

ASIAN DEVELOPMENT
Outlook
2003

Economic Trends and Prospects in Developing Asia

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Azerbaijan

The economy maintained strong growth momentum in 2002, mainly due to a rebound in FDI inflows into the oil sector. Growth is expected to remain buoyant in 2003–2004, underpinned by a continuing investment boom in that sector, though this oil-driven expansion will have only a limited impact on employment and poverty. The Government needs to maintain sound macroeconomic policies and speed up market-oriented reforms, if broad-based growth and a considerable reduction in poverty are to be achieved.

Macroeconomic Assessment

GDP growth accelerated slightly to 10.6% in 2002 from 9.9% in 2001, driven by increased FDI in the oil sector. Reflecting the launch of several large-scale investment projects, including the construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, gross FDI inflows into the oil sector surged from \$821 million (15% of GDP) in 2001 to \$1,521 million (25% of GDP) in 2002. This pushed the ratio of fixed investment to GDP to about 30% and provided a major impetus to the economy (Figure 2.19).

Manufacturing and services related to oil development, such as construction and the production of construction materials, expanded rapidly, although oil production itself increased by a modest 1.8% to 0.3 million barrels a day due to capacity constraints. A bumper grain harvest led to a 6.4% expansion in agricultural production and contributed to GDP growth.

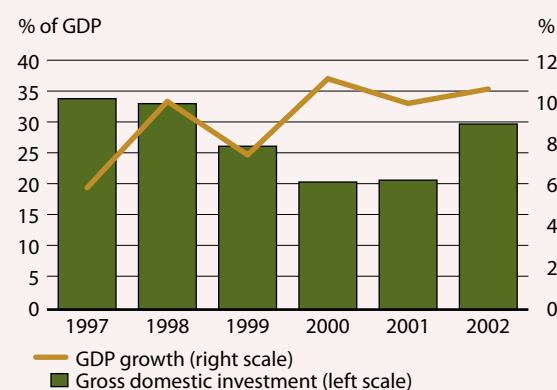
Since output growth resulted primarily from an increase in productivity, wages and salaries rose substantially, while employment increased only marginally. According to official statistics, the average wage rose by 20.3% in nominal terms (17.1% in real terms), while the unemployment rate is reported to have increased from 1.2% at end-2001 to 1.3% at end-2002. However, official statistics considerably underestimate the true unemployment

level. Results of recent labor market and household budget surveys suggest that, despite the impressive economic growth of the last 7 years, the actual unemployment rate in Azerbaijan remains well above 10%, while about half the population still lives in poverty.

The general government budget, which does not include the Oil Fund, recorded a deficit of AZM645 billion or 2.2% of GDP in 2002, compared with a 2001 deficit of 2.1% of GDP. Revenue performance improved from 18.0% of GDP in 2001 to 19.2% of GDP in 2002 but this was more than offset by an increase in expenditure. Similarly, while revenues of the Oil Fund continued to grow, the Government started utilizing its assets to finance social and investment projects. As a result, the Oil Fund's surplus fell to 3.5% of GDP in 2002 from 4.0% in the previous year.

Money supply increased by 13.1% during 2002. The level of financial intermediation, as measured by the ratio of broad money to GDP, remained low at about 13% of GDP, and the high degree of dollarization persisted, with foreign currency deposits accounting for about half of broad money. Average annual consumer price inflation accelerated slightly from 1.5% in 2001 to 2.8% in 2002. The nominal exchange rate of the national currency (the manat) depreciated by 4.4% against the dollar, and the real rate depreciated by 1.6%. Azerbaijan has so far avoided the excessive appreciation of the real

Figure 2.19 GDP Growth and Investment Ratio, Azerbaijan, 1997–2002



Sources: State Statistical Committee of Azerbaijan; staff estimates.

exchange rate that is often associated with a natural resource boom.

The external current account deficit widened substantially from \$73 million (1.3% of GDP) in 2001 to \$768 million (12.6% in 2002, as imports related to oil development increased sharply. This was fully financed by inflows of FDI and other capital flows such that the overall balance of payments recorded a surplus of \$230 million. Accordingly, gross official reserves, including Oil Fund assets, grew from \$1,194 million at end-2001 to \$1,373 million at end-2002. Reflecting the Government's cautious approach to external borrowing, the stock of public and public-guaranteed foreign debt increased by a modest \$94 million to \$1,356 million (22.3% of GDP), consisting mostly of concessional loans from multilateral and bilateral donors.

Policy Developments

Macroeconomic policies remained fairly tight in 2002. Although the general government deficit increased slightly from 2001, it was much smaller than the deficit of 4.0% of GDP envisaged in the 2002 budget. The refinance rate of the National Bank of Azerbaijan was lowered from 10.0% to 7.0% a year, but remained positive in real terms. However, in a worrisome development, several ad hoc decisions were made regarding the use of Oil Fund assets, including financing the state oil

company's equity participation in the BTC pipeline project. Such use of Oil Fund resources threatens to undermine the coherence and consistency of financial policies and entails the risk of destabilizing the macroeconomic situation over the medium term.

On the structural side, the Government took a number of measures to curtail implicit energy subsidies, enhance transparency and accountability of budget management, and improve the business environment. In particular, a program of strengthening financial discipline in the energy sector was adopted, and management of four electricity distribution networks, covering most of Azerbaijan's territory, was transferred to private firms, resulting in a significant improvement in tariff collection rates. In addition, all extrabudgetary funds, with the exception of the Oil Fund and the Social Protection Fund, were integrated into the state budget. In another major step toward greater fiscal transparency, implicit subsidies to the electricity and gas sectors, in the form of unpaid fuel deliveries to these sectors, were included in the 2003 budget. Furthermore, the number of business activities subject to licensing was reduced from 240 to 30 and licensing procedures were streamlined.

However, little progress was made in other areas of structural reform. The implementation of the second privatization program launched in 2001 was slow, and privatization of the International Bank of Azerbaijan, whose dominance of the banking system hinders competition in the financial sector, was delayed. Administrative reform, involving modernization of the Ministry of Taxes and the State Customs Committee as well as separation of regulatory and commercial functions of SOEs in the energy and transport sectors, was in effect stalled. Corruption remains a serious problem and much needs to be done to create an enabling environment for the development of a vibrant private sector in the non-oil economy.

The Government reaffirmed its commitment to foster broad-based and equitable growth, and to reduce poverty in the State Programme on Poverty Reduction and Economic Development for 2003–2005, which was unveiled at a high-level conference in Baku in October 2002. The Programme was prepared in a participatory process involving the donor community and civil society. Reflecting the multidimensional nature of poverty and development, the Programme pursues a broad agenda and

Table 2.19 Major Economic Indicators, Azerbaijan, 2000–2004, %

Item	2000	2001	2002	2003	2004
GDP growth	11.1	9.9	10.6	9.5	8.0
Inflation rate (consumer price index)	1.8	1.5	2.8	3.2	2.9
Money supply (M2) growth	26.2	30.5	13.1	-	-
Fiscal balance/GDP	-2.2	-2.1	-2.2	-	-
Merchandise export growth	83.1	9.0	12.7	9.8	-5.9
Merchandise import growth	7.4	-4.8	24.5	7.5	3.8
Current account balance/GDP	-2.4	-1.3	-12.6	-15.0	-18.0

- Not available.

Sources: State Statistical Committee of Azerbaijan; National Bank of Azerbaijan; staff estimates.

includes a wide range of policy measures aimed at reducing poverty and promoting sustainable development. However, it does not properly prioritize nor cost these measures, and neither does it set specific poverty reduction targets.

Outlook for 2003–2004

The economic outlook for 2003–2004 is positive, as the ongoing oil investment boom is expected to continue. GDP is projected to grow by 9.5% in 2003 and by 8.0% in 2004. FDI inflows into the oil sector, which are expected to reach \$1.7 billion in 2003 and \$1.8 billion in 2004, will remain the engine of growth. Manufacturing and services related to investment in the oil sector will continue to expand rapidly. Growth in oil production will likely accelerate to 3.0% in 2003 and to 8.6% in 2004 as capacity restraints are gradually removed. Growth in agriculture, however, will moderate to 3–3.5% as slow progress in sector reform and continuing deterioration of rural infrastructure impede productivity growth. Since GDP growth will be concentrated in capital-intensive sectors, a major fall in unemployment is unlikely, although wages are expected to continue rising.

