statistics, real per capita income grew by 13% in 2004 while unemployment declined from 8.8% in 2003 to 8.4% at end-2004 (Figure 2.22). This reflected the increased demand for qualified workers in certain areas (construction, services, and agriculture) and the impact of government measures for reducing unemployment through a public works program, providing training for the unemployed, and supporting SME development to create jobs. The Government also strengthened the Labor Code during the year to protect employee rights, and improved safety regulations. The share of the population living below the subsistence minimum (T5,427 or \$40) fell from 19.8% in 2003 to 15.0% in 2004, reflecting the economic expansion and the impact of the Poverty Reduction Program for 2003–2005. Improving living standards remains a major challenge in many rural areas, however, and reducing the urban–rural gap is a current development priority.

The general government budget, inclusive of the large savings of oil revenues made by the National Fund of Kazakhstan (NFK), recorded a surplus of 2.3% of GDP in 2004. The cautious

fiscal stance helped restrain aggregate demand and mitigate inflationary pressures in the context of large current and capital foreign exchange inflows during the year.

Excluding the NFK savings of 2.6% of GDP gives a small budget deficit of 0.3% of GDP. Despite tax cuts amounting to an estimated 1.2% of GDP, general budget revenues rose to 23.5% of GDP (excluding the NFK), reflecting strengthened tax administration, high world oil prices, and one-time payments related to oil and gas. Total budget expenditures grew to 23.8% of GDP, driven largely by higher expenditures on education, health, and social welfare; the state housing program; the Industrial-Innovative Development Strategy 2003–2015 (to foster economic diversification and technological upgrading); and public sector investments in Astana and Almaty. Total public debt in 2004 rose by 7.5% to \$5.1 billion (12.1% of GDP), entirely reflecting increased domestic borrowing as the outstanding external debt component declined by 11.0% to \$2.7 billion.

Monetary aggregates climbed rapidly in 2004. Nevertheless, inflation at 6.9% for the year was held just within the revised inflation target of the National Bank of Kazakhstan (NBK) of 5.6–7.0%. Higher prices for gasoline, transport services, and utilities contributed cost-push inflationary pressures, which also felt the demand-pull of rapid monetary expansion (M2 accelerated to 36.4% from 27.0% in 2003). Credit to the economy spiraled up by 51%, with banks giving priority to consumer, housing, and SME financing. Interest rates remained broadly stable. Remonetization of the economy has helped keep inflation within the NBK target; the ratio of M2 to GDP increased to 25.8% in 2004.

NBK continued its interventions in the market to prevent excess of volatility and undue appreciation of the exchange rate. There were pressures on the tenge due to a surge of inflows related to exports and FDI as well as greater external borrowing by the private sector. Over 2004, the tenge appreciated in real terms by 15.3% against the dollar, 7.0% against the euro, and 1.3% against the Russian ruble. The real effective exchange rate appreciated by 5.9% year on year, eroding domestic producers' price competitiveness.

Exports soared by 53.7%, propelled by high world oil and metal prices in 2004. Although

Table 2.20 Major economic indicators, Kazakhstan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	9.4	8.5	8.0	8.0
GDI/GDP	25.1	25.9	26.4	25.4
Inflation (CPI)	6.9	6.0	5.7	5.3
Money supply (M2) growth	36.4	26.7	22.4	22.6
Fiscal balance ^a /GDP	-0.3	-1.2	-1.0	-0.9
Merchandise export growth	53.7	14.2	15.0	17.3
Merchandise import growth	47.7	16.3	18.2	23.7
Current account/GDP	1.6	1.0	1.3	1.5

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. ^a Excluding the National Fund of Kazakhstan.

Sources: Agency on Statistics of the Republic of Kazakhstan; Ministry of Finance; National Bank of Kazakhstan; staff estimates.

imports also shot up by 47.7% as a result of strong domestic demand, the trade surplus expanded by two thirds to \$7.0 billion. While the usual deficits on the net balances in services, income, and current transfers widened (mainly due to hydrocarbons operations), preliminary data suggest that the current account switched to a surplus of 1.6% of GDP (\$0.7 billion). Total international reserves (including the assets of the NFK) improved by \$5.7 billion to \$14.3 billion at end-2004. Of this total, NBK's net international reserves amounted to \$9.3 billion (or 6 months of imports of goods and services). External borrowing by commercial banks, in response to offers of attractive rates and long maturities, increased substantially during the year to bring outstanding external debt (excluding intracompany debt) from 29.3% of GDP in 2003 to 34.2% at end-2004.

Macroeconomic policy developments

Underlining its commitment to prudent macroeconomic policy management, the Government took several major fiscal policy initiatives in 2004, including the development of the first medium-term fiscal policy for the period 2005–2007 (approved in September 2004) and improvements to the budget code. The objectives of the former are to improve the efficiency of government spending, ensure stability of government revenues,

and more consistently achieve the targets of development programs. In similar vein, the Government is considering adopting target limits on the non-oil budget deficit in an attempt to reduce volatility of oil-revenue fluctuations on fiscal policy, a step advocated by IMF.

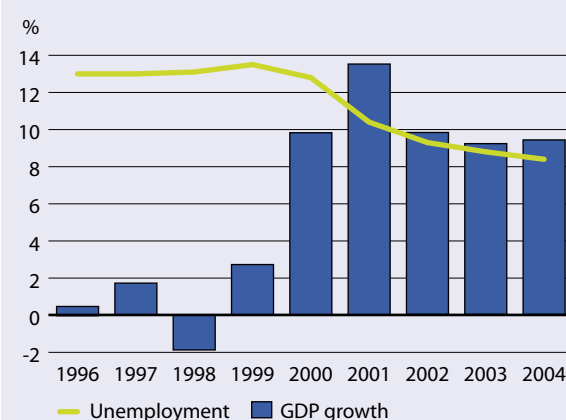
The changes to the budget code have provided a basis for greater transparency in budgeting and a clearer delineation of financial responsibilities between central and regional governments. For example, expenditures on health, social assistance to invalids, and special education programs were transferred to local budgets while spending on fire prevention and special state allowances were kept in the central budget. Furthermore, budget transfers were fixed for a 3-year period, allowing local governments to better plan their medium-term budgets.

