Central Asia

Armenia
Azerbaijan
Georgia
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Armenia

The global and regional recessions severely battered exports, workers' remittances, and private capital flows, forcing the country into its worst recession since just after independence. To counter the downdraft, the government implemented a wide-ranging anticrisis program. Its measures have maintained financial and external stability, kept inflation in check, and cushioned the adverse impact on the population. With momentum established, the outlook is for recovery with modest but strengthening growth. The medium-term challenges include broadening the production base, strengthening the fiscal position, and improving governance.

Economic performance

The global recession, as well as continued tension between Georgia and the Russian Federation (which disrupted trade routes), stopped the economy dead in its tracks in late 2008 and in 2009 after several years of strong performance.

Fortunately, due to previous significant reforms and prudent macroeconomic policies, the country entered last year with strong economic fundamentals—a small fiscal deficit, moderate inflation, and low external debt—allowing the authorities to respond with a comprehensive anticrisis plan. But GDP still contracted by 14.4%, its worst outturn in 16 years.

The blast of recession was felt from the start of the year, with GDP on a monthly basis hitting double-digit declines by May and bottoming in July. This trend eased throughout the rest of the year (Figure 3.1.1).

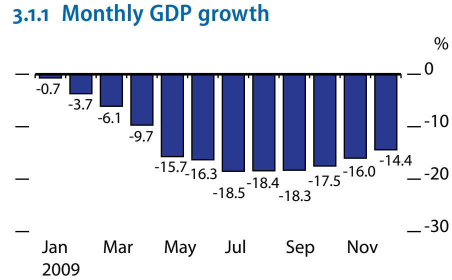
The economic downturn was experienced in all sectors of the economy (Figure 3.1.2). Construction, which had been the main driver of the economy, hemorrhaged with a 42.3% loss of output. The energy sector (electricity and natural gas) ebbed by 14.3%.

Other important industry activities, such as chemical products, building materials, mining and metallurgy, and the diamond-processing trade, all slumped. Agriculture saw no growth: lower animal output was offset by better crops. The services sector grew by a mere 0.7% due to reduced activity in finance, tourism, communications, and transport.

From the demand side, private investment tumbled by 25% as net inflows of remittances, which had driven the housing boom, sank by one-third (Figure 3.1.3) and net foreign direct investment declined by about one-fourth to about $700 million. Private consumption also withered due to the reduced remittance inflows and the economic downturn. Public consumption and investment, however, were bolstered by the anticrisis program.

To stimulate mortgage lending, a National Mortgage Company was

3.1.1 Monthly GDP growth



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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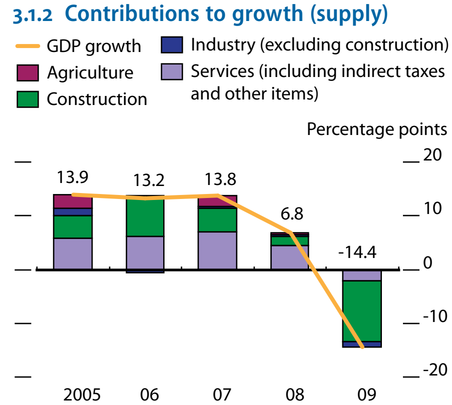
3.1.2 Contributions to growth (supply)



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 3 March 2010).

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This chapter was written by Kiyoshi Taniguchi of the Uzbekistan Resident Mission, ADB, Tashkent; and Grigor Gyurjyan of the Armenia Resident Mission, ADB, Yerevan.

established by the Central Bank of Armenia in July 2009. The new body began shoring up the construction sector by providing resources that are more affordable to participating banks and lending organizations.

The earlier, strong inflation pressures had dissipated by the early months of 2009 (Figure 3.1.4). However, the devaluation of the dram by 22% in March and a 40% increase in imported natural gas prices in April, along with rising international prices for oil, commodities, and basic foodstuffs in the second half, sent inflation back upward. Headline inflation hit 6.5% in December, beyond the upper limit of the central bank's inflation target band. In 2009, sugar, fuel, medicine, and household utilities, in that order, recorded the highest price increases (ranging from 34% to 20%). Despite the hike of inflation in the fourth quarter, average inflation was 3.4% for the year.

Monetary policy is underpinned by an inflation targeting framework. The target of 4% ±1.5% for 2009 was difficult to sustain due to the March devaluation and increased utility tariffs in April. Nonetheless, the devaluation and the subsequent program with the International Monetary Fund (IMF) served the economy well by restoring business confidence, reducing concerns about financial stability, and increasing competitiveness of exports.

By February 2009, gross official reserves fell to $1.1 billion or 3.9 months of imports, the lowest level since May 2007. Given the rapidly worsening economic situation, the government formulated an economic recovery program that was supported by an IMF standby arrangement that took effect in early March. From June, reserves started to accumulate as economic activity bottomed, climbing to $2.0 billion (6.6 months of imports) at year-end (Figure 3.1.5).

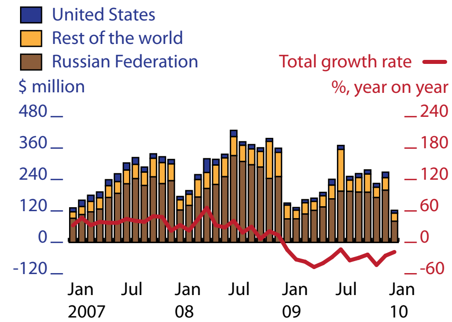
Real and nominal effective exchange rates depreciated throughout 2009. Due to the fear of further dram depreciation, dollarization accelerated: the share of deposits held in foreign currency doubled and that of loans climbed by half, relative to 2008. In such conditions, total lending volumes increased by 17.5% in 2009. The share of nonperforming loans edged down to 4.2% from 4.4% in 2008. Since banks are generally well capitalized, this increase presents no serious concerns.

To stimulate economic activity, the central bank implemented an expansionary monetary policy through quantitative easing and reduction of the refinancing interest rate, which it gradually cut from 7.75% in March to 5.0% at year-end. Money supply grew by 15.1%, reflecting increases in net foreign assets and credit to the economy (Figure 3.1.6).

In a deteriorating economic situation, fiscal policy was relaxed to boost aggregate demand. Public spending on pensions and public servants' salaries was increased by 16.3%, and other social outlays were largely maintained. Tax receipts fell with lower economic activity, helping push out the fiscal deficit to 4.7% of GDP from 0.7% in 2008 (Figure 3.1.7). External resources more than financed the deficit, and even permitted a buildup of government deposits in the banking system.

With budgetary and balance-of-payments financial support from development partners, external debt nearly doubled during 2009 to $3 billion by end-December 2009 (Figure 3.1.8). The public sector debt-to-GDP ratio hit 40.1%, with foreign currency–denominated debt at 34.0%. IMF debt projections indicate that the debt ratio may peak

3.1.3 Sources and growth of remittance inflows



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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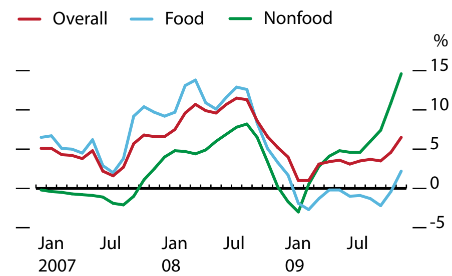
3.1.4 Inflation



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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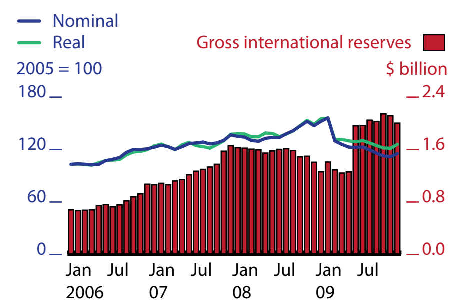
3.1.5 Effective exchange rates and reserves



Sources: International Monetary Fund. International Financial Statistics online database; Central Bank of Armenia. http://www.cba.am (both accessed 3 March 2010).

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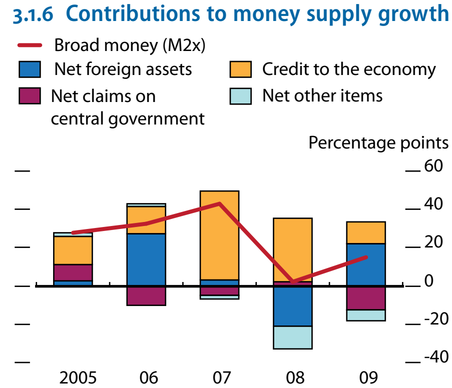
3.1.6 Contributions to money supply growth



Source: Central Bank of Armenia. http://www.cba.am (accessed 3 March 2010).

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at 46.6% in 2011 before falling to under 40% by 2013. While both the government and the IMF regard the debt dynamics as sustainable, these are subject to risks, such as the projected improvement in the fiscal position or in economic growth failing to materialize.

Weak external demand for the main exports and slower than expected benefits of the dram's devaluation resulted in exports falling by 35.0% in 2009. This decline in value terms nevertheless was outweighed by a 25.4% fall in imports due to weak domestic demand that stemmed from lower remittances. Imports suffered in all major categories. For example, precious metals and diamonds (both items for export processing) collapsed by two-thirds and cars and other transport equipment by nearly three-fifths. As a result, the trade deficit narrowed to $2.1 billion in 2009 from $2.7 billion in 2008.