Under the base-case assumption that fiscal policy remains sound and monetary policy sufficiently tight to preserve macroeconomic stability, annual consumer price inflation is forecast to remain within the range of 2.5–3.5%. The nominal exchange rate is expected to continue to depreciate moderately at about 3.0% a year, with the real exchange rate staying largely unchanged. Exports

of goods and nonfactor services are expected to increase from \$2.7 billion in 2002 to \$2.9 billion in 2003, due to a combination of higher world oil prices and larger exports volumes, but to decline to \$2.8 billion in 2004 as the anticipated fall in world oil prices more than offsets a continuing rise in oil export volumes. At the same time, imports of goods and nonfactor services will increase, from \$3.1 billion in 2002 to \$3.5 billion in 2003 and to \$3.6 billion in 2004, driven by increasing investment in the oil sector. Consequently, the current account deficit will widen further to 15.0% of GDP in 2003 and to 18.0% of GDP in 2004 and continue to be financed by inflows of FDI.

However, there is a risk that the Government will considerably increase budgetary and Oil Fund expenditures ahead of the presidential elections scheduled for autumn 2003. This will lead to a larger budget deficit and higher foreign exchange inflows from the Oil Fund, and will put upward pressure on the nominal exchange rate. With its net domestic credit equivalent to less than 1% of GDP and little room for sterilization of interventions in the foreign exchange market, the National Bank of Azerbaijan will have to make a difficult choice between, on the one hand, letting the nominal exchange rate appreciate and, on the other, absorbing additional foreign exchange inflows, which will increase money supply and fuel inflation. In either case, the real exchange rate will appreciate, which will adversely affect competitiveness of the non-oil traded goods sector. Consequently, output growth will be lower and the current account deficit higher than under the base-case scenario.

Kazakhstan

Overall economic performance remained strong in 2002, and the medium-term prospects are good, though they continue to depend heavily on the oil sector and thus remain vulnerable to external shocks. Effective management of large government oil revenues and continued structural reform will be necessary to ensure long-term sustained rapid growth, economic diversification, and employment creation.

Macroeconomic Assessment

In 2002, the economy continued its strong performance, despite weak world commodity markets; GDP growth of 9.5% exceeded the 7.0% government target. Fueled by past large investments and an improved transport infrastructure, production of crude oil and gas condensate expanded by 17.3% to 47 million metric tons in 2002, resulting in a 9.8% increase in industrial output (which accounts for about 30% of GDP). Growth in the manufacturing subsector slowed to 7.7% from 14.8% in 2001, mainly due to moderation in external demand. Agriculture sector output grew by 2.7%; growth in the livestock subsector was strong, but the grain subsector recorded only a modest rise due to a decline in crop productivity. Construction output rose sharply by 19.3%, largely as a result of rapid infrastructure development for the new capital, Astana, and rapid continued growth (at over 9%) in the services sector, mainly due to large rises in transport and telecommunications.

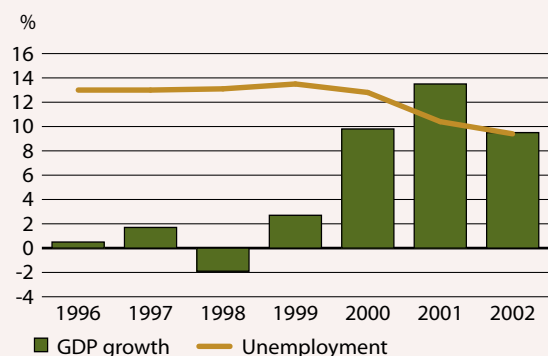
Fixed capital investment at 19.0% of GDP remained high, though somewhat below the 21.0% of GDP peak recorded in 2001. Investment in oil and gas activities increased to 53.0% of total investment from 41.0% in 2001. Transport and communications and manufacturing were also important investment destinations, accounting for 11.0% and 8.4%, respectively, of total investment. Domestic private investment continued to be the largest source of investment at 67% of the total, while

foreign and public sector investment accounted for 25.0% and 8.0%, respectively, of the total.

Living standards improved as continuing economic growth helped raise real incomes by 7.4% from the year earlier level. In 2002, average monthly wages reached T20,305 (equivalent to \$131), a 16.6% increase over the 2001 figure in nominal terms and 10.0% in real terms. However, regional income inequality remained, with wages in oil-rich regions double the country-wide average wage. Sustained economic growth and targeted poverty interventions helped reduce the proportion of the population living below the subsistence minimum of T4,734 (\$31) per month from 28.4% in 2001 to 27.0% in 2002. The state law on targeted social assistance became effective on 1 January 2002, providing allowances for those with incomes below T1,853 (\$12) per month. The unemployment rate declined from 10.4% to 9.4% in 2002, mainly due to greater employment in construction and services (Figure 2.20). However, unemployment is still a major problem, especially in rural areas and among women. While GDP growth has averaged over 10% in the past 3 years, employment growth has averaged only about 3%, largely because of the capital-intensive nature of the oil sector-led expansion.

The fiscal position continued to strengthen in 2002, aided by faster than expected economic growth. The general government (central and local) budget was essentially balanced (with a negligible surplus), compared with a small deficit of 0.4% of GDP in 2001. While tax revenues substantially

Figure 2.20 Change in GDP and Unemployment, Kazakhstan, 1996–2002



Source: National Statistics Agency.

exceeded budget targets, the revenue-to-GDP ratio fell as expected by about 1 percentage point to 21.9% of GDP, mainly because, in a classification improvement, privatization proceeds were treated as a financing item in 2002, rather than revenues as in 2001. Similarly, the expenditure-to-GDP ratio fell to 21.9% of GDP from 23.4% in 2001, mainly reflecting reduced allocations to the road and transport subsector after large increases and under-budget expenditures during the year.

While this presentation of the budget includes net balances of nonbudgetary accounts, it does not include revenues of the National Fund of the Republic of Kazakhstan (NFRK), which recorded a surplus of 1.4% of GDP in 2002; with this, the inclusive overall government surplus would have been 1.4% of GDP. The NFRK, which was established in 2001, accumulates a part of the Government's oil and mineral revenues for future investment to achieve economic diversification. While the mechanism used to calculate allocations of government revenues between the budget and the NFRK is complex, use of conservative baseline oil and mineral prices in planning, as well as provision for stabilization payments from the NFRK in case of lower than expected prices, works to assure that budget revenue assumptions are achieved. General government debt, including both external and domestic debt, was reduced to 15.0% of GDP from 17.3% in 2001, due to early repayments.

National Bank of Kazakhstan (NBK) monetary policy was generally accommodative during 2002. Broad money supply (M3) rose by about

33% in response to continued economic growth and financial deepening. A 36% surge in bank deposits in 2002 reflected rising public confidence in the banking sector, though the bulk of deposits continued to be held in foreign exchange-denominated accounts. NBK policy action during the year was evident in the easing of the refinancing rate to 7.5% from 9.0% in 2001. This led to a reduction in the average weighted interest rate for the corporate sector from 16.3% in 2001 to 15.5% at end-2002, and helped boost credit to the economy by 37.0% from the year earlier level.

Strengthened central bank control over reserve money and monetary growth kept the exchange rate stable and reduced annual inflation, measured by the CPI, to 5.9% from 8.4% in 2001. The tenge depreciated by 3.2% and 0.1% against the dollar, in nominal and real terms, respectively, in 2002; the average exchange rate was T153.5 to the dollar. The tenge also depreciated in real terms by 5.5% against the Russian ruble, thus helping keep domestic industry competitive vis-à-vis the country's main trading partner.

Kazakhstan's external position improved in 2002. The trade surplus increased to \$2.1 billion from \$1.2 billion in the previous year. Merchandise exports grew by 12.0%, after a 2.8% decline in 2001, mainly due to the marked increase in production and export volume of oil and metals that offset weaknesses in their international market prices. Imports rose by only 2.0%, following the large increase of 14.6% in 2001.