The Government has continued to strengthen the financial sector in order to assist economic diversification and private sector development, and articulated a number of policy initiatives including promotion of a stock market, pension system reform to improve asset management, modern risk-management systems for commercial banks and pension funds to facilitate investments in foreign securities markets, and development of insurance markets. The independent Financial Supervision Agency, established in January 2004 to oversee financial institutions, is now formulating a detailed action plan to implement these policy initiatives.

Following the establishment of the agency, NBK has concentrated on its macroeconomic policy functions. As part of its objective of price stability, NBK plans to adopt an inflationary targeting framework by 2006, and has developed a set of core inflation indicators that are closely monitored. To keep inflation within the target range in 2004, NBK conducted open-market operations to contain excess liquidity and growth in broad money. It also increased bank reserve requirements and raised the refinance rate from 7.0% to 7.5%.

The Government has strengthened efforts to diversify the economy through the development of nonextractive sectors. The Industrial-Innovative Development Strategy aims to develop priority nonextractive sectors in the context of a competitive economy. Detailed studies have

Figure 2.22 Unemployment and GDP growth, Kazakhstan, 1996–2004



Source: Agency on Statistics of the Republic of Kazakhstan, available: www.stat.kz/ru/index.shtml.

identified seven priority clusters: tourism, oil and gas engineering, food, textile, logistics services, metallurgy, and construction materials. These clusters are expected to facilitate development of industrial bases outside the extractive sectors. State-owned funds supporting the strategy have identified 24 projects for assistance and a further 350 are under consideration. The Government's efforts to support food industries will help prepare agriculture and agro-industries for WTO accession, while government infrastructure investments are being undertaken to provide an environment conducive to developing non-oil industries.

In addition, promoting a favorable environment for SMEs is among the Government's key development efforts, including streamlining of administrative procedures for business operations and setting up a small business development fund to help finance SME business opportunities.

While making efforts toward economic diversification, the Government is also seeking to ensure balanced, inclusive growth through support to rural areas. Priority programs are supporting the rural population. The 2004 budget allocated an additional T30 billion for rural education and health. A detailed medium-term plan for rural infrastructure has been prepared and the Government is planning to augment the 2005 budget by T100 billion with a large part directed to rural areas.

Outlook for 2005–2007 and medium-term trends

The economic outlook for the next 3 years is positive. Economic diversification remains a priority for reducing the impact of external shocks to the economy, and the Industrial-Innovative Development Strategy is expected to play an important role in promoting a larger non-oil sector. In the medium term, however, the oil and gas sector will remain the principal engine of economic expansion, with services, construction, and manufacturing continuing to play their supporting roles.

GDP growth is forecast to moderate to 8.5% in 2005, reflecting some easing in world oil prices and a softening of global growth. Oil production is expected to rise from 56 million tons in 2004 to 69 million tons in 2007. In 2006–2007, economic growth will likely continue at around 8%, on the back of accelerated activity in the non-oil sector stemming from economic diversification. These projections, of course, are sensitive to factors such as world oil prices, global demand, as well as the actual response to government policies and incentives in the non-oil sector.

The fiscal position is expected to remain strong in the medium term, since growing oil revenues and improvements in tax administration are expected to offset plans for additional tax cuts and to cover nearly all planned expenditures. Estimated revenue performance and future medium-term spending plans (particularly on infrastructure development, employment creation, and social welfare) indicate that the general budget deficit (excluding the NFK) will be in the range of around 1% of GDP in 2005–2007.

Fueled by increases in public sector wages and expansion in the money supply, inflation is expected to again be at the higher end of the current NBK target range (4.5–6.5%). Inflation

of 6.0% is projected for 2005, moderating to 5.7% and 5.3% in the next 2 years. The tenge is expected to continue appreciating but a weakening in world oil prices would halt this. Despite NBK plans to adopt an inflationary targeting policy in 2006, it will most likely continue sterilized intervention operations to prevent an undue appreciation of the exchange rate, as development of the non-oil sector is a key priority.

Exports of goods will likely remain buoyant at the level of \$20 billion–35 billion given expected world prices for Kazakhstan's major commodities (oil and metals), and projected production trends. Driven by anticipated strong domestic demand, imports of goods are set to rise to around \$15 billion in 2005 and to about \$23 billion in 2007. The trade balance is forecast to record a surplus in the medium term, scaling up from \$7.7 billion in 2005 to \$8.6 billion in 2007. The current account balance is projected to be positive at around 1–1.5% of GDP over 2005–2007, despite a rising trend deficit in services, income, and current transfers as payment outflows grow, especially of foreign investors' earnings.

Continued economic expansion will help improve living standards. According to official forecasts, the Government's efforts to reduce the urban--rural gap and to strengthen the social safety net for vulnerable people are expected to bring down the number of people living below the subsistence minimum to 10% by end-2007. However, improvements in living standards will depend substantially on new job creation by the private sector. In this regard, the ongoing measures to diversify the economy are likely to play an important part. A new state program on employment, approved in January 2005, sets specific measures to promote employment in SMEs and tourism, where two thirds of the targeted nearly 1 million new jobs are to be created during the next 3 years.

Kyrgyz Republic

Economic performance was robust due to favorable external conditions and prudent macroeconomic management, though excessive dependence on gold production, a high debt burden, and low levels of saving and investment threaten sustainable economic growth. Such growth requires diversification of exports, implementation of reforms to improve the business environment, restructuring of external debt, and fiscal consolidation.

Macroeconomic assessment of 2004

Belying expectations, GDP grew very rapidly in 2004, by 7.1%, underpinned by strong external demand and prudent macroeconomic policies. Agriculture, aided by favorable weather conditions and an improved external environment, expanded by 4.1%. Despite a setback to gold production, which has a 45% weight in industrial production, the industry sector grew by 3.5% as non-gold industrial output jumped by 6.7%, reflecting strong gains in electricity generation, food processing, chemicals, transport equipment, and coal. Of greatest importance, however, was the services sector. With a 32% share in GDP, it saw a large 11.7% expansion. A combination of higher tourist arrivals, buoyant foreign trade, and the introduction of a lump-sum tax (the “patent system”) on small businesses, which brought some of their activities into the registered sector, contributed to this strong performance. Gross domestic investment, having fallen from 17.6% of GDP in 2002 to 16.2% in 2003, may have recovered to 19.0% in 2004, despite an estimated decline in the externally assisted public investment program. This suggests a welcome pickup in private investment. Gross domestic saving is also expected to improve.