Due to lower remittance inflows and transfers, the current account deficit narrowed slightly to $1.3 billion from $1.4 billion, though it widened in relation to the shrunken GDP, to 15.4% from 11.6% in 2008 (Figure 3.1.9).

In support of its anticrisis program, the government received budgetary support from international financial institutions of nearly $300 million. In addition, it has been using a $500 million loan from the Russian Federation for earthquake zone reconstruction, as well as for support to the banking sector, large commercial firms, and small and medium-sized enterprises. These anticrisis measures stimulated the real sector, and output will further strengthen this year.

Economic prospects

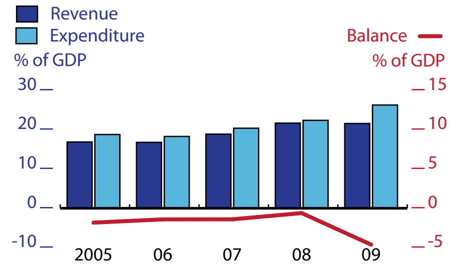
Economic recovery in large part depends on the assumed rebound in the Russian Federation, as resumed remittance inflows from the many Armenian workers there will be necessary for economic expansion. This pickup in remittances, improved external demand, and an increase in capital inflows are the ingredients to bring GDP growth to 1.5% then to 3.0% in the forecast period.

Fiscal policy will be gradually tightened in 2010 due to rising concerns on debt servicing. The fiscal position is expected to remain weak, and the recovery of tax revenue will be gradual. Yet excessive tightening in 2010 would slow the pace of the economic recovery. Still, through budgetary support from development partners as well as external borrowing, the public sector will remain one of the main economic buttresses in 2010–2011.

Inflation will be largely contained to a range of 4.5%–5.0% despite a 17% increase in the import price for natural gas that will push up utility tariffs and be generally passed on in higher transportation and consumer goods prices. Continuing weak demand and monetary policy, directed by the central bank's well-developed inflation-targeting procedures, should be able to keep inflation in check.

Remittance inflows and transfers are projected to grow by around 10%–15% in the forecast period, though they are not expected to recover to precrisis levels. Exports are seen rising by 5.2% in 2010 and then stepping up to 11.8% growth, supported by gradual strengthening in the diamond-processing, chemical, and metallurgy sectors. Import growth

3.1.7 Fiscal balance indicators



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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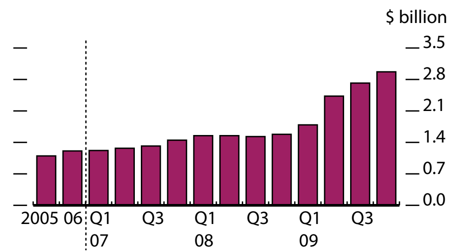
3.1.8 External debt



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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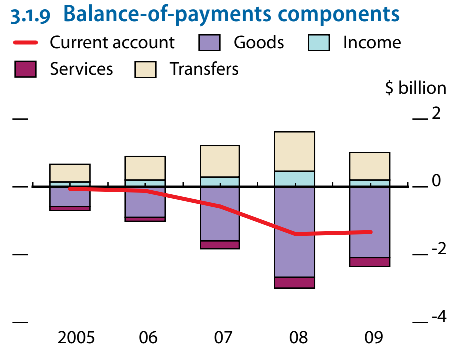
3.1.9 Balance-of-payments components



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 8 March 2010).

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3.1.1 Selected economic indicators (%)

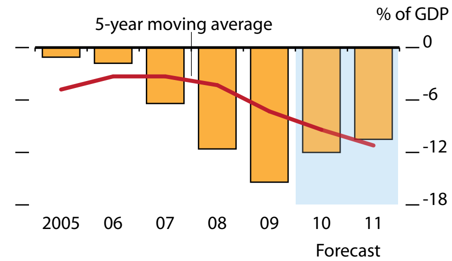
	2010	2011
GDP growth	1.5	3.0
Inflation	4.5	5.0
Current account balance (share of GDP)	-12.0	-10.5

Source: ADB estimates.

is projected to be moderate at 4.7% and then climb to 5.1%, on the net effect of a slow recovery in consumer spending but a faster pickup in investment goods. The current account deficit is expected to moderate to 12.0% of GDP in 2010 and to 10.5% in 2011 (Figure 3.1.10).

Exports of agricultural products will benefit from the early March reopening of the Upper Lars checkpoint at the Russian–Georgian border, which is Armenia's sole overland route to the Russian Federation and thence to Europe.

3.1.10 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 8 March 2010); ADB estimates.

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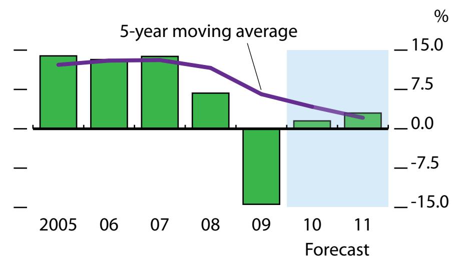
Development challenges

Over the last few years, the economy has generally benefited from greater openness to trade and investment, although the global recession took a heavy toll (Figure 3.1.11). The immediate to medium-term challenges include tightening the fiscal stance, limiting the rising external debt, broadening the production base, and adding trade partners. Establishing stronger trade relationships with European countries, while maintaining ties with traditional trade partners, is a hard juggling act.

The authorities acknowledge the need for a faster pace of reforms in the areas of tax policy and administration, and a more competitive business environment. An action plan with clear milestones will be necessary to implement reforms to improve governance, form an effective incentive structure for fair distribution of resources, and strengthen the antimonopoly policy.

The government recognizes the existence of oligopolies in key sectors of the economy that have strong links with entrenched elites. To reduce such conflicts of interest and to improve the business environment, it will continue its efforts to reduce corruption, modernize public expenditure management, and strengthen the civil service and judiciary.

3.1.11 GDP growth



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 8 March 2010); ADB estimates.

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Azerbaijan

Strong performance in the oil and gas sector, despite lower international prices, and a countercyclical policy helped sustain buoyant growth in 2009. Transfers from the State Oil Fund propped up public investment, while the authorities eased monetary policy aggressively. High growth is expected to be maintained in 2010 as oil prices climb and as public investment expands. Over the long term, the economy is challenged by its excessive dependence on oil and its low level of diversification. Measures are needed to transform the industry sector and to boost productivity in agriculture.

Economic performance

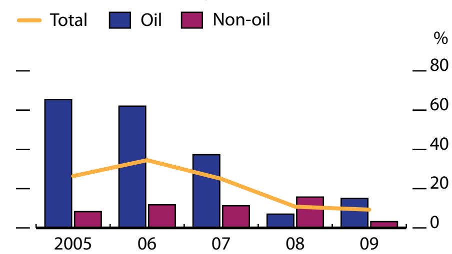
Despite the global financial crisis and fall in international oil prices from their 2008 highs, growth slipped only a little to 9.3% in 2009, from 10.8% in 2008. Helped by higher oil prices in the second half of 2009 and by increased production of hydrocarbons from the Caspian Sea, the oil and gas sector (constituting 55% of GDP and 95% of total export revenue) remained the major driver of growth (Figure 3.2.1). At 370 million barrels, oil production was higher than in 2008, as technical difficulties in a major oil field were overcome (Figure 3.2.2). Accommodative fiscal and monetary policies also worked to counter the impact of the global slowdown.

Construction, though helped by higher public investment, decelerated from 2008 as private demand for housing was damped by uncertain market conditions and lack of confidence in real estate. Mainly due to the slowdown of trade and transport, services growth declined (from 14.0%) but was still a robust 9.1% in 2009. Dynamism in information technology–related services, though still a relatively small area, helped sustain growth in services.

Agricultural growth fell by almost half to 3.5% in 2009 on account of expensive inputs, low credit availability, and water shortages in rainfed agriculture areas—most farmers continued to focus on subsistence wheat production. Overall, non-oil GDP growth at 3.2% of GDP in 2009 was much lower than its 15.7% growth in 2008, as activity was depressed by an uncertain economic outlook that restrained domestic demand and curtailed exports.

On the demand side, higher public investment, which rose to 21% of GDP in 2009, supported growth, reflecting government moves to counter the impact of the global crisis. That impact was, however, seen in falling private sector investment, which came down to only 6% of GDP in 2009. Lower prices constrained investment in the oil sector, which consequently accounted for a smaller proportion of total investment in 2009 than it did in 2008.

3.2.1 GDP growth by sector



Sources: Central Bank of Azerbaijan. 2009. *Statistical Bulletin*. No. 119. January; State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

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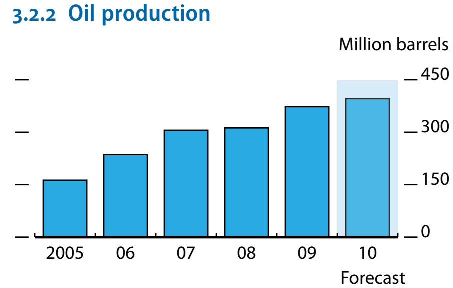
3.2.2 Oil production



Sources: State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org (accessed 22 March 2010); ADB estimates.

