Central Asia

Armenia
Azerbaijan
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Armenia

Largely on account of the rapidly growing nontradable sectors of construction and services, the economy continued to grow beyond expectations, at 13.4% in 2006. The fiscal deficit was kept in check through expenditure rationalization and tax reforms. Higher remittances, public spending, and private investment supported growth in domestic demand. Rising fuel prices and a poor agricultural harvest put some pressure on prices, but inflation remained generally contained. A moderate deceleration is expected in 2007–2008 as production capacity limits are reached and the pace of growth in construction and services eases. Prospects are promising, but structural reforms have to continue, parliamentary and presidential elections must be seen to be democratic, and regional conflicts need to be resolved to allow closed trade routes to open.

Economic performance

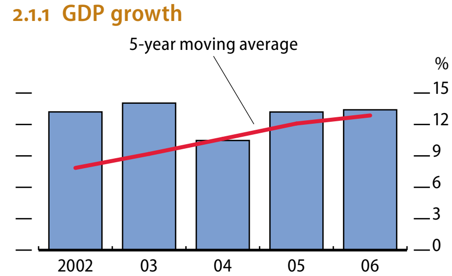
The economy showed substantial resilience as GDP grew by 13.4% in 2006, against the 11.0% projected in the 2006 budget program, continuing the double-digit growth trend of the past half decade (Figure 2.1.1). On the supply side, the main contributions came from rapid growth (37.1%) in industrial construction (for roads, mining, and energy infrastructure) and residential construction; services (20.2%); and retail trade (10.5%) (Figure 2.1.2). The share of construction in GDP now exceeds 20%.

GDP expansion would have been higher still but for the poor performance of manufacturing and agriculture. Manufacturing activity declined mainly due to disruptions in the external supply of raw diamonds for processing, but also due to low growth rates of jewelry, light industry, and chemicals, all reflecting low external demand. A narrow manufacturing production base remains a structural weakness and a constraint to sustaining high growth. Agriculture posted low growth of 0.4% on account of a poor harvest. On the demand side, government consumption and investment supported higher social and capital spending. Rapidly rising wages and remittance inflows bolstered private consumption.

The expansion in services and construction activities continued to help bring down the official level of unemployment from 8.1% in 2005 to 7.4% in 2006. Average monthly nominal wages rose by 23.5% in 2006, boosted by strong growth in public and private sector wages. Revised official estimates put poverty in 2004 at 35%, lower than the previous estimate of 39%. Sustained economic reforms, strong growth, and single-digit inflation reduced poverty further to 30% in 2005. Per capita GDP in US dollars has tripled since 2000, reaching almost $2,000 in 2006 compared with $1,524 in 2005, partly on account of the dram's appreciation (Figure 2.1.3).

Year-on-year inflation accelerated to 6.8% in July, reflecting a poor agricultural harvest, higher telecoms and other utilities tariffs, rises in import prices of energy and raw materials, as well as accelerated

2.1.1 GDP growth



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 9 January 2007.

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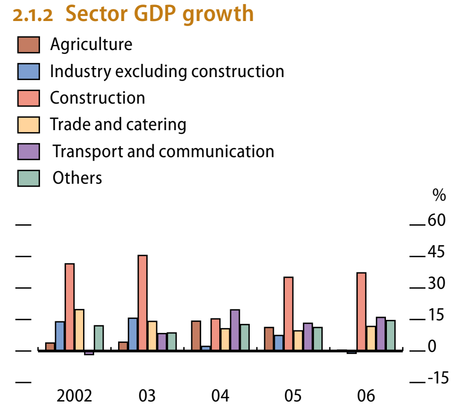
2.1.2 Sector GDP growth



Source: Ministry of Finance and Economy, available: http://www.mfe.gov.am, downloaded 12 March 2007.

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monetary growth (Figure 2.1.4) (due to sustained inflows of foreign exchange and limited ability to sterilize their impact). But inflation moderated to 5.2% by end-2006 on account of seasonal fluctuations in food prices and drops in sugar, gasoline, and diesel prices. Given deflation in the first quarter (Figure 2.1.5), average inflation for the year came in at 2.9%, just below the targeted 3.0%. In early 2006, the Central Bank of Armenia began a switch to a policy of inflation targeting from monetary targeting. It now issues regular inflation reports and is using a quarterly model for forecasting; it will shift to full-fledged inflation targeting over the medium term. The authorities will use short-term interest rates, central bank bonds, and monetary aggregates as control mechanisms.

The Government has pursued prudent fiscal policies and is now shifting its focus from expenditure contraction to revenue generation. The fiscal deficit continued its sustained reduction from over 5% of GDP in 1999 to 1.9% in 2005, falling to 0.6% of GDP in 2006 (Figure 2.1.6), well below the budgeted 2.9%. Lower than programmed budget expenditures and higher than expected GDP growth that helped boost tax receipts contributed to this outcome.