Broad-based growth in non-gold output (at about 5% annually since 2000), low inflation, increased real wages, and a decline in income

inequalities contributed to an overall improvement in living standards. The incidence of poverty fell from 55.3% in 1999 to around 41% in 2003, and preliminary estimates indicate a further decline to about 39% in 2004 (Figure 2.23). Nevertheless, poverty is still a major problem, especially in rural areas where some three quarters of the poor live.

The Government is estimated to have met the 2004 budget deficit target of 4.3% of GDP, an improvement on the 5.1% deficit recorded in 2003. Fiscal consolidation was achieved by an increase in tax revenues and cuts in nonsalary current and capital expenditures. Better tax administration and the measures taken to widen the tax net improved revenue performance. The external debt burden is large but falling, from 102% of GDP at end-2003 to an estimated 92% of GDP 12 months later. Since 91% of the external debt is public, it is an important determinant of fiscal sustainability.

High demand for money has sustained a substantial monetary expansion in recent years without causing inflation. Broad money grew by 32.0% in 2004 on top of a 33.5% increase in 2003. The growing coverage of credit unions in rural areas and improved availability of microcredit have propelled the rapid monetization process. Weighted average interest rates fell marginally, but remained high at 24.6% for domestic currency loans and 19.2% for foreign currency loans. The entry of a number of foreign banks, which now own about half of banking assets, seems to be

rekindling public confidence in the banking sector. The level of financial intermediation remains low, however. Consumer price inflation was 4.0%, associated largely with higher prices of energy, food, and public services.

Preliminary data indicate strong growth in foreign trade in 2004. Merchandise exports expanded by 23.8%, with a significant contribution from non-gold exports. Increased demand in the rapidly growing economies of Kazakhstan and the Russian Federation accelerated exports of a wide range of goods. Merchandise imports were up by 24.6%, reflecting strong consumer demand. The trade gap widened to \$171 million and, though private remittances accelerated, the current account deficit is estimated to have reached \$115 million, or 5.2% of GDP. Net FDI inflows grew to about \$122 million during the year. Together, FDI inflows, government portfolio sales, and official aid covered the deficit and helped raise gross international reserves to \$565 million, providing about 7 months of merchandise import cover. The Government maintains a managed floating rate regime. The som appreciated against the dollar by 5.1% in nominal terms during the year but this seems not to have affected competitiveness.

Macroeconomic policy developments

Structural reforms in 2004 focused on two areas—strengthening governance in both public and private sectors to create a conducive business climate, and improving public resource management.

Corruption, poor governance, and a weak judicial system have emerged as major impediments to private sector-led, pro-poor economic growth. A new national anticorruption strategy was adopted and the UN Convention against Corruption was ratified by Parliament in 2004. All government officials are now mandated to declare their income and wealth. A three-member council was constituted in September 2004 to manage and regulate the civil service as a prelude to comprehensive civil service reform. In addition, a Law on Fundamentals of Technical Regulation was introduced to make public consultation compulsory before any new business-related law or regulation is introduced, or existing ones amended. This

Table 2.21 Major economic indicators, Kyrgyz Republic, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	7.1	5.0	5.5	5.5
GDI/GDP	19.0	22.4	22.6	22.7
Inflation (CPI)	4.0	4.6	4.0	4.0
Money supply (M2) growth	32.0	15.0	15.0	15.0
Fiscal balance/GDP	-4.3	-4.3	-4.1	-3.7
Merchandise export growth	23.8	3.9	10.0	9.7
Merchandise import growth	24.6	9.3	7.8	6.7
Current account/GDP	-5.2	-5.8	-4.6	-3.3

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Ministry of Finance; National Bank of the Kyrgyz Republic; National Statistical Committee; International Monetary Fund; staff estimates.

will minimize the risk of introducing conflicting and excessive regulatory measures. The Law on Joint-Stock Companies was further amended in 2004 to align it with international best practices and to remove contradictions with the legislation governing banking regulation. The Government took further steps to implement international accounting standards in large joint-stock companies. Parliament also enacted the Bank Insolvency Law for expeditious liquidation of problem banks. The Law on Pledge was approved in January 2004 to bring it into line with international norms. This law is expected to protect creditors' rights; it should also help bring down interest rates as debtor behavior becomes more disciplined.

The Government has continued its efforts to broaden the tax base and improve tax administration. The customs code was revised and simplified to bring it in line with WTO requirements and the revised Kyoto convention, and came into effect on 1 January 2005. The Government has also improved coordination between the customs administration and the state tax inspectorate, and prepared a comprehensive plan to modernize the former. In addition, the tax code is being revised to simplify taxation, rationalize the rate structure, and make the tax system investment friendly without sacrificing revenue. The new tax code is likely to be adopted in 2005.

The Paris Club of creditors provided debt relief

Tajikistan

Following a period of robust growth that was grounded in recovery from the low base after the civil war and in strengthening export prices, a slowdown is expected in the medium term, though reforms under the Poverty Reduction Strategy Paper are likely to maintain the tempo of poverty reduction. Further domestic policy reform, economic diversification, and stronger regional cooperation could put the economy back on a high-growth track in the longer term.

Macroeconomic assessment of 2004

Building on annual average growth of 9.5% since 2000, the economy showed strong performance in 2004. GDP grew by 10.6%, due primarily to gains in light manufacturing and the fast-growing services sector, particularly trade and other market services. This outcome broadly follows the realignment observed in 2003 to broader-based growth beyond the traditional engines of cotton and aluminum. While cotton production is estimated to have expanded by 4%, aided by favorable weather conditions, the agriculture sector nevertheless remains hobbled by structural constraints, such as limited access to inputs and inadequate marketing and credit systems, as well as a deteriorating irrigation system and obsolete agricultural machinery.

In the industry sector, aluminum production is estimated to have grown by 9.4% in 2004 as higher global prices strengthened earnings at the large Tajik Aluminum Smelter.

On the expenditure side, growth continued to be fueled by demand from rapidly rising workers' remittances, financing higher consumption and investment expenditures.

Notwithstanding reforms to date, government officials still function in a command and control framework, hampering an enabling environment for private enterprises to operate. Accordingly, privatization of SMEs remained slow during the

year. Reinforcing this trend, the Government's emphasis on large-scale industrial projects has slowed the impetus for development of small private sector enterprises that have a significant employment potential.