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This chapter was written by Nail Valiyev of the Azerbaijan Resident Mission, ADB, Baku; and Safdar Parvez of the Pakistan Resident Mission, ADB, Islamabad.

Higher public investment was partly financed by the State Oil Fund (SOFAZ), to which a large part of the government's oil receipts are channeled. SOFAZ has become an important source of financing for important socioeconomic and investment projects. It focuses on financing contractual agreements with production-sharing companies and with the State Oil Company of Azerbaijan for operating and developing oil and gas basins. The overall aim is to reduce year-to-year variation in oil revenues and act as a wealth fund that supports long-term economic growth. SOFAZ's assets climbed by 32.8% in 2009 and stood at $14.9 billion (Figure 3.2.3).

Transfers from SOFAZ constituted 47.6% of total state revenue in 2009, up from 35.3% in 2008, as the government used them to finance its accommodative fiscal policy. The share of such transfers in total revenue has been growing since 2006. The budget deficit amounted to AZN242 million (0.7% of GDP). However, excluding SOFAZ transfers, the government ran a fiscal deficit of AZN5.1 billion in 2009 (14.8% of GDP), compared to an AZN3.8 billion (9.5% of GDP) deficit in 2008.

This dependence on SOFAZ points clearly to the need for generating more tax and nontax revenue. The tax-to-GDP ratio of around 15% is low and can be further scaled up. The budget deficit in these circumstances is currently being heavily financed by SOFAZ transfers, although the government intends also to use proceeds of privatization of state assets and domestic borrowing to finance part of the deficit in 2010.

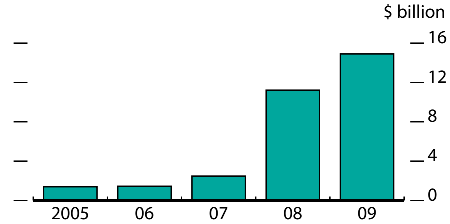
With falling international commodity prices, the consumer price index rose by only 1.5% in 2009, versus 20.8% in 2008 (Figure 3.2.4). The Central Bank of Azerbaijan's heavy market intervention maintained a stable exchange rate to the dollar in 2009 (at AZN0.8/$1), preventing a depreciation that would have caused inflation pressure and raised debt-servicing costs for businesses that have sizable foreign-currency loans. Stable civil service salaries and economic uncertainty helped bring down inflation pressure from the demand side.

Falling inflation allowed the central bank to relax monetary policy through phased but steep reductions in the refinancing rate, which ultimately fell to only 2% in 2009 from a high of 15% in 2008. In addition, the central bank markedly lowered banking sector reserve requirements to 0.5% in March 2009 from 12%. With greater liquidity, commercial banks' ability to lend was strengthened and they reduced lending rates. The central bank received new authority to provide long-term loans in different currencies, as well as subordinated loans. It also provided additional special financing support to banks and private companies.

These measures, as well as new tools employed by the central bank, such as swap operations and repurchase of mortgage notes, helped create additional liquidity and were an important countercyclical response from the monetary side. Domestic assets consequently increased by about 23% in 2009 though the broad money supply stagnated as net foreign assets fell (Figure 3.2.5).

Banking sector resilience grew as a result of monetary policy measures of the central bank. Despite slow growth, banks maintained strong loan portfolios, and the proportion of overdue loans was kept in check, at 4.5% of the total.

3.2.3 SOFAZ assets



Source: State Oil Fund of the Republic of Azerbaijan. *Annual Report*. Various issues. http://www.oilfund.az

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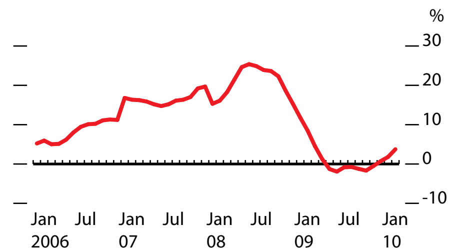
3.2.4 Inflation



Source: International Monetary Fund. International Financial Statistics online database (accessed 22 March 2010).

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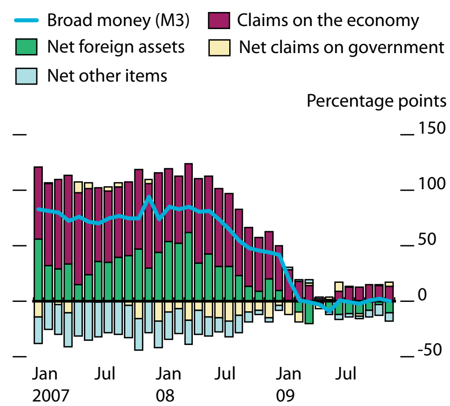
3.2.5 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 29 March 2010).

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3.2.1 Selected economic indicators (%)

	2010	2011
GDP growth	9.5	9.7
Inflation	5.8	6.0
Current account balance (share of GDP)	23.0	21.7

Source: ADB estimates.

As oil export income fell due to sliding international prices, the trade account is estimated to have posted a surplus of only $14.6 billion, down from $23.0 billion in 2008. This drop was mitigated by an estimated $1.1 billion fall in imports, largely because of lower food prices and a decline in oil companies' demand for investment machinery.

The lower trade surplus was offset to an extent by a sharp fall in net oil and gas factor income payments, helping reduce estimated net payments for services, income, and transfers by about one-third to $4.4 billion. Still, the current account surplus at $10.2 billion was much less than the $16.5 billion earned in 2008, falling as a share of GDP to 23.6% from 33.7%.

Gross international reserves contracted by $1.1 billion to $5.4 billion at end-December 2009. This decline, in a context of a current account surplus, reflected a buildup in SOFAZ investment assets abroad.

External debt rose slightly to $3.4 billion (8.8% of GDP) in 2009 from $3.0 billion a year earlier. Azerbaijan's debt at these levels remains low and there are no major risks to debt servicing in view of the $14.9 billion SOFAZ sovereign fund and the $5.4 billion in foreign reserves.

Economic prospects

Growth prospects hinge on oil. As oil prices rise in 2010 and as production levels increase, GDP is projected to accelerate a shade to 9.5%. Higher oil revenue through increased SOFAZ transfers in 2010 (for a total of AZN4.9 billion, or $6.1 billion) will also enable greater public investment that will sustain growth at this higher level. At the same time, cuts in corporate profit and personal income taxes should help boost domestic demand. Ample liquidity and a likely continued expansionary monetary policy will permit commercial banks to expand their lending and lower lending rates to the private sector.

Agriculture is expected to be more robust as various public investment projects are completed. Communication and transport sectors will also continue to contribute to growth. With oil prices set to rise further next year, GDP growth will edge up to 9.7%.

The focus of monetary policy in 2010 remains on keeping inflation low. The central bank currently projects inflation at 3%. However, rising commodity and food prices and higher public investment and demand fueled by oil revenue, along with the current relatively liberal monetary policy environment, suggest that estimates of 5.8% (and about 6.0% in 2011) mark a more likely outcome. However, the likely appreciation of the local currency on higher oil revenues this year could complicate monetary policy if the central bank needs to intervene in the market to keep a lid on appreciation.

The external account is expected to remain strong on higher oil export receipts with the current account surplus projected at 23.0% of GDP before easing to 21.7% next year (as stronger GDP growth sucks in imports). The recovery of the global economy will boost non-oil exports, too, while the upturn in the Russian economy will support higher workers' remittances. The larger current account surplus, along with larger transfers from SOFAZ, will preclude the need for net foreign borrowing. External debt is projected to fall over the forecast period.

3.2.1 Development challenges

Excessive dependence on oil is the Achilles' heel of this economy. Forceful moves to diversify are required for strengthening services and the non-oil industry subsector, for raising agricultural productivity (building on the budgetary allocations for irrigation), and for developing fisheries and livestock.

The fact that the country ranks number two among the Central Asian republics and 38 among 138 countries worldwide on the World Bank's *Doing Business 2010* report suggests that the relatively sound business environment offers a springboard from which to catalyze growth and innovation in the non-oil economy.

A linked challenge is to diversify sources of government income to provide for stable public spending during downturns in international oil prices. To a degree, SOFAZ receipts help the government smoothen public spending over oil-price peaks and troughs, but more widely, revenues need to be boosted and the tax-to-GDP ratio raised to provide for sustainable public finances. An already planned measure in this regard, which needs to be fully implemented, includes the online submission of value-added tax invoices.

Finally, electricity supply has to be improved and expanded. Greater investment in the sector is critically needed.

Kazakhstan

The economic contraction bottomed in the middle of 2009 and the economy marked positive, albeit modest, growth for the year, bolstered by a rally in international oil prices in the second half. An expansionary fiscal policy directed through an anticrisis program, an accommodative monetary policy, and banking sector stabilization constituted the main policy focus. Weak domestic demand and limited access to credit curbed inflation pressures. The outlook is for modest growth with moderate inflation and a current account surplus, though the banking sector still faces difficulties and domestic demand will remain weak.

Economic performance

In the second half of 2008, the oil-driven boom of previous years was put into a tailspin by the onset of the global financial crisis (because domestic banks had overborrowed from abroad) and then by the downdraft in oil prices. In 2009, GDP contracted by 2.2% in the first 3 quarters, but managed a marked rebound to post growth of 1.2% for the year (Figure 3.4.1) on the impetus of strengthening oil and commodity prices.