Reflecting the improved trade balance, the current account deficit narrowed sharply to \$200 million (around 1% of GDP) from \$1.2 billion in 2001. Although net FDI inflows were substantially less than the exceptionally high amount recorded in 2001, a capital account surplus continued to ensure an overall payments surplus. Gross international reserves (including assets held by the NFRK) increased over the year by \$1.3 billion to \$5.1 billion at end-2002. The NFRK's assets increased by about \$700 million to \$1.9 billion, while NBK's official reserves rose by about \$600 million to \$3.1 billion, a level equal to 3.5 months of imports of goods and services. Total external debt is estimated at about \$18 billion at end-2002 (about 74% of GDP); public sector debt accounted for only \$2.9 billion of the total. The fact that official reserves exceed public sector external

Table 2.20 Major Economic Indicators, Kazakhstan, 2000–2004, %

Item	2000	2001	2002	2003	2004
GDP growth	9.8	13.5	9.5	6.0	6.2
Gross domestic investment/GDP	18.1	26.9	-	-	-
Gross domestic savings/GDP	20.1	22.2	-	-	-
Inflation rate (consumer price index)	13.2	8.4	5.9	5.9	5.4
Money supply (M3) growth	44.9	45.1	33.0	22.4	16.6
Fiscal balance/GDP	-0.1	-0.4	0.0	-2.0	-1.9
Merchandise export growth	55.1	-2.8	12.0	5.1	4.3
Merchandise import growth	21.2	14.6	2.0	6.0	5.7
Current account balance/GDP	3.7	-5.6	-1.0	-1.5	-1.8

- Not available.

Sources: Ministry of Economy and Budget Planning; Ministry of Finance; National Bank of Kazakhstan; National Statistics Agency; staff estimates.

debt reflects one aspect of Kazakhstan's striking success in attracting FDI in its development effort.

Policy Developments

The Government continued with its policy effort to encourage fiscal consolidation. The new tax code, which codified all previous tax laws and reduced rates on SMEs, came into force on 1 January 2002. Administrative reforms included setting up a monitoring unit for large taxpayers and introducing an electronic registration of taxpayers and a tax reporting system. Modernization of the treasury system enhanced transparency of the fiscal system. Fiscal management improved through the adoption of a medium-term fiscal framework that will ensure a planned stable flow of resources to carry out the medium-term development strategy (2002–2004). In this regard, the framework sets the education and health sectors as priority budget areas for improved services, as their shares in expenditures have declined in recent years.

The central Government has initiated steps to reform fiscal relations among the various levels of government by approving a new delineation of powers among the levels along with changed fiscal relations based on a functional review. Corporate income taxes, which were previously shared equally between the central and local governments, are now to be collected by the central Government

and transferred to local governments following guidelines, both to reduce the vulnerability of local budgets to revenue fluctuations and to distribute revenues among the regions more equitably. In an effort to promote customs administration reform, the Customs Committee was upgraded to an independent agency reporting directly to the prime minister.

On the monetary side, NBK continued to target the growth of reserve money as its main monetary policy instrument and is preparing to move toward an inflationary targeting framework. Reserve money increased by 19.0% as planned, and inflation remained within the 5.0–7.0% target range. The policy on exchange rate management was unchanged with periodic interventions by NBK to prevent excessive appreciation of the tenge in the auction exchange market.

To enhance the stability of the financial sector, NBK continued to strengthen prudential regulations as well as its own ability to conduct effective banking supervision. These efforts resulted in a reduction in the number of commercial banks from 57 in 2000 to 38 in 2002.

WTO accession remains a priority for the Government and moves toward negotiations on membership have been gaining momentum. However, much work needs to be done to relax protective measures, including high tariff rates for agriculture, food processing, and light industry.

The Government continued its efforts to improve the investment climate. A new investment law was promulgated, which stipulates equal investment incentives to both domestic and foreign investors. To increase spillover effects from FDI, the Government is seeking to increase procurement from domestic firms; however, a deliberate phasing-in of measures will be necessary for smooth implementation. Notably, in September 2002, Moody's upgraded the sovereign credit rating of Kazakhstan to investment grade, the first in the Commonwealth of Independent States to achieve this distinction.

Outlook for 2003–2004

The underlying assumptions of the following forecast are that the global economic recovery will continue; world commodity markets will be stable, at least to the level of 2002; the Russian economy will grow at about recent rates; and subregional stability will be maintained.

The outlook is expected to stay positive and the Government has projected GDP growth in the range of 6–7% over the next 2 years. The economy will continue to be driven by the oil sector where annual production growth is likely to exceed 10% during this period, causing industrial output to grow by 8–10%. GDP growth is expected to slow from the over 10% average rate of the last 3 years, which was achieved by large oil and infrastructure investments coming on line, though growth on the upper side of the 6–7% range appears likely if global and oil market conditions are relatively benign. Agricultural output is projected to grow by 2–3% annually in 2003–2004; however, as rural development is a key government priority for 2003–2005, performance may be higher if the Government is successful in expanding its budgeted development program for rural areas and in strengthening the relevant legal framework, especially in terms of handling the complex issue of introducing private land ownership.

The fiscal position is expected to continue to be strong. General government revenues are projected at 20.9% of GDP in 2003 and 20.5% in 2004 in the government budget forecast, which assumes a cautious baseline oil price for Brent crude of \$19 per barrel. General government expenditures are projected to grow essentially in line with nominal

GDP, with spending at 22.9% and 22.4% of GDP in 2003 and 2004; thus, the general fiscal deficit is expected to be about 2% of GDP in both years. However, government projections indicate very substantial savings of oil and mineral revenues in the NFRK, especially in 2003. Consequently, the overall government fiscal balance, including the NFRK, should likely show a strong surplus, perhaps averaging at least 1–2% of GDP over the 2 years.

The central bank intends to implement policies that would keep inflation within the range of 4–6% over the forecast period. Given its growth and inflation objectives and accounting for changes in monetization, money supply is expected to grow by 22.4% and 16.6%, respectively, in 2003 and 2004. In these circumstances, the exchange rate is likely to be largely stable with a nominal yearly depreciation of about 4%.

The trade balance is likely to stay positive as oil production increases. In this context, exports are forecast to grow by about 5% in 2003 and by about 4% in 2004 as demand from subregional trading partners strengthens and as recovery of the global economy continues. Imports are projected to grow by about 6% in each year, mainly reflecting developments in capital goods imports related to oil sector investment. The current account deficit is likely to increase only slightly from the 2002 level and remain at less than 2% of GDP. Anticipated foreign investment inflows and other capital flows are expected to more than fully cover the current account deficit.

Continued economic growth is expected to improve living standards as the average real wage is projected to rise by 8–9% annually over the 2002 level. The Government recently approved a state program on poverty reduction for 2003–2005, which aims to bring down the number of people living below the subsistence minimum to 25.0% in 2005 from 27.5% in 2002.

To this end, the Government expects economic growth to raise GDP per capita from the current \$1,631 to \$2,000 in 2005. In addition, given the Government's medium-term priority for rural development, its efforts should produce an accelerated reduction in poverty in rural areas through targeted social assistance and through the promotion of rural microcredit and public works that enable more rapid economic development.

Kyrgyz Republic

A contraction in the economy, stemming from an accident at the country's largest gold mine, exposed the narrow economic base and vulnerability of the economy to external and domestic shocks. Consequently, medium-term prospects depend largely on rapid diversification of the domestic production base and exports. Debt relief from Paris Club members has provided some additional resources and time to carry out the necessary structural reforms.

Macroeconomic Assessment

GDP is estimated to have fallen by 0.5% in 2002, as against 5.3% growth in 2001. This is mainly due to a 26% drop in gold production caused by an accident at the Kumtor gold mine in July—the mine contributed 9% of GDP and 40% of industrial output in 2001. Industry declined by 11.2% during 2002 on account of the steep fall in gold production and a downturn in electricity generation, which resulted from low export demand. However, a few sectors showed a strong turnaround: textiles, glass, leather products, and food processing. Late sowing due to adverse weather conditions delayed the agricultural harvest and affected crop yields, but sector output is expected to have risen by 3.3%, somewhat below the target of 4.0%. The services sector is estimated to have grown by about 4.2%. The output of hotels and restaurants rose by 28.5% and retail trade by 8.2%, mainly because of the foreign troops now based in the country and higher numbers of tourist arrivals.