Strong growth, policy reforms, and a favorable economic environment led to a sustained reduction in poverty from 82% in 1999 to 64% in 2003, based on a daily \$2.15 per capita purchasing power parity expenditure poverty line. Per capita nominal GDP is estimated to have grown from \$236 in 2003 to \$269 in 2004, but this is still way below \$1 a day. Significant regional differences in poverty persist. Moreover, inequality has worsened and is higher in Tajikistan than in other low-income countries in central Asia.

One result of these developments is that poverty and a lack of proper facilities keep school attendance low, while inadequate funding has led to a severe shortfall of teachers, as many have moved to better-paying jobs. Economic opportunities are still sparse, which encourages continuing outward migration.

Those engaged in cotton farming—the largest source of employment and the core of the agriculture sector—account for three quarters of all farmers. Yet cotton farming suffers from restrictive financial practices (contract farming), low productivity, official intervention in farm decisions, and poor marketing. Reflecting this, cotton farm debt owed to banks and investors is estimated to

have increased from \$180 million at end-2003 to \$230 million at end-2004, as falling cotton prices over the year exacerbated structural weaknesses.

Through rationalized tax and fiscal policies, the budget in 2004, excluding the externally financed public investment program (PIP), was kept in surplus, at 0.3% of GDP. In exchange for a space-monitoring center, the Russian Federation in 2004 wrote off \$250 million of its total debt of \$300 million owed by Tajikistan. Debt-restructuring negotiations with bilateral creditors reduced external public debt from \$1.0 billion or 66.3% of GDP at end-2003 to \$822 million or 41.1% of GDP at end-2004. The improved external debt outlook allowed the limit on the PIP to be raised from 3% to 4% of GDP.

The National Bank of Tajikistan adhered to all of its monetary policy targets in 2004. Strengthened execution of monetary policy and a stable nominal exchange rate contributed to a substantial reduction in inflationary pressure. From 17.1% in 2003, inflation in 2004 fell to 6.8%, within the Government's target of 7%. With the repeal of 30% duty on remittances, more people used banking channels to send funds from abroad and flows through formal banking channels reached \$300 million in 2004 (about 15% of GDP). This was also reflected in an upward trend in domestic bank deposits over the year.

With higher import prices and a drop in cotton export prices, the trade deficit is estimated to have risen to \$290 million or 14.5% of GDP in 2004 from \$204 million in 2003. Mainly reflecting price developments, over this period the share of cotton fiber in exports fell from 24% to 16% while the share of aluminum increased from 54% to 62%. Despite high global oil prices and a decline in prices for cotton, the current account deficit in 2004 was kept relatively low at \$46 million or 2.3% of GDP (1.3% in 2003) due to the larger inflow of workers' remittances. The overall balance-of-payments position was in surplus; preliminary data indicate that foreign exchange reserves were \$192.9 million at end-2004, the equivalent of 2.2 months of imports.

Macroeconomic policy developments

The Government has been pursuing an economic and financial reform program supported by

Table 2.22 Major economic indicators, Tajikistan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	10.6	8.0	6.8	5.9
GDI/GDP	-	-	-	-
Inflation (CPI)	6.8	7.1	5.0	5.0
Money supply (M2) growth	26.7	17.8	-	-
Fiscal balance ^a /GDP	0.3	-0.5	-0.2	-0.1
Merchandise export growth	15.4	2.2	5.4	6.8
Merchandise import growth	20.8	7.9	6.6	7.2
Current account/GDP	-2.3	-5.2	-5.9	-6.5

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. ^a Excluding the public investment program.

Sources: Ministry of Finance; National Bank of Tajikistan; State Committee on Statistics; International Monetary Fund; staff estimates.

IMF's Poverty Reduction and Growth Facility (PRGF) over the past 2 years. The fiscal reform measures initiated in 2003 were consolidated in 2004 through a new tax and customs code compliant with the requirements of WTO, which was passed by Parliament for implementation effective 1 January 2005. Moreover, the Tajik Aluminum Smelter and Barki Tajik (the state power company) are now required to make full tax payments. Based on a new tariff policy, also beginning on 1 January 2005, a mechanism of quarterly adjustments will be implemented to raise power prices over the next few years to cost-recovery levels and to maintain gas tariffs at their real end-2003 (cost-recovery) level. These moves represent an attempt to make the energy sector self-sufficient, addressing the issue of large arrears (mainly in power) that amounted to about 20% of GDP at end-2003. A compensation mechanism introduced in 2003 mitigates the impact of energy price increases on the poorest 20% of the population.

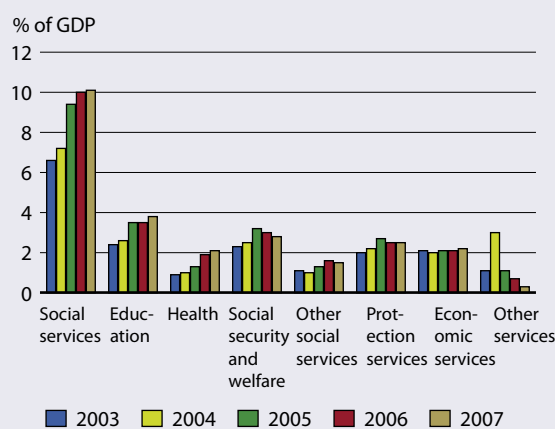
It is estimated that improved governance has led to better internal security and higher living standards. Good governance received enhanced emphasis from donors at a consultative group meeting in November 2004, which also drew attention to a slowdown in the reform drive and emergence of serious governance issues. Corruption, though less severe, persists,

preventing to some extent the Government's efforts to fulfill its obligations in many public sectors, such as education and health. Indicators in these sectors have deteriorated since independence. To address such problems, the Government is spending more on the social sector, especially education and health, through the 2005 national budget passed by Parliament in December 2004 and the medium-term budget framework (Figure 2.24). This increase is partly financed through a reallocation of spending from noncore social services and savings in interest payments resulting from debt write-offs. The Government will also continue efforts to improve local service delivery and the quality of public services by strengthening local government capacity and by fostering a favorable investment climate for developing the private sector.

The civil service reform that began in 2003 is raising public sector wages and reducing staff numbers in phases. In continuation of this initiative, a major structural reform of public administration consonant with the transition to a market economy was approved in 2004. Key ministries will be restructured and streamlined. Departments are to be grouped according to function and noncore functions eliminated. As part of the PRGF program, there will be an upfront reduction in staff positions of 3–5% to accommodate substantial public sector wage increases geared to structural changes in agency operations that enhance productivity. These higher wages are intended to boost worker performance and improve the quality of hires. This scheme has been approved by Parliament and will be implemented in five *raions* (districts).