On the supply side, industry (excluding construction) grew by 1.8%, with output on the rise over much of the year (Figure 3.4.2). A fillip to growth came from a 13.8% expansion in agriculture as good weather produced a record grain harvest. Services output shrank marginally, and construction dropped by about 5%.

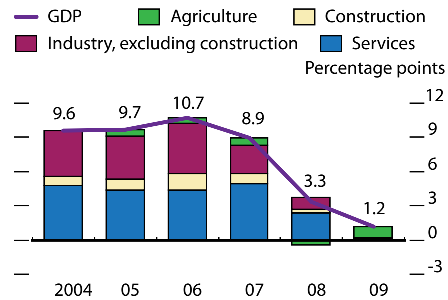
While data on the expenditure side are not yet available, private consumption and (non-oil) investment likely contracted or stagnated. One of the most significant impacts of a local banking crisis, which has wracked the country since end-2007 and essentially froze lending, has been a sharp slowdown in domestic demand.

In prior years, local banks had relied on external borrowing to finance large increases in construction, real estate, and personal lending. When international capital dried up (from late 2007), the banks faced an increasingly serious liquidity crisis that in effect ended new lending, deflating the property boom and leaving many projects unfinished (Figure 3.4.3). Moreover, many consumers found themselves overindebted as the economy slowed. In response, the government adopted an anticrisis program (Box 3.4.1).

Annual average inflation fell to a low of 7.3% in 2009, from 17.3% in 2008, due to weak domestic demand and low international commodity prices, particularly at the start of the year. Even February's currency devaluation (adding upward price pressure to imports) could not outweigh the inertia of weak private consumption. Year-on-year inflation at end-December was 6.2% (Figure 3.4.4). By main component, food was

This chapter was written by Kiyoshi Taniguchi of the Uzbekistan Resident Mission, ADB, Tashkent; and Asset Nussupov, consultant of the Kazakhstan Resident Mission, ADB, Almaty.

3.4.1 Contributions to growth (supply)



Source: Agency of Statistics of the Republic of Kazakhstan.

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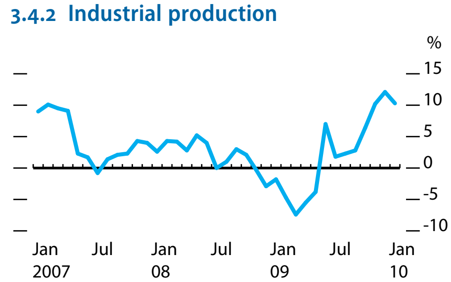
3.4.2 Industrial production



Source: Agency of Statistics of the Republic of Kazakhstan.

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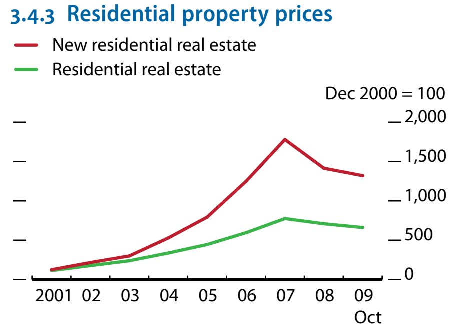
3.4.3 Residential property prices



Source: Agency of Statistics of the Republic of Kazakhstan.

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3.4.1 Dealing with domestic crisis

In response to banking and real-sector woes, the government launched an anticrisis plan in late 2008. A total of $10 billion or 9.5% of GDP, largely from the National Fund of the Republic of Kazakhstan—the national oil fund—was pledged.

The plan focused on the following: capital injections in four major banks (made through Samruk Kazyna, the government holding company for state-owned assets that also provides development finance); support for construction and the real estate market; assistance to small and medium-sized enterprises and agriculture; and public investment in industry. The initiative has stabilized the economy but a strong revival in the non-oil sectors does not appear at hand.

To deal with the banking crisis, the government early in 2009 effectively nationalized two of the largest banks and provided two financial institutions with relatively smaller amounts of capital. In the course of 2009, however, four financial institutions defaulted on external debt obligations, and all are now in negotiation with their creditors to restructure a total of about $20 billion in debt.

To strengthen confidence in banks, the authorities enhanced the existing deposit guarantee for individuals from T700,000 to T5 million. To back up this move, they also increased the capital base of the deposit insurance fund to T100 billion.

In addition, a distressed asset fund was established in October 2009. The government provided most of its resources, though the fund is relatively small.

up only 3.0% from a year earlier while nonfood items and services were about 8.5% higher.

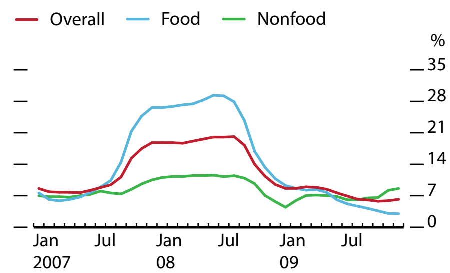
On the monetary front, inflation's tumble created space for monetary easing. The National Bank of Kazakhstan (NBK), the central bank, cut the refinancing rate (the main policy rate) seven times in 2009 from 10.5% at the start of the year to 7.0% by September. It also lowered reserve requirements from 2.0% to 1.5% for domestic obligations and from 3.0% to 2.5% on foreign borrowing to boost banks' liquidity. Broad money grew by 17.9% during 2009, mainly reflecting an increase in net foreign assets. Even though bank credit to the economy marked a 5.8% increase in 2009, growth came from the change in valuation of foreign currency loans due to the devaluation (Figure 3.4.5).

The exchange rate came under increasing downward strain toward the end of 2008, as oil and commodity prices fell, and as pressure on the foreign reserves mounted. The NBK devalued the tenge, the local currency, by about 20% from T120/$1 to T150/$1 (with a 3% band) on 4 February 2009 (Figure 3.4.6). This step essentially matched an adjustment in the Russian ruble in late January.

The devaluation proved a success on the whole, because speculative pressures against the currency dissipated, the rate remained relatively stable against the dollar, and the foreign exchange reserve position strengthened over the rest of the year. However, the rate adjustment entailed costs of higher debt service on foreign borrowing and ate into the benefit that falling global commodity prices had for inflation. Subsequently, on upwardly mobile hydrocarbon prices and the nascent global economic recovery, the NBK widened the trading band to T127.5–165/$1 from 5 February 2010.

Reflecting the slow economic activity as well as tax-easing measures that underpinned the anticrisis program, current revenue (comprising tax and nontax revenue and capital receipts) contracted by 18.9% in 2009. In moves to support domestic demand and to mitigate the downturn's impact on vulnerable groups, the government pushed up its social outlays, including a 25% increase in public servants' salaries and pensions. Current expenditure rose by an estimated 10.4%. Taking account of smaller capital

3.4.4 Inflation



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 9 March 2010).

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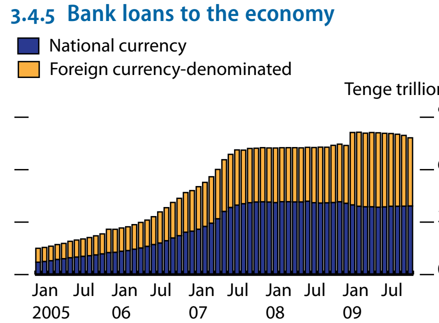
3.4.5 Bank loans to the economy



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 9 March 2010).

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expenditure and transfers from the National Fund of the Republic of Kazakhstan (NFRK), the general government budget deficit widened to 3.1% of GDP in 2009 from 2.1% a year earlier (Figure 3.4.7).

Export revenue is estimated to have declined by 38.9% year on year in 2009 (mainly on lower oil prices), and imports by 25.2%, primarily due to weak domestic demand, slimming the trade surplus by more than half to $15.2 billion. Both exports and imports strengthened in the second half, and nearly three-fourths of the annual trade surplus was earned in this period.

The stronger second-half performance stemmed from increased exports on the back of better oil prices. Imports stayed anemic, reflecting what was only a slight improvement in economic activity in this period. A sharp fall in the large income payments made to foreign investors in the oil industry offset around two-fifths of the drop in the trade surplus (Figure 3.4.8). As a result, the current account was held to a deficit estimated at $3.4 billion (3.2% of GDP) in 2009 following the $6.3 billion surplus in 2008 when oil prices were much higher.

Capital inflows more than covered the current account deficit, generating an estimated overall balance-of-payments surplus of $2.5 billion and bringing the NBK's international reserves to $23.2 billion at end-2009 (Figure 3.4.9). Assets of the NFRK were $24.4 billion at this time. Assets of both the NBK and the NFRK grew in the first 2 months of 2010.

In 2009, the government committed $10 billion from the NFRK to support the anticrisis plan. After that drawdown, the NFRK stood at around $27 billion–$28 billion, of which the foreign currency reserve accounted for $23 billion, and a bond to Samruk Kazyna for $5 billion (denominated in tenge).

Private sector external debt (excluding intracompany debt, which is mainly related to oil and gas corporations) grew rapidly over the years through end-2007 to $95.3 billion (78% of GDP), when bank debt peaked at $46 billion. Subsequently, there was only a moderate increase in private debt to $108.5 billion at end-2009, and bank debt declined to $30.1 billion (Figure 3.4.10).