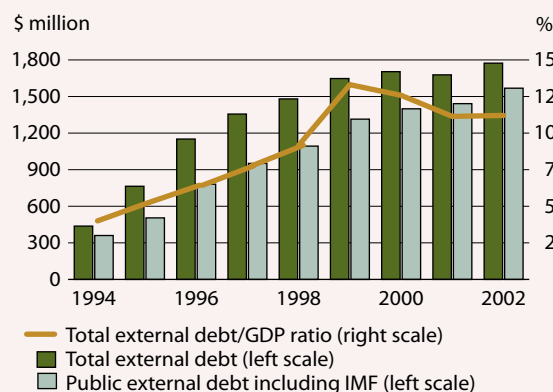
Gross domestic capital formation declined from 20% of GDP in 2000 to about 18% of GDP in 2001 due to a fall in the Public Investment Program (PIP) as a result of budgetary pressure. This trend appears to have continued in 2002 and PIP disbursements are expected to fall short of target by over 10%, which might reduce the overall capital formation rate in 2002 to about 17% of GDP.

The incidence of poverty fell from 52% in 2000 to 47.6% in 2001. Despite the economic contraction in 2002, the potential impact on poverty is likely to be limited because of a 10.5% increase in average monthly wages in the year to September 2002, coupled with low inflation and continued growth in the agriculture sector, which employs about half the workforce. The level of unemployment is not officially available; however, it was likely little changed from the 7.8% estimate for 2001.

In 2002, the estimated fiscal deficit of 5.9% of GDP, higher than the target of 5.1%, is attributed to the fall in GDP and the consequent loss of revenues. The Government succeeded in eliminating pension arrears, and in reducing arrears in counterpart financing of externally assisted projects and payments to the medical insurance fund. The debt service burden eased with the decision of Paris Club members in March 2002 to reschedule repayments due between December 2001 and December 2004. They also agreed to consider providing more enduring long-term debt relief in the form of concessional stock treatment if the ongoing IMF-supported Poverty Reduction and Growth Facility (PRGF) is successfully implemented (Figure 2.21).

Broad money expanded by 34.1% in 2002, mainly due to the rise of foreign assets held by the central bank. This rapid expansion did not, however, cause a rise in inflation, on account both of increased demand for domestic currency spurred

Figure 2.21 External Debt, Kyrgyz Republic, 1994–2002



Source: National Bank of the Kyrgyz Republic.

by the strong som, and of increased monetization of the economy. Expansion of credit unions in rural areas and improved availability of micro-credit contributed significantly to the monetization process. Indeed, inflation continued falling with consumer prices rising by only 2.0% on average for the year (2.3% in the year to end-December 2002). Weighted average interest rates fell slightly during the year but were high at 36.4% for domestic currency loans and 22.7% for foreign currency loans in October 2002. Bank lending rates are very high due to large default risks and problems arising from the difficulties in enforcing claims against collateral.

Foreign trade increased in 2002 for the first time since 1998; it is estimated to have grown by about 14%, aided by a 25.4% increase in imports. The trade deficit is expected to exceed \$50 million, as exports grew by only 3.7%. Imports of petroleum products for the foreign troops stationed in the country and strong domestic demand contributed to the surge in imports. Exports of precious metals (which accounted for 47% of total exports in 2001) fell by over 27% and the sale of electricity to neighboring countries declined. This would have caused a considerable drop in exports but for the notable export performance of agriculture and light industry products. The current account deficit for 2002 is expected to widen to 2.0% of GDP, from 2001's level of 1.3%. The inflow of FDI was a meager \$1.6 million during the first 11 months. Foreign exchange reserves are sufficient to cover about 7 months of imports.

Policy Developments

The Government undertook several structural reform measures in 2002 to stabilize the economy, raise the quality of public resource management, and improve governance to create an environment in which the private sector can function efficiently. It has successfully implemented the policy benchmarks stipulated for 2002 under the PRGF. A draft of the National Poverty Reduction Strategy, which provides the blueprint for development for 2003–2005, has been prepared and was submitted to donors at the Consultative Group meeting held in October 2002 in Bishkek.

The Government made significant progress in fiscal reforms in 2001 and continued the momentum in 2002. Effective July 2002, it cut the business profit tax rate to 20% for all entities except natural monopolies where the tax cut was deferred until 2003 on revenue considerations. Personal income tax rate slabs (previously from 5% to 30%) were consolidated into two slabs of 10% and 20% to reduce the tax burden and simplify administration. Other revenue measures included removing many VAT exemptions, increasing the retail sales tax rate, and raising the nonagricultural land tax. The rate of employers' contribution to the Social Fund was reduced, aiding both business profitability and lowering employment costs. In an effort to improve revenue administration, the Government decided in September to merge the State Tax Inspectorate, the Customs Committee, the Financial Police, and the revenue-collecting division of the Social Fund into a single independent revenue-collecting organization under the Ministry of Finance. Moreover, it initiated steps to reform and strengthen the customs administration and to create a special unit to monitor and collect taxes from large taxpayers. Energy tariffs were increased by 20% to reduce the quasi-fiscal deficit, and further adjustments will be required. The Government, however, made little progress in privatizing four large SOEs in the electricity, gas, airlines, and telecommunications subsectors.

The primary objectives in the monetary area are to contain inflation and to improve financial intermediation through financial sector reforms. In 2002, the Government submitted amendments to the Law on Licensing of Banks to impart more authority to the central bank to revoke or suspend licenses of delinquent banks and to adjudicate disputes relating

Table 2.21 Major Economic Indicators, Kyrgyz Republic, 2000–2004, %

Item	2000	2001	2002	2003	2004
GDP growth	5.4	5.3	-0.5	5.2	4.5
Gross domestic investment/GDP	20.0	18.0	17.0	19.3	-
Inflation rate (consumer price index)	18.7	6.9	2.0	-	-
Money supply (M2) growth	12.1	11.3	34.1	13.0	-
Fiscal balance/GDP	-9.2	-5.0	-5.9	-4.7	-4.3
Merchandise export growth	10.4	-6.0	3.7	13.9	-
Merchandise import growth	-8.0	-13.1	25.4	10.6	-
Current account balance/GDP	-5.6	-1.3	-2.0	-3.4	-5.6
Debt service ratio	28.1	30.8	-	-	-

- Not available.

Sources: National Bank of the Kyrgyz Republic; National Statistics Committee; staff estimates.

to bank liquidation. The central bank has approved a strategy for reforming the banking sector and initiated measures to improve the payments system in the country with a view to encouraging banking system payments rather than cash in settling transactions. The Government is carrying out background work to introduce legal reforms for enforcing creditor rights, quickly resolving business disputes, improving corporate governance in the banking sector, and protecting depositor rights. Other notable structural reform measures include the phased introduction of international accounting standards, preparation of a blueprint and a time-bound implementation plan for judicial reforms, and initiation of steps to facilitate the early implementation of SOE reforms. Many of these measures are expected to be undertaken in 2003.

Outlook for 2003–2004

The Kumtor accident demonstrated the extent of the economy's vulnerability to internal and external shocks. It is difficult to insulate a small economy like that of the Kyrgyz Republic completely from such shocks. However, diversification of domestic production and foreign trade, rapid implementation of structural reforms, and continued pursuit of solid macroeconomic policies are needed to reduce such risks in the medium term. With revival of gold production in early 2003, GDP is expected to grow by about 5% in both 2003 and 2004. The Govern-

ment intends to reduce the fiscal deficit to 4.7% of GDP in 2003 by mobilizing additional revenues, which will also allow increased spending on social services. According to a recent survey, business confidence is high but business people cited expensive credit, intrusive regulations, and corruption as their most important constraints.