Monetary policy in 2004 was designed to bring down inflation by improving liquidity management. Operations in the foreign exchange market helped keep the exchange rate stable. Under the PRGF agreement, the National Bank of Tajikistan has stopped providing credit to the banking sector (except for true lending of last resort) and it is to pay no dividends. Both policies aim to ensure better control over growth in reserve money. To assist commercial banks in their operations, the central bank is to help develop mechanisms for interbank lending. An innovation for 2005 is the plan of the Ministry of Finance to issue and auction short-term treasury securities.

Figure 2.24 Public spending on social and economic services, Tajikistan, 2003–2007



Sources: Tajikistan authorities; International Monetary Fund estimates.

Reforms in the agriculture sector have been slow. The enormous cotton debt that has been accumulated requires cotton farms to repay \$65 million credit annually before the start of the new season. Building on an initiative in 2004, the Government, with donors, has developed a two-track comprehensive solution to the farm debt problem: measures to address debt reduction and the introduction of more competition in marketing, and the elimination of intervention in producer decisions related to cotton production.

The Government is seeking to integrate the economy with foreign markets, particularly through regional cooperation with neighboring countries. In this regard, a recent agreement with the Russian Federation is to generate a substantial investment in the energy sector while Iran is to invest in the Sangtuda hydropower plant and the Anzob tunnel in the north. A new road between Tajikistan and the PRC, laid in 2004, will facilitate better trade with that country. The Government has also sought cooperation with Afghanistan on establishing power, transport, and trade links.

In its preparation for accession to WTO, the Government is developing a domestic and external trade regime and will need to balance its tax harmonization commitment to its subregional country customs partners against WTO requirements of reduced tariffs. Having implemented a WTO-compatible tax code, it also plans to bring relevant laws into line with WTO requirements.

Outlook for 2005–2007 and medium-term trends

The high GDP growth achieved in the last several years depended to a large extent on external factors such as export earnings that were boosted by higher international prices and ever-growing workers' remittances. However, cotton and aluminum, the two major export products, are susceptible to price volatility that can impact both export earnings and tax receipts. Due to anticipated global price trends and capacity constraints in aluminum production, a slowdown in growth is expected in the medium term.

Consequently, GDP growth is projected at 8.0% in 2005 with the downtrend continuing to about 6% by 2007. The impact of, for example, strengthened domestic policies, development of markets, accelerated investments in infrastructure and industry, as well as more effective use of development aid is likely to be felt only with a lag.

Policy changes in the agriculture sector could boost agricultural productivity and contribute to growth, since the Government now has a better appreciation of the importance of diversifying farm production to achieve higher growth. Resolution of the cotton farm debt issue and accession to WTO would allow better access to foreign markets and would expand the scope for a market-based strategy, allowing farmers to allocate crops based on profitability.

The budget for 2005 envisages the fiscal deficit to be limited to 0.5% of GDP. Total budgetary expenditure (excluding the PIP) is estimated to rise to 18.2% in 2005. Social sector spending is emphasized, and is projected to increase markedly from 6.6% of GDP in 2004 to 7.2% in 2005. Government revenues are also anticipated to rise to 17.7% of GDP due to the implementation of new measures on tax and customs codes, despite a decline in sales tax revenues stemming from the drop in cotton prices. Revenue measures include new taxes on businesses and a unified land tax.

External debt is projected to fall from 41.1% of GDP in 2004 to 37.5% in 2005, reflecting the impact of successful debt negotiations; it should stabilize at about 35% of GDP thereafter. Future debt service obligations would see a steep fall to 10.1% of exports in 2007, down from 49.2% in 2004, giving fiscal space for social expenditures. The budget deficit (excluding the PIP) in 2006–2007 is expected to be very small, at about 0.1–0.2% of GDP.

Inflation is expected to remain under control, bearing witness to improved implementation of monetary policy. It is expected to be 7.1% in 2005, reflecting pressures from wage adjustments granted in the budget, and then to moderate to 5.0% in the following 2 years.

In the face of export growth slowing to 2.2%, large hydropower projects will mean a faster expansion in imports, of 7.9%, than exports, which will substantially raise the current account deficit in 2005 to 5.2% of GDP. Larger capital inflows and external aid are projected to more than offset this and allow for some increase in gross international reserves. The current account deficit is likely to widen to 6.5% by 2007, mainly due to continued high levels of project implementation.

While poverty has declined in Tajikistan, it is still the highest among the Central Asian republics, and the country remains one of the poorest in the world. High growth and climbing per capita income mask rising inequality, and provision of adequate social services remains a challenge.

Economic developments so far indicate that it is unlikely that growth will be sustainable at high levels without structural reforms. Although the prospects for the medium term are for moderate growth, the long-term prospects could be brighter, but they depend on the strength of actions taken on domestic policy reform and on institutional change that the Government is undertaking, as well as on the success of regional cooperation.

Turkmenistan

Official statistics indicate that the economy continued to grow very rapidly in 2004. The ongoing expansion of energy production and exports will underpin economic activity and ensure reasonable growth in the medium term. However, more broad-based and equitable growth requires greater reliance on macroeconomic management and structural reforms.

Macroeconomic assessment of 2004

According to official statistics, gross output (used as a proxy for GDP) grew by 21% in the first 11 months of 2004, only slightly down from 23% in 2003. This contrasts with IMF's estimate of 7.5% growth in GDP for the whole of 2004. The difference in growth rates exemplifies the difficulties in using available statistics for assessing economic development. Government figures showing the breakdown of gross output by main economic activity are not available for 2004. Figures for 2003 indicate that gross industrial output (including gas extraction, oil extraction, and oil refining) grew by 22.0%, agriculture by 20.2%, and services by 18.5%.

On the expenditure side, growth continued to be driven by domestic investment, which for the first 11 months of 2004 reached TMM15.6 trillion (15.6% of gross output), up by 15% from the same period of the previous year. The priority areas were, as before, oil and gas extraction, petrochemicals, electricity generation and transmission, textiles, and luxury housing. The share of foreign capital in total investment in the country increased from 6.0% in 2003 to 9.2% in 2004, due to the nearly fivefold increase in the amount of foreign credits in domestic investments.