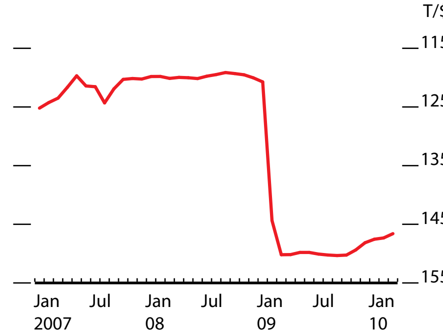
Economic prospects

GDP is projected to grow modestly by 2.5% in 2010 and 3.5% in 2011, as the global recovery consolidates. Oil prices are expected to move up to average $82 a barrel in 2010 and $86 in 2011, and oil production is expected to increase by 4.6% or to 80 million tons in 2010, which will continue to grow by 5.0% or to 84 million tons in 2011. Construction will likely face difficulties still, as the property market adjusts, though it should post moderate growth as infrastructure and oil sector investment expand.

Agricultural growth over the forecast period will likely be modest due to the base-year effect of 2009's large gain. Foreign direct investment in oil and gas projects will continue at a relatively high level.

Public expenditure will continue exceeding non-oil sector private investment over the forecast period. Even though fiscal space will stay tight in 2010, the government will persist in its expansionary policy to

3.4.6 Exchange rate



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 31 March 2010).
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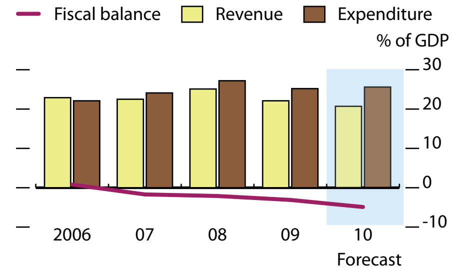
3.4.7 Fiscal indicators



Sources: Ministry of Finance; ADB estimates.
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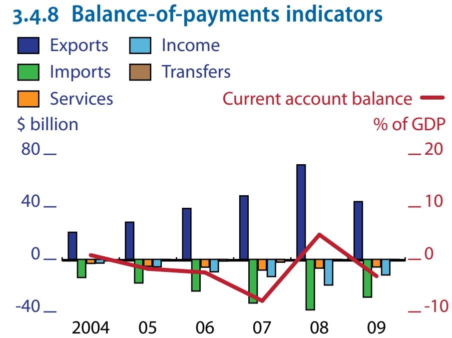
3.4.8 Balance-of-payments indicators



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 31 March 2010).
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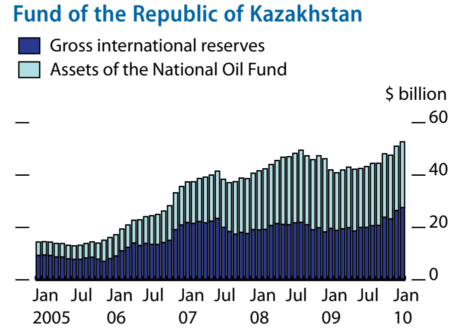
3.4.9 Reserves and assets of the National Fund of the Republic of Kazakhstan



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 9 March 2010).
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maintain a high level of social outlays and investments in infrastructure. Total expenditure and net lending together are expected to grow by 4.6%. At the same time, total revenue and grants are expected to contract by 3.6% in view of tax concessions and continued slow growth. The budget envisages a fiscal deficit of 4.9% of GDP in 2010. The budget will continue to be boosted by a transfer of T1.2 trillion from the NFRK.

Inflation is forecast at 6.8% in 2010 and 6.5% in 2011 on the assumption that domestic demand remains weak, and access to credit stays tight due to the time needed to resolve the domestic banking problems. Even though global commodity prices will edge up, moderate appreciation in the exchange rate will help offset external price pressures.

The current account is forecast to be in surplus in 2010 and 2011. Exports are expected to increase by 30% in 2010, due to higher prevailing oil prices, and then advance by about 13% in 2011 on about a 5% strengthening in both oil prices and export volumes in conjunction with some further gains in non-oil exports as the global recovery strengthens further. Since domestic demand will gradually come back throughout the forecast period, imports will increase moderately.

These estimates point to a substantial trade surplus, though a pickup in income payments on direct investment in the oil sector will likely hold the current account surplus to about $2.8 billion in 2010 and $4.6 billion in 2011 (2.3% and 3.3% of GDP, respectively).

The main downside risk to the forecast is in weaker oil prices. In addition, it is important that ongoing negotiations on foreign debt restructuring by the defaulting banks be concluded soon so that more normal financing conditions for investment and consumption can reassert themselves. If economic recovery in the Russian Federation is slower than expected, export demand will be crimped.

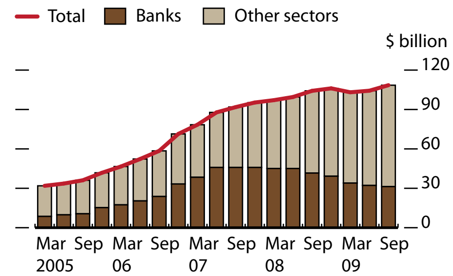
Development challenges

The economy is still narrowly based, with economic activity and investment concentrated in the hydrocarbon and mining sectors. The current crisis has underlined the need to accelerate polices to diversify the production base beyond these sectors and their immediate feed-in industries.

In this context, under the state program for advanced industrial development and industrialization, the government plans to implement 162 projects totaling T6.5 trillion (about $45 billion) in investments during 2010–2014.

For its part, the thin financial market requires deepening through improvements to the capital market's infrastructure and through revamps to the banking system. Moreover, it is critical to strengthen bank supervision to monitor risk-management and asset-valuation practices, if another round of asset boom and bust is to be avoided.

3.4.10 Private external debt



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 31 March 2010).

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3.4.1 Selected economic indicators (%)

	2010	2011
GDP growth	2.5	3.5
Inflation	6.8	6.5
Current account balance (share of GDP)	2.3	3.3

Source: ADB estimates.

Kyrgyz Republic

Despite the global and regional downturns and power supply issues, the economy showed modest growth in 2009 on the back of a fiscal stimulus and strong performance in agriculture. Inflation fell sharply and the external position improved. The outlook is for accelerating, though moderate, growth given the expected recovery in major economic partners and the construction of new power generation capacity. The authorities are pursuing reforms to render the public sector more efficient and to create favorable conditions for private sector development.

Economic performance

Economic downturns in Kazakhstan and the Russian Federation (the major economic partners) and the country's power shortfalls took economic performance in 2009 down to 2.3% from 8.4% in 2008 (Figure 3.5.1). Their difficulties hit the economy through reductions in three channels: remittances from migrant workers (which constituted around 20% of GDP in 2008); inflows of foreign direct investment; and demand for exports.

GDP growth was driven mainly by a robust performance of agriculture (due to favorable weather conditions), which grew by 7.3%. Construction increased by 6.3%, after a 10.8% contraction the prior year, a rebound primarily due to activity in the hydropower generation and mining subsectors, rehabilitation and construction of roads, and residential building. However, industry overall declined by 3.4% because of reduced output in the textile and sewing industry, transport equipment, electric energy, and gas and water distribution. Gold production also declined.

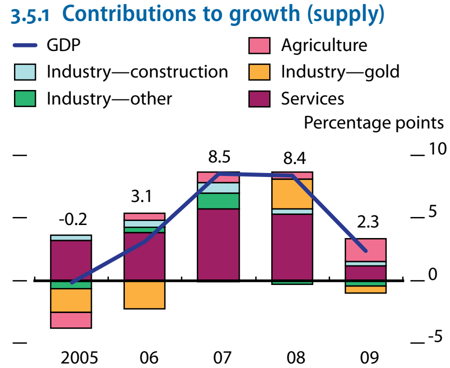
The traditionally high-performing services sectors grew only moderately (2.4%) as the downdraft in workers' remittances crimped consumer expenditure.

Reduced demand, together with sliding world food and energy prices, slashed average consumer price inflation from 24.5% in 2008 to 6.9% in 2009. The rate fell steadily during the year and by December was zero (Figure 3.5.2). The good domestic harvest also helped lower food prices, to 7.4% below December 2009 levels.

Services sector prices also tumbled. Nonfood goods inflation stayed relatively high as depreciation has worked against the decline in global prices of imported commodities and consumer goods.

Boosting expenditure on social safety net programs and infrastructure projects, the government took a strong countercyclical fiscal stance: it propelled budget expenditure by 35% (to nearly 38% of GDP). Financial assistance from the Russian Federation, in the form of a $150 million

3.5.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 3 March 2010).
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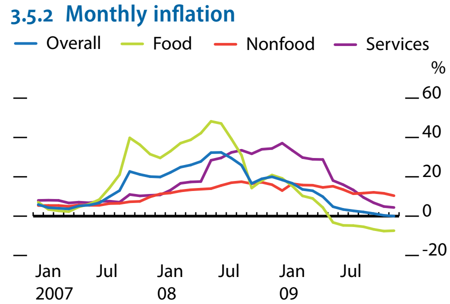
3.5.2 Monthly inflation



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 3 March 2010).
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This chapter was written by Nurbek Jenish, consultant of the Kyrgyz Resident Mission, ADB, Bishkek; and Gulkayr Tentieva of the Kyrgyz Resident Mission, ADB, Bishkek.

grant and a $300 million concessional loan, enabled such a boost. This increase in official transfers—they shot up to seven times the 2008 level—lifted total budget revenue by 25.8%. It also was instrumental in holding the deficit to only 1.8% of GDP in 2009 (Figure 3.5.3) from the original budget plan of 4.6%. The government intends to use the loan to finance infrastructure projects and support small and medium-sized enterprises.