Medium-term economic prospects for maintaining 5% GDP growth will depend on the resolution of two inexorable trends during the next few years: a gradual reduction in foreign funding of the PIP to around 3% of GDP after 2005, and the beginning of a decline in gold production at Kumtor. These two developments underscore the immediate need for enhancing private investment, identifying new sources of production and exports to compensate for the fall in gold output, and raising domestic resources for maintaining the required levels of public investment. These can be accomplished only with further progress in financial sector reforms, improvement in governance, implementation of legal reforms, and removal of remaining impediments to private business.

The rescheduling of debt service payments by the Paris Club creditors and the promise to provide further debt relief through stock treatment in 2004–2005 have provided an opportunity and appropriate environment for the Government to pursue these goals. However, it will need to secure domestic resources and external grants to fund increasingly more of the PIP.

Tajikistan

Overall economic performance was strong in 2002. Macroeconomic management improved as Tajikistan continued in the effort to rebuild its economy and institutions shattered by civil war. A Poverty Reduction Strategy Paper was finalized and presented to Parliament. Implementation of its stabilization and structural reform policies is necessary to sustain economic growth and move toward a reduction in poverty.

Macroeconomic Assessment

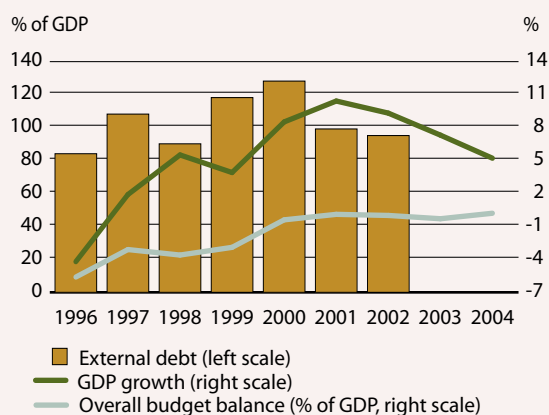
GDP grew by 9.1% in 2002, the fifth consecutive year of strong economic growth. As in the past, growth was driven by the post-conflict recovery of output in aluminum, electricity, and agriculture. Aluminum output increased by 6.1% (total industrial growth was 8.2%), electricity was up by 5.0%, and cotton production rose by 13.9% (total agricultural growth was 15.0%). The end of a drought in 2002 also pushed up production of wheat, which is rain fed and not irrigated and, for the first time in many years, the country produced enough wheat to avoid dependence on foreign aid to supplement domestic production. Light industry, mostly textiles, and cotton processing grew markedly by about 27%. Construction was another major growth area, up 30%, but its 4% share of GDP somewhat limited its impact on overall growth. Domestic demand and economic growth were boosted by worker remittances, estimated at \$120 million or about 10% of GDP. It is estimated that up to 1 million Tajiks, almost 17% of the population, live abroad either permanently or temporarily, and mainly in the Russian Federation.

Fixed capital investment amounted to only 7.0% of GDP in 2000, the latest year for which data are available, and it is unlikely to be any higher in 2002. The Public Investment Program (PIP) was equal to 2.8% of GDP in 2002, a slight increase from 2001. The PIP is financed by foreign aid, and most

expenditures are directed toward the rehabilitation of agriculture, transport, and social infrastructure. After a trough in 2001, when the signing of several FDI contracts was delayed because of the crisis in Afghanistan, FDI inflows in 2002 picked up, doubling to \$21.0 million. FDI continued to be concentrated in textiles and mining.

Reliable statistics on poverty trends since 1999 are not yet available, but anecdotal evidence and regional surveys suggest that incomes, both cash and noncash, increased substantially since the finalization of the peace agreement in 2000. This is mainly due to growth in informal, service-oriented activities. Most people's wages are substantially below the minimum consumption basket, and only a small share of the labor force is engaged in formal sector employment—an area that has shown little growth. While the official unemployment rate rose only slightly from 2.3% to 2.7% in 2002, unofficial estimates place unemployment or underemployment much higher, at over 30% of the labor force. For many Tajiks, informal activity, agricultural labor, and jobs abroad are the most likely sources of employment.

Under IMF economic programs, Tajikistan managed to improve revenue collection rates steadily from 12% of GDP in 1998 to over 15% in 2001. In 2002, fiscal performance was better than anticipated: faster than expected economic growth, an increase in cotton exports (leading to an increase of cotton sales tax collection), and a more system-

Figure 2.22 External Debt, GDP Growth, and Overall Budget Balance, Tajikistan, 1996–2004

Note: External debt data for 2002 are for January–June only.
Sources: Government of Tajikistan; *Asian Development Outlook 2002*; International Monetary Fund; staff estimates.

atic implementation of the new VAT regime based on the destination principle meant that revenue collection was stronger than budgeted. After VAT, the cotton and aluminum sales tax, at 10% and 2%, respectively, are the largest revenue sources for the Government (together providing 20% of revenues). On the expenditure side, revenue performance allowed a 25% increase in civil servants' wage rates; these are very low and have been heavily eroded by inflation. Social expenditures accounted for about 43% of revenues. Excluding the foreign-financed PIP, the budget deficit was 0.2% of GDP (up slightly from 0.1% in 2001) and is among the lowest in Central Asia.

Public external debt is very high at over 87% of GDP (a total of \$962 million, with about one third owed to the Russian Federation). The debt is a major obstacle in fiscal management: in 2002, total scheduled debt service amounted to 5.3% of GDP (Figure 2.22). In early 2002, the Government renegotiated concessional terms on debts with Kazakhstan and Uzbekistan, and a major breakthrough was achieved by the restructuring of debt to the Russian Federation on concessional terms in December (this lowered debt service due in 2002 from 41% to 18% of fiscal revenues).

The central bank, the National Bank of Tajikistan (NBT), in general pursued a tight monetary policy, which, with moderation in food price increases (due to the end of the drought) helped

pull down inflation to 14.5% in 2002 from 38.6% a year earlier. Implementation of monetary policy, however, was uneven. During 2002, the exchange rate depreciated by 14% against the dollar.

Recent movements of commercial interest rates have become more market oriented, have fluctuated less, and indeed became positive for the first time in many years. However, as there is a high degree of credit rationing, interest rates are not significant determinants in lending.

The health of the banking sector has not improved significantly. Two of the four major banks have effective negative net capital, and two are severely underprovisioned. Only five (out of 14) banks meet the minimum capital requirements. As part of the reform effort, improved banking regulations were issued during the year and supervision capacities of NBT were improved. Two regulations that stifled banking activities—a tax on remittances and the ability of the tax authorities to freeze accounts without a court order—were removed in 2001 and 2002, respectively. Reflecting these changes and an improving economy, household deposits increased by 85% in 2001 and by 22% in the first quarter of 2002. Nevertheless, deposits amount to little over 4% of GDP, representing a somewhat lower degree of mobilization than in most other transition economies.

The external sector performed significantly better in 2002 than a year earlier. Exports grew by 11.0% (to \$723 million) while imports rose by only 6.0% (to \$819 million). This reduction in the trade deficit and an improved surplus in invisibles narrowed the current account deficit to 4.1% of GDP from 7.1% in 2001. Exports and imports have been growing strongly since 1998 (except in 2001). However, export growth is not only highly dependent on world market prices—especially for cotton and aluminum, which weakened in the previous 2 years—but also on political relations with neighboring countries. Exports in 2001 suffered heavily because of the closure of the only railway line through Kazakhstan to Tajikistan's main export markets. In 2002, rail transport resumed, but export and import levels are still somewhat below their 2000 levels.

The current account deficit is financed almost entirely by external assistance. Capital flows, however, have been sufficient to increase gross international reserves and keep import cover stable

Table 2.22 Major Economic Indicators, Tajikistan, 2000–2004, %

Item	2000	2001	2002	2003	2004
GDP growth	8.3	10.2	9.1	7.1	5.0
Inflation rate (consumer price index)	32.9	38.6	14.5	10.0	6.0
Fiscal balance/GDP	-0.6	-0.1	-0.2	-0.5	-
Merchandise export growth	18.3	-17.3	11.0	11.3	10.5
Merchandise import growth	20.3	-7.3	6.0	4.0	3.7
Current account balance/GDP	-6.5	-7.1	-4.1	-4.0	-4.0
Debt service ratio	17.5	25.6	21.0	22.6	-

- Not available.