The Government has not released inflation figures for 2004, although IMF estimates 5% for 2004 as a whole, which is in line with the *ADO 2004* forecast. At end-December

2004, the official exchange rate remained pegged at TMM5,200/\$1 (as it has been since 17 April 1998), but the parallel market rate rose to TMM24,500/\$1 from TMM20,000/\$1 in 2003, due to a scarcity of foreign exchange. This depreciation led to significant price increases for most imported goods.

The average monthly wage rose by 12% to TMM1.8 million (equivalent to \$346 at the official rate of exchange) in 2004 due to improved conditions for activity outside the state sector and the development of private entrepreneurship (the private sector's share of GDP is about 25% according to the European Bank for Reconstruction and Development). In industry, transport, and construction, the average wage increased to TMM2.0 million a month. Official unemployment figures are unavailable. However, there are indications that a rise has occurred in unemployment, reflecting a public employee retrenchment program begun in February 2003 that sought to reduce public sector spending.

The state budget deficit, according to official figures, amounted to TMM12.2 billion, equivalent to less than 1% of GDP. Of total expenditures in 2004, the bulk went to social and public services, mainly education (27.8% of total expenditures) and health care (12.5%). However, the budget does not capture the true scale of government operations, since many state spending commitments are carried out through extrabudgetary funds, which are not reflected in the official figures.

The total trade surplus for the first 11 months of 2004 narrowed to \$546 million from \$918 million in the same period in 2003. Exports rose to \$3.4 billion, a 9% same-period increase, mainly due to high world prices for energy products and cotton fiber. There was a relative increase in the share of high-value exports, such as refined oil products, textiles, and cotton fiber, whereas the share of natural gas and crude oil in total exports declined. The commodity composition of imports changed little, with capital goods and raw materials accounting for 64% of total imports. Ukraine remained the largest trading partner (72% of all gas exports and 34% of total exports). A notable reorientation of trade away from countries in the Commonwealth of Independent States toward other countries was seen during 2004.

Determination of poverty is difficult, since there is no official poverty line and the figure for the subsistence minimum is kept strictly confidential. Nevertheless, income inequality appears to be the worst among the Central Asian republics, according to a recent living standards survey conducted by the National Institute of State Statistics, which indicates that the country has a Gini coefficient of 0.39.

Macroeconomic policy developments

Central planning and management persist. Production targets, mandatory state procurement, directed bank credits, foreign exchange restrictions, and intergovernment trade arrangements continue to be used by the Government. Key sectors, including oil and gas, remain in state hands. A central element of social protection is the provision to the entire population of basic services, goods, and utilities (e.g., electricity, gas, and water) free of charge, or at heavily subsidized prices.

The Government has now completed a full year of the implementation of its Strategy for Turkmenistan's Economic, Political, and Cultural Development for the Period up to 2020. This 2020 Strategy sets ambitious production targets for all sectors of the economy, to be supported by state-led investments. Initial implementation results seem, however, mixed at best. On the production side, the Government appears to have achieved its wheat target under the strategy; however, only one

third of the cotton production target was met. In an effort to revive the flagging agriculture sector, the People's Council adopted new land and water laws in October 2004, though most observers believe that these new initiatives are unlikely to greatly improve the situation.

The Government adopted an investment program covering the period mid-2004 to end-2005. Although specific details of the program are lacking (the Government considers it confidential), press reports indicate that the program included a total of 442 projects amounting to more than \$6 billion for the 18-month period. In 2005, the program reportedly plans that 244 projects will be implemented, in the amount of \$4.8 billion.

A balanced state budget was approved for 2005, with both revenues and expenditures set at TMM76 trillion (\$15 billion at the official exchange rate). Under the budget, the Government continues heavily subsidized provision of basic services, goods, and utilities. Revenues from taxes contribute only a low share of government income—less than 25% in the 2005 budget—in part because of widespread tax exemptions for state enterprises, which in practice means the majority of the economy. Moreover, revenue collection measures are ineffective, with tax revenues in 2003 coming in at less than half of the amount targeted. The People's Council approved a new tax code at its October 2004 session. This is intended to streamline the tax system, though the majority of commentators do not believe that this will be very successful in boosting revenue collection.

More job cuts are expected in the public sector, as an offset to plans to increase salaries by 50% in January 2005. This would be the third major job-cut drive in the last 4 years. Earlier redundancy programs concentrated on health care and education, while other areas of government remained relatively unaffected. This time the cuts appear to be across the board. The increase of salaries at the expense of jobs will add to unemployment, as the fledgling private sector will be unable to absorb the released workforce.

In terms of energy policy, the existing long-term intergovernment agreement on gas shipments to Ukraine was renegotiated in January 2005. Gas prices, previously fixed at \$44 per 1,000 cubic meters (m³) and 50:50 barter/cash transactions, were increased to \$58 per 1,000 m³.

Although a similar long-term agreement is in place with the Russian Federation, negotiations to increase gas prices have been inconclusive. The current agreement stipulates a gradual increase of gas shipments from 5 billion m³ in 2004 to 80 billion m³ in 2028, though the throughput capacity of the old Central Asia-Centre (CAC) pipeline will be unable to accommodate the expected volumes of gas without the rehabilitation of the entire pipeline system. Even if upgraded and modernized in the future by Gazprom (the Russian company that has announced a rehabilitation of the CAC pipeline), the growing gas export potential of Uzbekistan could significantly impinge on the pipeline capacity that could be devoted to gas exports from Turkmenistan.

Thus the continued expansion of gas exports faces major constraints. Consequently, the Government has been searching for alternative ways to secure the export of its gas, including via Afghanistan, for example by participating in the Turkmenistan-Afghanistan-Pakistan (TAP) Natural Gas Pipeline Steering Committee. It is also concluding the certification of the Dauletabad gas field reserves, and the results will be an important factor in determining the final economic feasibility of the TAP pipeline.

Outlook for 2005–2007 and medium-term trends

Analysts share a general consensus that growth prospects will be quite good over the short run. *ADO 2005* forecasts slowing GDP growth of 10.0% in 2005, 7.0% in 2006, and 6.3% in 2007. This reflects expected declines in world oil and gas prices, which are likely to more than outweigh the anticipated increase in the Government's oil and gas production and exports, against a background of slowing export earnings that will limit investment and growth.