Tax revenue declined by 17.8% in 2009, mainly on a reduction of the average value-added tax (VAT) rate from 20% to 12%, and abolition of some levies such as road and emergency taxes. Customs collection also declined, by around 11%, reflecting weaker trade.

The government forecasts its budget deficit at 5.1% of GDP in 2010. The widening deficit is a result of the increased budgetary allocations for the development budget (mainly infrastructure projects), monetization of benefits, higher pensions, and increased compensation to vulnerable groups (to offset an increase in electricity and heating tariffs).

The National Bank of the Kyrgyz Republic (NBKR) followed an expansionary monetary policy. It reduced banks' reserve requirement from 10% at the start of the year to 9.5% from June; and lowered the discount rate from 14.4% in January to a record low 0.9% at year-end. Although the commercial banks' lending rate remained almost unchanged (at about 20%), credit to the private sector surged by 46.5%. For the year, money supply rose by 20.4%, carried by increased net foreign assets (reflecting the budget assistance) and the expanded credit to the private sector.

The NBKR continued its managed floating exchange rate regime. Following a sharp depreciation of the Russian ruble and Kazakh tenge in early 2009, the NBKR opted for a smooth depreciation of the national currency, the som. Given the large import content of consumption, the NBKR had to sell foreign currency extensively to prevent rapid depreciation of the som in the first quarter. Over the year, the som depreciated by around 15% against the United States dollar (Figure 3.5.4).

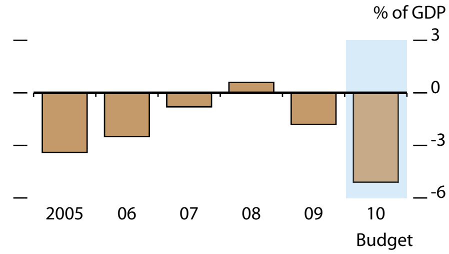
The economic downturn in the country's main partners cut their demand for products from both the Kyrgyz Republic and the People's Republic of China (PRC), the latter's products reexported to neighboring countries. Preliminary data indicate that exports fell by 11.3% in 2009, mainly due to weaker demand for domestic textile exports and the PRC's reexports.

At the same time, imports decreased by 24.3% owing to the slowdown in the economy and the drop in imports for reexport. As a result, the trade deficit decreased by about 37% to $1.2 million in 2009 and the current account deficit to an estimated 10% of GDP from around 12% (Figure 3.5.5). A capital account surplus more than fully financed the deficit, and reserves increased by about $364 million to $1.6 billion at end-2009.

A new tax code, in effect from 1 January, cut the number of taxes (as well as reducing the VAT rate). To offset the revenue losses, the authorities introduced new taxes on owners of automobiles and property. Overall, many of these changes were welcomed by large businesses. The authorities also introduced a new "tax contract" scheme under which businesses pay a fixed amount indicated in the contract and are not subject to further tax inspections.

Among financial reforms, a deposit insurance scheme was launched

3.5.3 Budget balance



Sources: International Monetary Fund. 2008. *Exogenous Shocks Facility-Staff Report*. December; 2009. *Article IV Consultation*. July. http://www.imf.org; Ministry of Finance.

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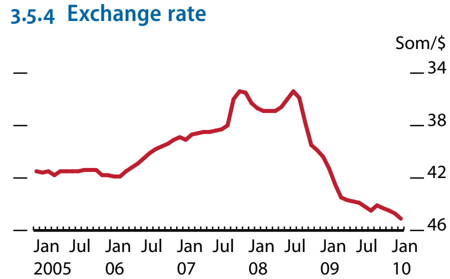
3.5.4 Exchange rate



Source: International Monetary Fund. International Financial Statistics online database (accessed 22 March 2010).

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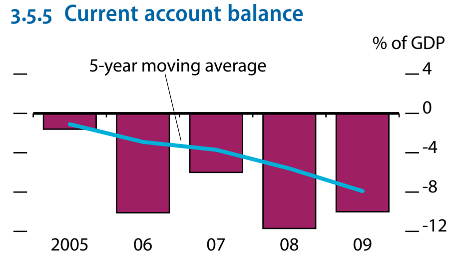
3.5.5 Current account balance



Source: National Bank of the Kyrgyz Republic. *Balance of Payments of the Kyrgyz Republic*. Various issues. http://www.nbkr.kg

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in April 2009, covering deposits up to Som100,000 ($2,290). All banks are required to participate. A new law under which agricultural land can be used as collateral for loan receipts was adopted on 29 June 2009.

In the energy sector, the government believes that the new tariff will bring the sector to cost-recovery levels and attract private investment. It has no plans for any further tariff increases this year.

The PRC made a preliminary agreement to grant a $342 million loan for a power transmission line, which would help the country ensure energy security. Construction is expected to start in 2011 and finish 2 years later.

In October 2009, the country embarked on a government sector reform under which the number of ministries and agencies has been reduced. The reform also envisages cutting the number of government employees by 30% and aims to streamline the work of government and cut other costs.

3.5.1 Selected economic indicators (%)

	2010	2011
GDP growth	5.5	6.0
Inflation	8.5	9.0
Current account balance (share of GDP)	-12.0	-12.0

Source: ADB estimates.

Economic prospects

GDP is projected to grow at 5.5% and 6.0% in 2010 and 2011, respectively. The expansion is mainly due to the expected recovery of Kazakhstan and the Russian Federation, boosting demand for exports, foreign direct investment inflows, and migrants' remittances—the last of which will directly bolster private consumption. Foreign-financed hydropower projects should carry on underpinning strong construction growth, but until all those projects are brought into commission (the first is scheduled for May), power shortfalls will continue to hamper manufacturing.

The government will also provide impetus to growth as it is planning to raise spending on wages and pensions and on infrastructure, the latter with financing assistance from development partners.

The expected increase in global food and oil prices will exert upward pressure on prices, though the contracted import price for natural gas will fall by about 10%, as will stronger workers' remittances. These forces will push up inflation in 2010 and 2011, to 8.5% and 9.0%, respectively.

Given the large import share in the consumer basket, the NBKR will use the exchange rate to mitigate inflation. Credit growth will remain subject to the bottlenecks that face Kazakh banks (which account for half the banking sector) in supplying capital to their subsidiaries in this country. However, increased foreign exchange inflows may allow the NBKR to adopt an accommodative credit policy.

The expected regional economic revival is expected to increase demand for Kyrgyz exports by about 10% in the forecast period, while workers' remittances will increase, though not dramatically. The expected recovery of the Kyrgyz economy and continued project implementation will increase demand for imports by an estimated 15%. The current account deficit is projected at 12% in 2010 and 2011.

3.5.1 Development challenges

The government recognizes that in order to achieve a sustainable growth path it has to push through institutional reforms and changes in key areas such as energy, trade facilitation, and customs administration.

It has undertaken major administrative and government reforms to make public-sector decision making more efficient. In addition, it is revising its long-term development strategy with a key focus on the business investment environment.

Complementing these moves, it has to design and implement mechanisms to substantially raise the level of private domestic saving and investment.

Success is essential both to lay the foundation for sustainable, inclusive, private sector–driven growth and to strengthen the country's ability to resist external shocks.

Turkmenistan

Relying heavily on gas, the economy slowed in 2009 because its major gas export pipeline was shut for most of the year, though increases in public and foreign direct investment helped underpin a moderate GDP expansion. Inflation sharply decelerated on lower import prices and tight monetary policy. With new gas pipelines now operating, the outlook is for a return to high GDP growth. A challenge for the government is to diversify its production base.

Economic performance

The impact of the global recession was limited because the economy is at the very early stages of integrating itself into world markets. In April 2009, however, a technical accident in the main gas pipeline to the Russian Federation, as well as lower energy demand, suppressed gas exports. Even though the gas pipeline was reportedly restored by September, shipments of gas to the Russian Federation—a mainstay of production and exports—did not resume until January 2010. Reportedly, total forgone gas export revenue amounted to about $7 billion–$10 billion.

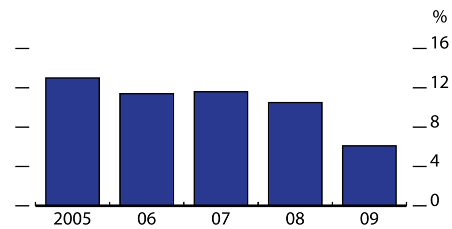
Still, GDP growth in 2009 came in at 6.1% (Figure 3.7.1), on robust growth in construction, services, and agriculture. The main driver of growth was public investment, which amounted to 25 billion Turkmen manat (TMM) (or $8.8 billion), or 1.6 times the 2008 level. A general increase in investment was supported by a state program to support small and medium-sized enterprises. In addition, there was a surge of externally financed infrastructure projects.