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

at approximately 2 months since 2000. Total debt service due in the first 6 months of 2002 increased to 20.0% of exports, from 16.0% over the same period in 2001, due to the expiry of loan grace periods. Because of Tajikistan's high level of exports (over 70% of GDP), the debt service ratio appears to understate the magnitude of the problem of managing a debt burden at nearly 100% of GDP.

Policy Developments

The Poverty Reduction Strategy Paper (PRSP) that was presented to Parliament in June 2002, finalized after 2 years of deliberation and consultations with civil society, outlines the major issues that the Government intends to address in the next 3 years. Identified reforms cover all major sectors and aim to promote the transition to a market economy and to combat poverty. The next steps are arguably even more difficult for the Government than producing the PRSP: to prioritize and implement the identified reforms and find necessary international concessional funding.

The healthy economic and fiscal performance in 2002 gave the Government some scope to plan for the 2003 budget to include an average 15% civil service wage increase and for social expenditures to rise to around 46% of the budget. Larger spending in the context of a balanced budget for 2003 was aided by the successful 2002 debt relief negotiations. Renegotiation of the Russian debt, which includes a 3-year grace period, considerably reduced the debt service burden. It fell to 18% of revenues in 2002 (it would have been 41% without restructuring) and

will remain low at approximately 12% until 2004. However, because of the heavy debt service and lack of counterpart funds for projects, the Government needs to limit the PIP to the availability of concessional funds and keep disbursement at approximately 3% of GDP.

During the next 2 years, the Government plans to reduce the quasi-fiscal deficit, mainly subsidies to the energy sector, that are estimated at about 5% of GDP. Plans include some increase in tariffs and increasing collection rates by cutting off commercial customers who fail to pay.

The Government's plans call for a continued tight monetary policy to reduce inflation to about 6% by 2004, which is very ambitious. One of the main contributors to inflation has been an excessive volume of loans directed almost exclusively to the cotton sector. Pressure on NBT to grant such loans might lessen, however, as more private finance by cotton investors and banks becomes available. Plans are in the pipeline to introduce a proper functioning interbank credit market in 2003 and this should facilitate a more efficient credit system. It is planned to allow banks to hold their capital in foreign exchange, a step intended to encourage them to increase their capital. No changes were made in the floating exchange rate regime during the year.

Ongoing bank restructuring will continue and the Government is committed to enforcing all prudential requirements in the first half of 2003. By end-September 2003, noncomplying banks (other than those currently being restructured) will be either closed or merged. Minimum capital requirements will increase to \$2.0 million in December

2003 for existing banks, while for new banks the requirement is \$3.0 million.

Agriculture sector restructuring is high on the reform agenda as it offers strong prospects for growth and poverty reduction. Ongoing farm privatization has created 14,500 *dekhan* (private) farms, which are either privately owned or operated by collectives. The proliferation of household plots as well as plots granted by the president means that private and *dekhan* farming has taken over the larger share of agricultural production (in volume terms) in all categories except cotton and silk. The Government plans to privatize all remaining farms by 2005. Some 225 very large farms are yet to be privatized, but they are burdened with large debts that make them unattractive to private investors; the Government is exploring options to deal with this problem. Other important agricultural reforms include removing government interventions in production and marketing decisions of producers and improving producers' access to finance and markets.

Since the economy is still very much in the process of recovering from civil war, it is crucial to physically rehabilitate infrastructure and utilities, particularly in power. With donor assistance, the Government has committed to unbundling and corporatizing utilities and to privatizing transport. The large aluminum smelter, TADAZ, is currently undergoing an international audit, as a first step toward restructuring in this crucial firm.

Outlook for 2003–2004

The outlook for the next few years is uncertain. International attention focused on the country and grant aid (mostly from the US) increased substantially after the events of September 11. Assuming that the goodwill of the international community persists, the inflow of additional funds and grants may well continue, significantly relieving pressure on the budget and current account. Increasing regional stability following the elimination of the Taliban in Afghanistan and subsequent regional integration will also contribute to the positive effect of economic reforms by reinforcing diversification and stabilizing the prospects for economic growth.

Nevertheless, Tajikistan's economic development remains extremely vulnerable to various constraints, including remnants of the monolithic culture of industrial and agricultural production, weak institutions and administrative capacities to carry out reforms, a high debt burden, and a narrow export base subject to volatile price swings.

In the period ahead, the economic policy framework is based on the PRSP, which focuses on enhancing macroeconomic stability and structural reform to reduce poverty. Key components of the strategy are reducing inflation, achieving modest fiscal strengthening while reducing quasi-fiscal energy subsidies, improving NBT operations, continuing agricultural privatization, and improving governance.

Aided by further diversification of agricultural production and expansion of light industry, GDP growth is expected to decline to about 7% in 2003 and then to about 5% in 2004, as aluminum production reaches capacity limits. It is expected that domestic demand will continue to be supplemented by substantial worker remittances from abroad. Assuming that NBT continues its tight monetary stance, inflation is expected to fall to about 10% in 2003 and to 6% in 2004. The budget, excluding the PIP, is expected to be kept in near balance.

The current account deficit is not expected to change much over the next 2 years. Stagnant or even slightly decreasing prices of the major exports (due to slower global demand for aluminum and large global stocks of cotton) are expected to lead to slow export growth. Two opposite pressures will influence import growth: on the one hand, demand for imported consumer goods will increase, financed in part by remittances, while on the other, this will be kept in check by slower growth of PIP-related capital goods imports. The immediate pressure on the budget to service external debt will be substantially reduced through 2004; however, further debt restructuring may be required to keep the subsequent debt service burden manageable.

Whether Tajikistan fully succeeds in implementing the measures outlined in the PRSP will depend on a host of uncertainties. That a political consensus has emerged to set out such a detailed plan is, however, a basis for some optimism.

Turkmenistan

With cotton output falling sharply, GDP growth in 2002 slowed. The growth was based primarily on further increases in natural gas production and exports. However, the prevailing macroeconomic and education sector policies need to be urgently reviewed to sustain industrial growth and diversification and avoid adverse long-term consequences.

Macroeconomic Assessment

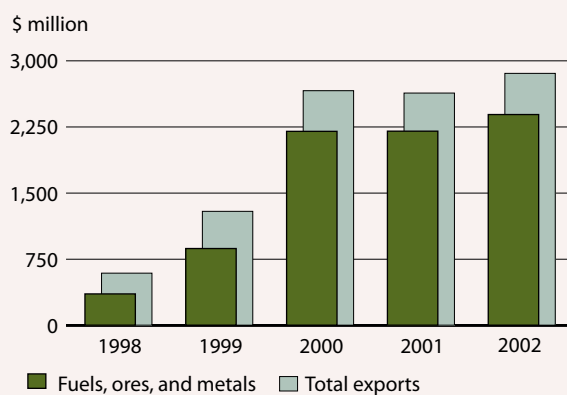
GDP growth in 2002 slowed significantly on account of an extremely poor cotton harvest, which declined to a mere 0.5 million tons from 1.1 million tons in 2001, and against an official target of 2.0 million tons for the year. Performance in the agriculture sector, which accounts for some 25% of GDP and provides a livelihood for over one half of the population, was boosted by expansion of wheat and rice output bringing grain production up by 15% for the year to meet its official target.

According to preliminary official estimates, GDP growth was an impressive 14.9% in 2002, based primarily on a further increase in the export of natural gas, oil, and oil products and an increase in output of food processing and light industry. These official growth estimates are based on a 25.0% increase in industry sector output that in turn is reportedly derived from a 41.0% and 66.0% increase in the output of light industry and food processing subsectors, respectively. These estimates, however, do not appear to reconcile with other officially reported economic indicators such as consumption of electricity, which remained stagnant in 2002, an 11.0% decline in imports from already low levels in 2001, and continuing high levels of unemployment. Moreover, there are hardly any signs of increased private sector activity, except for the continuing boom in construction of luxury housing in Ashgabat.