The Government has not released information on its new 2005 targets for natural gas and oil production. The Government's 2020 Strategy has indicated that natural gas production should increase to 67 billion m³ in 2005, of which 53 billion m³ are for export. Likewise, crude oil production according to the 2020 Strategy should increase to 18 million tons. Many commentators consider these government targets somewhat

ambitious. Nevertheless, the production and export of natural gas, crude oil, and petrochemicals products are likely to increase substantially in 2005–2007, as are the production and export of electricity. In contrast, agricultural production is likely to stagnate (in the case of cotton this is already the case), unless the Government initiates much-needed sector reforms, including the dismantling of the existing mandatory state procurement system.

Inflation is expected to be kept to about 5% by a combination of tight monetary policy, subsidies, price controls, and cash restrictions. The official exchange rate is likely to remain fixed at TMM5,200/\$1, and the parallel market rate broadly stable at around TMM25,000/\$1.

The total trade surplus is forecast to widen further in 2005. Exports will rise, mainly due to an increase in the volume of energy exports. Imports are also projected to strengthen, in part because most of the country's natural gas is exported under the barter arrangements, and in part because of the ongoing construction of large-scale projects.

The anticipated rapid output growth, macroeconomic stability, and trade surpluses will have only a limited positive impact on the living standards of the majority of the population. The reason is that few new jobs will be created, while much of the additional national income will be invested in state-led projects of questionable economic and social value.

Furthermore, the economy will remain vulnerable to possible swings in world energy prices, bottlenecks in export routes, and possible delays in payments for deliveries of natural gas by its major trading partners. A sharp fall in world oil prices or constraints on increased exports of natural gas due to the limited throughput capacity of existing pipelines would have a major adverse impact on exports, output growth, and the Government's fiscal position. Finally, growth based on exploitation of natural resources is likely to be short lived, if the experience of many other resource-rich countries is repeated. Therefore, in order to foster broad-based sustainable and equitable growth, the Government needs to rationalize public expenditures, halt—and then reverse—the negative developments in the country's human capital base, and embark on structural reforms to diversify the economy.

Uzbekistan

Tight economic policies in 2004 resulted in further macroeconomic adjustment, but progress on structural reforms was uneven. Accelerated GDP growth, a balanced budget, a sizable current account surplus, and the maintenance of current account convertibility must be set against the continuance of trade restrictions and the imposition of further impediments in the internal market. A reinvigorated approach to structural reform is needed to speed development and poverty reduction.

Macroeconomic assessment of 2004

Recording the highest rate since independence, GDP growth in Uzbekistan accelerated to 7.7% in 2004, according to official estimates. Growth was led by the agriculture sector but the other major sectors all played their part. Favorable climatic conditions contributed to agriculture's strong performance, with the cotton crop showing a recovery after a poor harvest in 2003. Grain production in 2004 was lower though than in 2003, in part due to a reduction in the land area sown. Notably, the contribution of private farms to crop production doubled in 2004. The acceleration in industrial growth was driven by the resource sectors, particularly fuel and ferrous metals, and machine building, especially the automotive and aircraft industries.

Economic assessments based on official data need to consider the following two factors. First, in the past, official real GDP growth estimates were higher than other estimates partly because of differences in GDP deflators. For 2004, while there was a significant drop in the official GDP deflator, other official inflation estimates, such as producer prices, stayed high. Second, in past years, the official growth numbers based on the production side of the national accounts were inconsistent with GDP by expenditure category. For 2004, even taking into account the significant contribution of net exports of goods and

services, the officially estimated 7.7% growth would require unrealistically sharp growth in domestic consumption and/or investment. Preliminary unofficial estimates put GDP growth for 2004 at 5.5%.

Limited employment opportunities and low returns to labor have perpetuated poverty levels at more than a quarter of the population. Poverty data based on a household budget survey updated in 2003 show a marginal decline in poverty incidence from 27.5% in 2000 to 26.2% in 2003. Surprisingly, the latest results also indicate a very sharp decline in poverty incidence in the southern region, hitherto the poorest in the country, from 47.4% to 26.4% in the period. The official reported unemployment rate is 3.1%, but alternative sources suggest that the actual rate is about 6%. While this figure appears relatively low by international standards, the significant informal sector (estimated at between a third and a half of the economy) engaged in less productive activities suggests that there are bottlenecks in labor absorption, including impediments to private sector development. Employment growth during 2004 remained stagnant.

The authorities maintained a tight fiscal stance in 2004 with the budget balance (excluding extra-budgetary funds) posting a small surplus. The revenue-to-GDP ratio decreased to 23.7% in 2004 from 24.2% in 2003, due in part to cuts in certain tax rates. Budget expenditures as a share of GDP

declined to 22.9% in 2004 from 24.6% in the previous year. The burden of the expenditure cuts has fallen on centralized investment financing and “other expenditures.” The share of social sector spending has been maintained, but spending on social protection continued to decline.

Inflation in 2004 remained subdued and virtually unchanged as per the official estimates, with the year-on-year end-period change in the CPI at 3.7%. (Alternative estimates suggest an inflation rate of around 15%. These estimates are based on the consideration that the basket used to compute the official estimates does not adequately represent goods and services actually consumed by the public.) Higher nonfood prices, led by utility price increases, partially offset the fall in food price inflation. Broad money grew rapidly during the latter half of 2004, reflecting mainly the accelerated growth in net foreign assets prompted by the balance-of-payments surplus.

Strong export growth of goods and services in 2004 of 30% contributed to a current account surplus estimated at 8.4% of GDP, the third consecutive year of surplus. Higher world prices for gold and an expansion in energy exports were the main drivers, since cotton export earnings increased only modestly due to the poor harvest in the previous year. Consistent with the reported pickup in investment, import growth accelerated to 28.2%, with higher imports of machinery and equipment, as well as metals. The deficit on the capital account is estimated to have widened as higher FDI inflows were counterbalanced by other capital outflows. Overall, the large current account surplus outweighed the capital account deficit. Foreign exchange reserves were about \$2.1 billion at end-2004, providing over 6 months of import cover.

Macroeconomic policy developments

Macroeconomic management has tended to have a short-term focus of addressing individual problems, such as containing the fiscal deficit and reducing inflation, in ways that could generate longer-term problems. In 2004, the authorities further reduced the base rate of the profit tax on enterprises to 18%; effective 1 January 2005, it was brought down further, to 15%. Also, preferential rates and other tax incentives are applied to enter-

prises included under the revitalized localization program. Consequently, tax revenues from this source fell sharply in 2004. The Government has often equated fiscal reform with tax rate cuts, with insufficient regard to ensuring an adequate tax base and a tax administration system that are capable of sustaining pro-poor spending. It is essential to strengthen the revenue effort and improve revenue buoyancy by keeping exemptions and discretionary rates to a minimum and by improving tax administration.