Official statistics indicate that consumer price inflation sharply decelerated in 2009 to an average of 0.1%, down from 14.5% in 2008. High inflation in 2008 reflected both the unification of the informal and the (substantially appreciated) formal exchange rates in May, and commodity price pressures, while the drop in 2009 was mainly due to the sharp fall in global non-oil commodity prices (the country imports much machinery and food) (Figure 3.7.2).

The Turkmen manat was redenominated on 1 January 2009 with 5,000 of the old denomination made equivalent to one of the new. The exchange rate, set at TMM2.85/$1, was stable throughout 2009. According to the International Monetary Fund, broad money is estimated to have contracted by 4.4% in 2009, reflecting a tight monetary policy. To maintain low inflation as well as to stabilize the nominal exchange rate, cash circulation was tightly controlled.

The government ran an accommodative fiscal policy in 2009, with the budget surplus estimated to have fallen to 3.0% of GDP in 2009, down from 11.3% in 2008 (Figure 3.7.3). Rapid expenditure growth was

3.7.1 GDP growth



Sources: International Monetary Fund. 2009. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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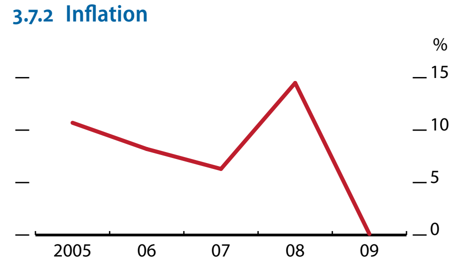
3.7.2 Inflation



Sources: International Monetary Fund. 2009. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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This chapter was written by Kiyoshi Taniguchi of the Uzbekistan Resident Mission, ADB, Tashkent; and Nariman Mannapbekov of the Central and West Asia Department, ADB, Manila.

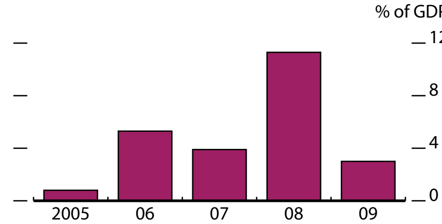
maintained while the nonhydrocarbon tax base was broadened, mainly due to high growth of construction activity. The fall in the surplus was largely a reflection of less buoyant receipts from the oil and gas sector, the source of about 75% of fiscal revenue. State budget surpluses are accumulated in the Stabilization Fund of Turkmenistan, which was created in October 2008.

In December 2009, the government announced a 10% across-the-board increase in salaries for public sector employees. Pensions and other social benefits were also raised. As a result, the average salary for these employees increased to TMM598 ($210) per month.

Despite the gas pipeline shutdown for most of the year, hydrocarbon sector exports, which accounted for more than 80% of total exports, continued to underpin the 2009 outturn. Export revenue managed to increase by 8.0% (in US dollars) in 2009 though performance was well less than the 27% gain a year earlier. At the same time, due to substantial increases in major capital investment projects and construction, imports increased by 19.2%. As a result, trade surplus shrank to 21.0% of GDP in 2009 from 23.4% in 2008 and the current account surplus decreased to 17.8% of GDP, down from 18.7% in 2008 (Figure 3.7.4).

December 2009 saw the opening of a natural gas pipeline connecting the People's Republic of China and Turkmenistan via Uzbekistan and Kazakhstan, thereby helping loosen the stranglehold that the Russian Federation had on Turkmenistan's natural gas exports. The pipeline is capable of delivering 40 billion cubic meters a year of gas at full capacity in 2012. A second pipeline to Iran came into operation in January 2010 with capacity of 12.5 billion cubic meters a year.

3.7.3 General government fiscal balance



Sources: International Monetary Fund. 2009. *Regional Economic Outlook, Middle East and Central Asia*. October; Ministry of Finance; ADB estimates.

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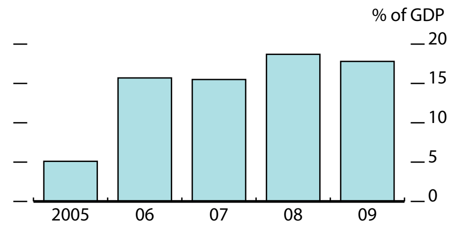
3.7.4 Current account balance



Sources: International Monetary Fund. 2009. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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Economic prospects

Growth of the economy will continue to be robust, supported by buoyant hydrocarbon exports and investment activity. GDP is projected to grow in 2010 and 2011 by 6.5% and 11.0%, respectively. By 2011, hydrocarbon exports will be back to the level of the pre-accident period as the phase-in of newly constructed pipelines will be able to handle gas at about full production capacity.

The government is likely to stick to its accommodative fiscal policy. Due to the expected strengthening of nonhydrocarbon commodity prices, inflation is projected to accelerate to 3.5% in 2010 and to 5.0% in 2011. Since large current-account and overall balance-of-payments surpluses are expected these years, the central bank will need to carry out sizable sterilization operations to keep the large foreign exchange inflows from boosting the money supply and creating sharply higher price pressures.

Despite the expected increases in imports owing to a step-up in investment and increased commodity prices, it is likely that the current account surplus will grow substantially in 2010–2011, mainly due to a surge in gas exports (reflecting the completion of gas pipeline construction). The current account surplus is forecast to reach 30% of GDP.

3.7.1 Selected economic indicators (%)

	2010	2011
GDP growth	6.5	11.0
Inflation	3.5	5.0
Current account balance (share of GDP)	30.0	30.0

Source: ADB estimates.

Uzbekistan

The government responded to the recent global financial and economic crisis with a well structured and timed anticrisis program. The program substantially increased domestic investment to create employment opportunities that offset the impact of the crisis on exports. The government has strengthened its efforts to diversify the economy through the private sector. Further acceleration of sector modernization will help greater private sector mobilization. The recovery of the global economy will improve external demand, providing an opportunity to accelerate reforms.

Economic performance

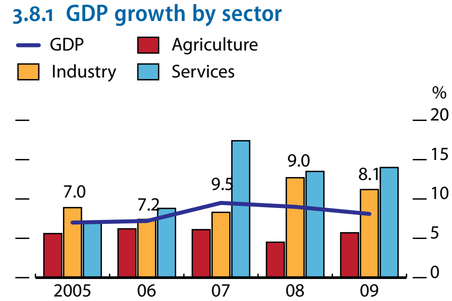
Despite the global recession and economic contraction among its major trading partners, Uzbekistan continued its strong economic performance in 2009 with GDP growth of 8.1% (Figure 3.8.1). The economy was affected by the recession through weaker external demand and lower remittance inflows.

The government responded to the recession early with a large-scale anticrisis program for 2009–2012, which was adopted at end-2008. Measures included substantial public infrastructure investment, tax preferences to exporting industries and small and medium-sized enterprises, increases in public sector wages, and recapitalization of commercial banks. The program was financed through the government budget, state-owned enterprises (SOEs), and the Fund for Reconstruction and Development (FRD), a sovereign wealth management fund established in 2006. Healthy budget revenues and good export performance of gold and natural gas supported the program's implementation. As a result, GDP growth was sustained by output gains in industry, including construction (11.2%) and services (14.0%).

Nonconstruction industrial growth is attributable to increased production of hydrocarbons, machinery, and chemicals, which together accounted for 42% of total industrial production. These three subsectors combined posted growth of 13.1%. The performance of other industrial subsectors was more modest, with the output of nonferrous metallurgy (mainly gold, silver, and copper) growing by 2.6%.

Within industry, construction shot up by 33.1%. This gain was driven primarily by an increase in fixed capital investment. According to official data, such investment rose by 24.8% in 2009. Construction output was lifted by public infrastructure development projects in rural areas. Notable sources of construction demand were large SOEs under government-led sector modernization and renovation programs (primarily manufacturing and mining). The share of fixed capital investment in GDP increased from 23.0% in 2008 to an estimated 26.1% in 2009.

3.8.1 GDP growth by sector



Sources: International Monetary Fund. 2008. *Article IV Consultation*. July. http://www.imf.org; State Statistics Committee of Uzbekistan; ADB estimates.

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This chapter was written by Iskandar Gulamov and Kiyoshi Taniguchi of the Uzbekistan Resident Mission, ADB, Tashkent.

Rapidly growing telecommunications and financial markets were one of the major contributors to growth in services: mobile subscriber numbers have increased 10-fold in less than 4 years. The financial services market is growing fast in areas of microfinancing and bank debit card processing. In response to rising demand for credit from microenterprises, especially in rural areas, the volume of microfinance lending reached $200 million in 2009.

Agriculture posted growth of 5.7%. Although difficult climatic conditions impacted the cotton harvests, increased production of cereal crops and vegetables supported sector growth.

The government reported that foreign direct investment in 2009 increased by 80% from 2008. The bulk of the increase came from expansion of activities in the hydrocarbons and communications sectors. In December 2008, the government established the first free industrial-economic zone in the Navoi region (FIEZ Navoi), which provides tax and customs preferential facilities for foreign investors. By end-2009, the government had signed 37 investment agreements with various foreign investors for FIEZ Navoi amounting to more than $500 million. The first investment outlays are expected this year.