The officially estimated shares in GDP for 2001 are about 35% for industry, 25% for agriculture, 32% for services, and 6% for construction. Official 2002 growth estimates of 9.5% in agriculture and services and 6.5% in the construction sector look plausible. However, keeping in view the performance in electricity output and the decline in imports, industrial growth estimates seem highly exaggerated. The natural gas subsector is estimated to account for nearly three quarters of the industry sector value added (official estimates state this to be much lower at 45% of the sector). Its output increased by 4.0% in 2002. Based on these observations, it appears that industry sector growth can be more realistically estimated at about 7–8%, even allowing for some growth in the light industry and food processing subsectors. This yields an estimate of GDP growth of about 8.6% for 2002, a substantial drop from the 20.5% increase recorded in 2001, and well below the preliminary official estimates.

Inflation increased to 8.8%, from 6.0% in 2001. However, changes in the official price index reflect a controlled and repressed price structure that is largely determined by the government policy of providing utility supplies like gas, power, and water almost free of cost and heavily subsidizing other necessities such as housing, bread, and transport and by the use of price controls. Monetary policy is not geared to macroeconomic considerations as the Central Bank of Turkmenistan (CBT) and the operations of the largely state-owned commercial banking sector are almost entirely oriented

Figure 2.23 Share of Fuels, Ores, and Metals to Total Exports, Turkmenistan, 1998–2002



Source: National Institute of State Statistics and Information of Turkmenistan.

to directed lending to meet the needs of SOEs. Frequent management changes at CBT during the year appear to have further limited its effectiveness, while the banking sector continued to stagnate because of extensive controls and restrictions. The large differential between the market and official exchange rates remained virtually unchanged during 2002, although the market rate appreciated by about 2% to TMM22,300 to the dollar. The official rate remained pegged at TMM5,200 to the dollar.

The 2002 state budget was essentially balanced, with expenditures exceeding revenues by only TMM500 billion or about 0.1% of GDP. The overall fiscal position of the Government, however, is difficult to assess because of large off-budget accounts including the foreign exchange reserve fund that is managed by the President's Office. Indeed, nonbudget funds managed by various ministries and government agencies received about TMM40.5 trillion, or more than three times the budget revenues.

Foreign trade turnover in 2002 stagnated, reflecting an 11.0% fall in imports and an 8.9% increase in exports. The trade surplus almost doubled to \$1 billion from \$535 million in 2001 with the \$465 million improvement about equally due to the export gain and the import decline. The decline in imports is worrisome as it reflects, perhaps, Turkmenistan's growing disengagement from global trade and investment flows and a

slowdown in industrial expansion and diversification. With exports of cotton fiber declining by nearly 46%, the export increase was mostly due to a 9.4% rise in unit value for natural gas (as well as some increase in volume). The predominance of hydrocarbons in total exports increased from 82.8% to 84.0% in 2002 (Figure 2.23). Data on other accounts—services, capital, and reserves—of the balance of payments are not available and this would be necessary to better understand recent economic developments. However, Bank for International Settlements data indicate an over \$200 million increase in Turkmenistan deposits in banks abroad in the 9 months through September 2002 and this would suggest an overall surplus on the balance of payments.

The Government's policy of heavily subsidizing consumption of basic necessities, combined with an increase in average nominal wages by about 20% during 2002, has ensured maintenance of welfare levels. However, this masks the increasing gap in living standards in urban centers like Ashgabat compared with provincial capitals and rural areas. Moreover, the worsening state of education and health facilities in rural areas, which is a result of a decline in their share of budgeted expenditures, is a further area of concern in growing welfare disparities. Growth and income prospects in the longer term are being undermined by education policies that have cut the number of years of education to nine and generally caused deterioration in educational facilities and standards. This issue is emerging as a source of discontent within the professional and educated urban population.

Policy Developments

The macroeconomic policy regime remained unchanged—to the extent that it did not regress—during 2002. The most deleterious aspect of this policy regime is the more than 300% spread between official and market exchange rates, which effectively translates to a regime of arbitrarily determined multiple exchange rates. This is a severe impediment for private sector growth and inhibits FDI. The policy of heavily subsidizing consumption of utilities and basic necessities needs to be reviewed and gradually moved toward approaching full cost recovery. This would allow self-financing in these sectors and restrain wasteful consumption.

Moreover, the policy of maintaining nonbudget funds under independent charge of individual ministries needs review. These funds, which financed 24.0% of total fixed investment in 2002, also accumulate as unspent balances.

Integrating nonbudget funds and their balances with the budget, if transparently managed and audited, would be a substantial improvement in fiscal management and enhance fiscal stability. Finally, there is a growing emphasis on directing education to vocational training in the belief that higher education and advanced skills are not at present needed for the economy. This policy and experimentation with the curriculum is resulting in dilution of education standards and, if not corrected urgently, is likely to result in a de-skilling of the workforce, adversely affecting productivity and management over the longer term.

Outlook for 2003–2004

Reconstruction of Afghanistan and trade expansion with neighboring Iran could provide new sources of external demand for Turkmenistan's hydrocarbon, energy, textiles, and light industry exports. There are reports also of new, larger contracts under negotiation for natural gas exports with the Russian Federation and Iran that will help improve utilization of existing production capacities. Domestic demand is unlikely to show significant improvement in a

policy regime characterized by strict price controls, a pervasive industrial licensing system, and tight control of banking and foreign transactions. Cotton production and exports should also do better in 2003 after their dismal performance in 2002. Based largely on external demand for hydrocarbons, cotton, and textiles, as well as some strengthening of domestic demand, arising mainly from an improved agricultural performance, GDP growth is expected to be an annual 7–8% in 2003 and 2004, subject to risks of adverse global price fluctuations and transport bottlenecks. With the continuation of the existing price control and subsidy policies, inflation may be expected to continue to remain within single digits during 2003–2004.

The completion of a feasibility study for the trans-Afghan natural gas pipeline, designed to export 30 billion cubic meters of the country's gas to Pakistan and other Asian markets, is likely by October 2003. The study's findings may result in heightened investor interest yielding substantial benefits, improving growth prospects for 2004 and beyond. Nonetheless, growth based primarily on capital-intensive extractive sectors is unlikely to generate sufficient employment to absorb the existing pool of unemployed and new entrants to the work force. Therefore, unemployment and social stress may well increase in the next few years unless a more active policy is pursued both to stimulate private sector-led growth and to diversify exports.

Uzbekistan

GDP growth in 2002 remained slow and, with unchanged policies, the medium-term outlook is for continued sluggish expansion. The Government wants to attract greater investment inflows to accelerate development, but this would require action to carry out far-reaching economic and structural reforms.

Macroeconomic Assessment

Growth in GDP, according to official estimates, slowed to 4.2% in 2002 from 4.5% in 2001 and was below the official 5.0% target. Agriculture and industry recorded moderately improved performance, though expansion in other sectors, mainly services (accounting for about 50% of GDP), slowed markedly to about 1.5% from 14.2% in 2001. Value added in agriculture, the largest employer and exporter, rose to 6.1% growth from 4.1% in 2001. Productivity and area increases raised grain production by 38% to 5.3 million tons, exceeding domestic consumption needs. Adverse weather lowered the cotton harvest by 80,000 metric tons to 3.2 million tons, but most of it was of premium quality. The industry sector reportedly grew by 8.5%, up from 8.1% growth in 2001, though the data are unclear on what drove it. Intensified import restrictions and a weaker exchange rate boosted domestic manufacturing but hurt import-dependent enterprises and retail trade.

Oil production rose for the second consecutive year, by 2.4%, and natural gas production increased by 1.8%. The transport and communications subsector posted stronger performance, of 6.8% compared with 3.3% in 2001, driven mainly by the operations of Uzbekistan Airways. Retail trade output contracted by 0.5%, against 8.6% growth in 2001, as the impact of intensified trade restrictions on imports disrupted trade. The number of private SMEs continued to rise during the year with most new entrants in the agriculture sector.

Regional disparities in incomes persist. Per capita incomes in Tashkent were the highest at \$40 per month (at the official exchange rate) and the lowest were in Samarkand at just \$10 per month. Official unemployment data at 0.4% of the labor force continue to mask hidden unemployment as they do not include the unregistered unemployed. Actual unemployment remains high, especially in poorer regions, and mirrors regional variations in SME growth. No sustained migration out of depressed regions has been observed.