In order to contain inflation and maintain stability of the exchange rate, cash circulation restrictions remained in force in 2004, a mechanism that raises the risk of liquidity shortages for enterprises and a buildup of arrears (as occurred in 2003). With the pilot phase of the “plastic card” (a type of bank debit card) system of payments ending in 2004, a nationwide rollout is planned in 2005. The Central Bank of Uzbekistan (CBU) has given a commitment that the system will be implemented on a purely voluntary basis, though some in the private sector fear that the system could be used for further restricting cash transactions. CBU cut its refinancing rate twice in 2004, bringing it down to 16% to align it with inflation.

The authorities have ensured a gradual depreciation of the exchange rate in nominal terms (0.7% per month). The track record on currency convertibility remains good according to the findings of a recent IMF review mission, but progress on complementary structural reforms has been slow.

Banks have seen a deceleration in net income growth over the past few years, largely due to the sizable level of NPLs of the large state-owned banks. CBU set up a national institute of credit monitoring in 2004 to improve this area. Despite recent growth of small and medium private banks, the state-owned banks remain dominant. Privatization of Asaka Bank, the second-largest state-owned bank, originally scheduled for 2004, appears stalled for the present. Economy wide, the authorities reported that 966 enterprises were privatized in the first 3 quarters of 2004 but only one large privatization deal was brought to closure.

A presidential decree on the creation of a chamber of commerce and industry was issued in

July 2004 that could pave the way for a dialogue between representatives of the private sector and the Government on measures to improve the business environment.

Uzbekistan's foreign trade regime is characterized by a moderate average unweighted tariff rate (lowered in 2004 to 14.6%), but the four-band system of tariff escalation based on stages of production is geared toward protecting selected domestic industries. Numerous nontariff barriers restricting trade also remain in place, presenting a risk that the efficiency gains from the introduction of currency convertibility may not be realized. Indeed, the regulatory burden on "shuttle" trade was intensified in 2004.

Restructuring loss-incurring cooperative farms (or *shirkats*) into private farms continued in 2004, with the latter increasing to over 100,000 toward the end of the year. Most private farms are required to produce cotton and wheat on 85% of their leased land but have freedom to make their own farming decisions on the remaining 15%. The Government has credited its policy of restructuring *shirkats* with giving a major boost to the efficiency of the rural economy. It does indeed seem that private farms have lower production costs than *shirkats*, as the incentives to divert resources that are common in *shirkats* are absent in private farms. In other respects however, the profitability of private farms is held down by shared disincentives inherent in the state procurement system for cotton and wheat.

The Government recognizes that if it is to make a dent in the poverty incidence, it will need to sustain high rates of growth through structural reform with complementary changes to the provision of human development and social protection services. Its Living Standards Improvement Strategy, completed in June 2004, is now being further developed into an Interim Welfare Improvement Strategy Paper (I-WISP), a framework that sets out the following targets: reduction in poverty incidence from 26.2% in 2003 to 20% in 2010; annual GDP growth of 8.0–8.5% over 2007–2010; inflation in the range of 4–5%; investment growth accelerated to 12% a year with the incremental capital output ratio (ICOR) falling from 5.8 to 3.2; export growth maintained at 10–12%; the share of industry in GDP increased to 20%; the number of employed

increased to 13.2 million; and unemployment brought down to 2%. Additional work is required to develop the draft strategy into a coherent and consistent economic program.

Outlook for 2005–2007 and medium-term trends

Sustaining the growth rate achieved in 2004 will not be easy. Some of the key sources of recent growth have an uncertain future, including strong prices for commodity exports—in particular cotton where prices have weakened—but also gold and energy. Key to the medium-term outlook will be the extent to which the Government adopts an accelerated reform program. In the near term however, the growth dividend from an accelerated reform scenario could be small.

In 2005, the external environment is seen as being less favorable. World cotton oversupply is likely to depress demand for cotton fiber exports, gold prices are expected to decline from the record high seen during 2004, and while the outlook for energy prices is positive, it is uncertain. Officially reported consumer inflation is set to remain in the 6–8% range but actual inflation (factoring in prices in markets where consumer goods are traded) is likely to be higher at 12–15%. Adherence to the Government's commitment to assuring enterprises' access to cash will be essential for ensuring that wages are paid and that the purchasing power of the poorer sections of society is maintained. Overall, a moderate deceleration in GDP growth to around 5.0% in 2005 may be expected.

Over 2006–2007, the acceleration in GDP growth to 8.5% envisaged in the I-WISP appears ambitious, but an improvement to around 6.5% is possible if some pickup in structural reforms and a positive global environment are seen.

Currently, the investment rate is around 22% of GDP. To achieve a growth rate of 6.5% and assuming an ICOR of 4.4 will require an investment rate of 28–30% of GDP. In the past, the government budget funded investment of around 6% of GDP a year. The ability of the budget to finance higher levels of public investment appears constrained by the anemic revenue mobilization effort. FDI inflows account for less than 1% of GDP, and while the energy

sector has good prospects for FDI projects financed by the Russian Federation, other foreign investors appear lukewarm because of the investment climate in the country. This leaves domestic private investment to fill the gap, which would need to improve from its current level of about 14%.

The current investment climate for both domestic and foreign enterprises makes achievement of this investment target challenging. A lower investment rate with higher investment efficiency could achieve the 6.5% growth target, but the prevailing strategy of import-substituting industrialization would have to be reoriented.

Under this policy, large sectors of the economy are subordinated to the promotion of selected industrial activities—at considerable cost to overall economic efficiency. Moving toward and sustaining the GDP growth target will therefore

require a refocus of the development strategy to enable both a higher level of investment and an improvement in its quality.

Assuming acceleration in structural reforms, growth could pick up to around 6.0% and 6.5%, respectively, in 2006 and 2007. The impetus for this growth is expected to come from private investment and exports. The balance-of-payments outlook for 2006–2007 under an accelerated reform scenario is one where both exports and imports are likely to rise to fuel higher investment and growth. The emerging current account deficit of the scenario is likely to be readily financed with additional official development inflows and FDI inflows accompanying reforms. In short, growth over the medium term will depend on whether the authorities adopt a substantially reinvigorated structural reform program or continue with the current direction and pace of reform.