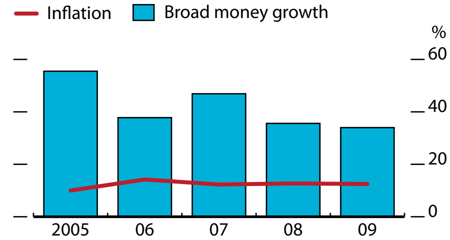
Inflation has been falling since 2008 despite inflation pressures stemming from a nominal depreciation of the exchange rate against the US dollar (of around 10% in 2009) and public sector wage increases. Such pressures were balanced by lower global commodity prices, coupled with administrative price caps on energy and utilities. The government reported end-period consumer price inflation of 7.4% for 2009. The latest estimate of the year-average consumer price index by the International Monetary Fund is 12.5%. Broad money growth is estimated at 34.0% in 2009 (Figure 3.8.2).

The depreciation of the local currency supported exports. Sharp falls in the Kazakhstan tenge and Russian ruble against their respective major trade partners added downward pressure on the nominal exchange rate.

The main elements of the anticrisis program implemented through fiscal policy were recapitalization of commercial banks to support lending; increased public infrastructure development to support job creation; and tax exemptions to support exporting industries and small and medium-sized enterprises. The government also increased public sector wages by 40% on average in 2009. These expenditures were offset by strong revenue receipts stemming from high export prices (especially for gold and gas) and tax reforms. The general government budget is estimated to have posted a surplus of 0.2% of GDP in 2009. Including the FRD, the consolidated budget surplus is estimated at 4.4% of GDP (Figure 3.8.3).

The crisis had impacts on exports and remittances. Exports to Uzbekistan's main markets, namely Kazakhstan, the Russian Federation, and Ukraine, and remittances from Kazakhstan and the Russian Federation, were heavily affected. Nonhydrocarbon exports contracted by 11% in 2009. Machinery (with a 61% decrease to $341 million) and cotton (a 6% drop to $1.0 billion) were among the worst hit, but their lower export revenues were offset by strong global demand for gold and income from natural gas sales to the Russian Federation (the largest customer). Hydrocarbon exports increased by 41% to $4.0 billion. With the gold and gas prices hitting records, export revenue increased by about 2.0% relative to 2008.

3.8.2 Inflation and money



Sources: International Monetary Fund. 2009. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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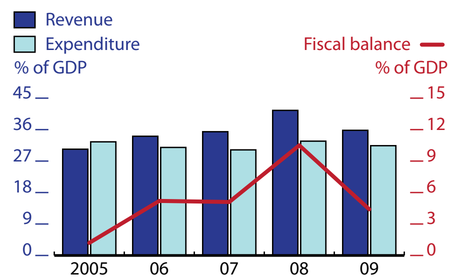
3.8.3 Fiscal indicators



Sources: International Monetary Fund. 2009. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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The growth of imports is estimated at 25.8% in 2009. As in past years, machinery and equipment were the largest import items, reflecting infrastructure development. The sharp fall in export growth, increased imports, and lower remittances cut the current account surplus to an estimated 12.0% of GDP at end-2009, down from 16.7% in 2008 (Figure 3.8.4).

In the framework of its anticrisis program for 2009–2012, the government will continue its infrastructure development initiatives as well as sector modernization programs. This implies significant investment commitments, most of which will be financed by domestic banks, the FRD, and SOEs. Domestic investments by SOEs will be geared toward the hydrocarbon, energy, chemical, and transport sectors. Foreign direct investment will also provide important financing for investment. The government's investment program envisages a $2.4 billion inflow of foreign direct investment in 2010, out of which $2.0 billion will be directed to hydrocarbons. In April 2009, the national oil and gas company, Uzbekneftegaz, established a $2.5 billion international joint venture to produce gas-to-liquid synthetic fuel.

Due to the active industrial policy, foreign investments are expected to increase steadily in the near future. At FIEZ Navoi, 16 investment projects for a total amount of $200 million are forecast to start in 2010. A major part of the foreign investment is expected to be from Asia and the Middle East. The government plans to attract about $1.0 billion of investment into FIEZ Navoi in the medium term. It has supported the private sector through reductions in rates of unified and fixed taxes, as well as value-added tax refunds and soft loans through commercial banks for exporters.

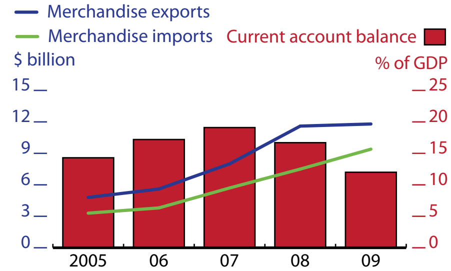
Economic prospects

Due to the economic recovery of the major trading partners as well as the government's active industrial policies, improved export performance and higher investment inflows are expected to be major drivers of growth in the forecast period (at 8.5% and 9.0%). International prices for Uzbekistan's major export commodities look favorable in 2010 and 2011 (Figure 3.8.5).

The downside risks to these forecasts lie in external factors related to the situations in the main trading partners, as well as persistent fundamental imbalances in industrial countries. On the domestic side, timely implementation of the investment program and continued efforts on sector modernization would ensure intended outcomes of the government's anticrisis program. Well-designed public and private investment, including commercial bank lending, will benefit a broader population through improved access to credit and increased employment opportunities.

The government will continue increasing its social and infrastructure expenditures while broadening the tax base and reducing tax rates. The 2010 budget, approved by Parliament at end-December 2009, envisages increasing these expenditures to 13.5% of GDP in 2010, up from an estimated 11.5% in 2009. The rates of both corporate and personal income taxes will be decreased to stimulate business investment and private

3.8.4 Current account indicators



Sources: International Monetary Fund. 2008. *Article IV Consultation*. July. http://www.imf.org; ADB estimates.

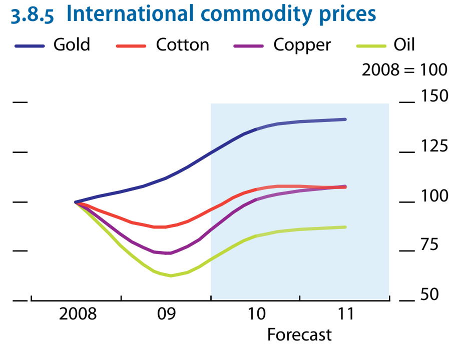
Click here for figure data

3.8.1 Selected economic indicators (%)

	2010	2011
GDP growth	8.5	9.0
Inflation	9.3	9.0
Current account balance (share of GDP)	13.0	14.0

Source: ADB estimates.

3.8.5 International commodity prices



Note: Prices of commodities are based on US$ prices.

Sources: World Bank. 2010. *Global Commodity Markets*. www.worldbank.org/globaloutlook; Bloomberg (accessed 8 March 2010); Economic Intelligence Unit. 2010. *Global Outlook*. March; ADB estimates.

Click here for figure data

consumption. The corporate and personal income tax rates will fall by 1 percentage point to bring rates to 9% for corporations, 8% for small businesses, and 11% for individuals. The revenue will be sustained by the recovery in international commodity prices for certain exports that weakened in 2009, counterbalancing the increasing expenditures. The consolidated budget, including the FRD, is seen posting a surplus of 5.5% of GDP in 2010 and 6.5% of GDP in 2011.

Investment will also be boosted by increased bank lending and FRD resources. The banking sector increased its lending to small businesses by 50% in 2009, and this trend is expected to continue in 2010 and 2011 in light of significant demand for small and micro-lending. A new direction in the investment activities will be residential construction. The rural residential housing construction program for 2010 plans to allocate up to SUM588.7 billion ($390 million) for this purpose. A large portion of funding will come from the new Rural Construction Bank, established in 2009, in which the government is the majority shareholder.

Strong external demand and rising exports will stimulate growth in net foreign assets and the money supply, creating inflation pressures that will be boosted by the large increases in public sector wages. It is expected that nominal depreciation of the sum will be gradual. Thus, fully sterilizing the excess liquidity from the large foreign exchange inflows may be a challenge. As a result of these factors, the government forecasts inflation at about 9% in 2010–2011.

The gradual recovery of the global economy and expected growth of world trade will underpin the current account surplus. The country will benefit from the international prices of its main export commodities, which will stay high on rebound.

Export gains will be partly offset by rising imports. Import growth will be determined mainly by demand for inputs into modernization of manufacturing and public infrastructure development, and by higher global commodity prices. The current account surplus is forecast at 13.0% in 2010 and 14.0% in 2011.

Development challenges

The immediate challenge is to mitigate emerging inflation pressures from rising exports and continued fiscal expansion. A close coordination of monetary, fiscal, and industrial policies will be useful in ensuring price relative stability and continued economic development. For the longer term, the major challenge is to diversify the economy. Currently, it is resource-based, making it susceptible to global commodity price fluctuations. The sources of export income need to be more widely spread.

In order to achieve broad-based inclusive growth, private sector development, industrial diversification and trade liberalization are essential. Accelerating ongoing reforms in these areas, along with the continued efforts to streamline public administration, would help sustain economic growth and broaden improvements in living standards. The recent economic achievements of the country provide a sound opportunity for speeding up the transition to a sustainable and competitive economy.