The fiscal deficit in 2002 was 0.8% of GDP according to official sources, with about one half of the deficit financed by privatization revenues, mainly equity sales to foreign investors, and the balance by credit from the Central Bank of Uzbekistan (CBU). Most government expenditures, 38% of the total, were on welfare and social programs, while subsidies and investment took up 7% and 20%, respectively, of the total, with most of this directed to state-owned industry and infrastructure.

While a tightening stance was adopted in January 2002 when CBU raised its monthly benchmark refinancing rate from 2.0% to 2.5% (for an annual compounded rate of 34.5%), monetary operations remained largely oriented to financing the credit needs of SOEs and the budget. Accordingly, little progress was made during 2002 in reducing inflation with the official CPI indicating an average annual rate of 27.6%, against a target of 18.0% and virtually unchanged from the previous year. Moreover, price controls, an artificial exchange rate, and methodological issues cause the official

CPI to underestimate true inflation. Devaluation of the official exchange rate and a rise in fuel prices, pensions, and public sector wages were the main sources of pressure on prices, as were import restrictions that led to shortages of consumer goods.

The official exchange rate was devalued in steps by about 30% against the dollar over the course of 2002 and the spread between the official and black-market rates was markedly narrowed. However, the 35% spread at year-end failed to achieve the 20% government target. The black market exchange rate appreciated by about 12% by year-end; however, since such strong action was taken to repress private import trading during the year, the appreciation may not reflect a fundamental improvement in the exchange market. At end-2002, the dollar was trading at 1,320 sum on the black market compared with the official rate of 970 sum. A secondary official rate, at which the public may buy limited amounts of foreign exchange, traded at 1,020 sum.

The trade surplus rose to \$276.4 million from \$35.0 million in 2001, due to import compression. Exports fell by nearly 6%. Cotton export earnings were lower than in 2001, as were exports to Commonwealth of Independent States (CIS) countries; however, higher global gold prices boosted gold earnings. Cotton, gold, and energy products, and for the first time, services were large foreign exchange earners. Imports fell by more than 13% from the 2001 level. Machinery and equipment and foodstuffs accounted for most of the import bill. The Russian Federation remained the main trade partner.

The estimated current account surplus of \$47 million was around 0.6% of GDP, a turnaround from a deficit of about 0.5% of GDP in 2001. Estimates of the capital account are highly tentative, though it appears that FDI was substantially lower than in 2001 and the capital account was in deficit. Bank for International Settlements deposit data suggest that reserves have declined during the year. External debt is estimated at \$4.4 billion (about 56% of GDP) at end-2002, and the debt service ratio for the year was 29.0%. The ratio of debt service costs to hard currency exports was over 40%.

Policy Developments

The Staff Monitored Program (SMP) agreed between the Government and IMF dominated

macroeconomic policy in 2002. The Government stated its intention to accelerate the transition to a market economy and achieve macroeconomic stability by reducing the role of the state in the economy and adopting tight fiscal and monetary policies. Government policies in 2002 were consequently aimed at establishing an economic structure in line with SMP objectives while implementing safeguards against outcomes unwanted by the Government and ensuring government monitoring and control. However, progress in transition was far from satisfactory. The Government was especially sensitive to possible outflows of international reserves. Monetary and fiscal policies were broadly in line with agreed benchmarks through mid-2002.

In 2002, the Government was under particular pressure to show progress in three key areas of the SMP: (i) liberalization of the foreign exchange regime, (ii) trade liberalization, and (iii) reform of the state procurement system for cotton and grain. On the first, the Government devalued the official foreign exchange rate and liberalized over-the-counter foreign exchange transactions that are conducted at the secondary market rate. At the same time, wary of the possibility of large foreign exchange outflows and with a view to controlling imports, it enforced trade and exchange restrictions that allowed it to ration and reduce demand for foreign exchange. These restrictions adversely affected private business. Multiple exchange rates continued to be applied and a substantial spread between the secondary official rate and the market rate reemerged after its elimination in May.

The Government's policy measures were designed to redirect unofficial transactions to the more liberalized official channels. This was done to protect local industry and curb illegal trading. These regulations were accompanied by incentives to domestic producers of consumer goods. But cumbersome industrial licensing procedures restricted the growth of private enterprises. In addition, restrictions aimed at curbing imports adversely affected private retail trade.

The Government gradually moved to liberalize the agriculture sector, but needed reforms are so numerous that a gradual approach is, indeed, required. The Government has achieved successes in areas such as livestock, fruits and vegetables, and farm restructuring. However, as with other reforms, the Government has been careful to ensure that any

changes do not cause disruptions that it considers unacceptable. Grain self-sufficiency remains a particularly sensitive matter: government efforts to stabilize grain production have ensured input and credit availability as well as a working marketing channel but have, in some cases, crowded out private rural enterprises.

Reforms have also been tempered by the importance to government finances of the foreign exchange earnings from cotton. While the general rationalization of regulations that apply to private enterprises and the liberalization of certain subsectors encouraged the development of agricultural SMEs, state ownership and control, as well as marketing restrictions, prevent the potential benefits of rural enterprise development from being realized fully. Export bans on certain products have been used to foster development of the domestic agroprocessing industry.

Government cotton procurement accounts for 50% of total production. However, despite being permitted to do so, farmers find it difficult to sell the remaining 50% on the free market because of inadequate private marketing channels. Ambiguities in the interpretation of resolutions and persistence with old practices by local leaders have impeded reform of the procurement system. Government procurement prices for wheat and cotton were increased to adjust for inflation and international price increases in 2002, but not for exchange rate changes.

Banking sector reforms were prominent in the Government's reform agenda. CBU officially reduced its directed lending and other interference in the operations of commercial banks. Informal control, however, persisted. Low deposit interest rates and regulations limiting private cash withdrawals from bank accounts continued discouraging savings, and inadequate domestic deposit mobilization has resulted in a large exposure of the banking system to external borrowing. During 2002, the Government made efforts to withdraw cash from circulation to reduce unmonitored cash transactions and this adversely affected private business activity. In these circumstances, the population generally continues to show distrust of the banking sector.

Overall, the Government has been hesitant to make substantial changes to existing economic policies because it weighs the potential benefits of

liberalization against its view of potential serious problems, including reduction in state direction and the adverse impact on the budget of unification of the exchange rate, especially on the state system of consumer subsidies and the domestic cost of external debt service.

Outlook for 2003–2004

Growth in 2003 is likely to remain at 2002's level or to fall slightly. Government steps to shore up its foreign exchange position and to avoid foreign exchange volatility are likely to continue to adversely impact private sector growth in the period ahead. GDP growth in 2003 is expected to be 3.5% with a moderate increase in 2004 to 4.0%.

Industrial growth is likely to remain slow in the forecast period and, without substantial foreign exchange reforms, state enterprises and private firms are unlikely to be able to attract significant FDI. Agriculture will probably continue on its present course with the slow pace of reforms unlikely to have any substantial impact on growth unless policies are adopted to substantially improve the incentive structure facing farmers. Indeed, if the Government persists with its plan to increase the grain crop area by 12% in 2003, it will probably be faced with a poor harvest as it fails to finance the input needs of this additional acreage. The services sector, particularly retail trade and restaurants, is likely to continue feeling the adverse effects of government trade controls in 2003.

Medium-term developments on the balance of payments are difficult to assess given the limited information available and the recent policy actions that have mixed exchange market reforms with strong administrative action to restrict trade activity. Barring introduction of comprehensive economic reforms, it appears that exports would grow by perhaps 4–5% in the medium term, bolstered by an improvement in cotton prices, as expansion in export volume is limited. Growth in imports would continue to be affected by restrictions on consumer goods so as to limit the bulk of spending on capital goods in support of the Government's investment program. In these circumstances, the recorded trade surplus is likely to remain at about \$250 million, essentially the 2002 outcome, unless a stronger degree of import compression than was seen in 2002 leads to a further decline in imports.