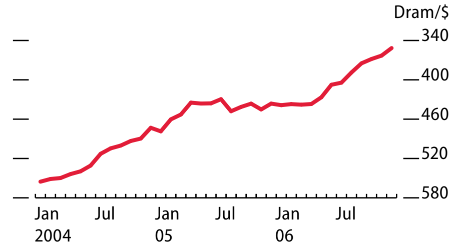
Although nominal tax revenues have been rising gradually, the tax-to-GDP ratio remains essentially stable (at about 14% of GDP) because of widespread tax evasion, weakness in tax administration, excessive exemptions that limit the tax base, and heavy reliance on indirect taxes (about 60% of total tax revenues). Consequently, the major contributors to economic growth—construction, services, and agriculture—have largely escaped the tax net. Lack of buoyancy in the services tax is partly because it is specific rather than ad valorem. Agriculture is not taxable until 2009, in accordance with an agreement with the World Trade Organization. According to the World Bank's *Doing Business 2007*, foreign and joint-venture companies form the top taxpayers while many large domestic enterprises avoid the tax net.

In 2006, the Government implemented several measures to boost tax revenues to finance higher spending in infrastructure and social services in line with commitments made in its poverty reduction strategy paper (PRSP). These included moves to broaden the tax base by reducing exemptions and loopholes and to improve the efficiency of tax administration. The State Tax Service amended the law to tax property above a threshold limit. The authorities prepared a draft bill to tax construction projects. With improved collection from value-added, income, and profit taxes, tax receipts improved marginally to an estimated 14.4% of GDP in 2006 from 14.3% the year before.

Recognizing that reducing the size of the shadow economy is vital to improve compliance, the parliament approved a financial disclosure bill making income and property declaration mandatory for citizens earning more than $19,000 per year, an amount that is more than 10 times the official average salary. The law is expected to come into force in 2008. The Tax Inspection Unit published the list of the 1,000 largest taxpayers. The Government envisages lowering dependence on external grants and meeting the budget targets through internally collected revenues to enhance sustainability of its resources.

Imports showed robust 21.8% growth in 2006, largely owing to a pickup in capital goods and mineral products, which reflected the

2.1.3 Nominal exchange rate



Source: Central Bank of Armenia, available: http://www.cba.am, downloaded 21 February 2007.

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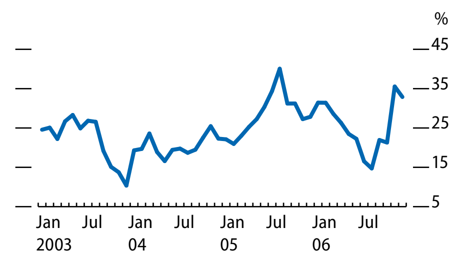
2.1.4 Money supply (M2x) growth



Sources: International Monetary Fund, *International Financial Statistics* online database; Central Bank of Armenia, available: http://www.cba.am; both downloaded 10 March 2007.

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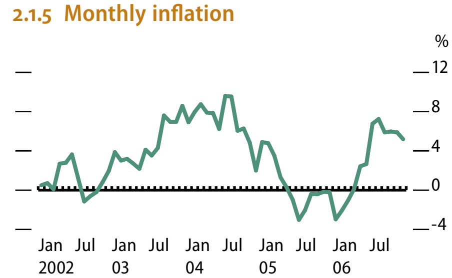
2.1.5 Monthly inflation



Sources: International Monetary Fund, *International Financial Statistics* online database; National Statistical Service of the Republic of Armenia, available: http://www.armstat.am; both downloaded 10 March 2007.

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expansion in construction and investment activity as well as higher commodity prices. Exports, though, achieved only low 3.1% growth, mainly because of a fall in base-metal exports (as modernization programs restricted activity), a drop in the diamond-processing trade (amid supply disruptions and stiffer competition from other countries), and stagnant foodstuff exports. The upshot was a widening of the trade deficit to $1,190 million or 18.6% of GDP (Figure 2.1.7). Considerable inflows of transfers and income from abroad helped narrow the current account deficit to about 5% of GDP. Gross official international reserves increased by $402 million in 2006 and stood at about 5 months of imports of goods and services.

Continued official emphasis on a sustainable debt-management policy has seen a marked reduction in external public debt as share of GDP in recent years. It remained at 20.5% of GDP in 2006 (Figure 2.1.8), while the debt service ratio was only 4.2%, as essentially all outstanding debt is on concessional terms.

In 2006, Armenia received an international credit rating for the first time. Moody's assigned a BA2 grade of foreign and local currency rating which signifies a medium level of creditworthiness and a stable outlook. Fitch's assigned a lower BB- sovereign credit rating indicating a relatively high risk of doing business, as the economy remains vulnerable to shocks due to its high degree of dollarization, underdeveloped financial services, low value-added economic activity, as well as the Nagorno-Karabakh conflict.

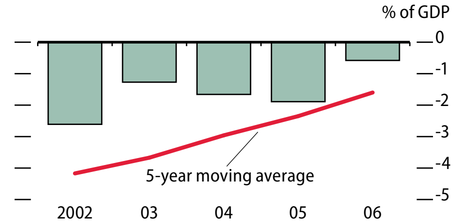
The banking sector has improved but the nonbank financial services market needs attention. The diaspora seems keen to maintain the significant flow of investment spending seen in the last several years. But owing to continuing weaknesses in business procedures, foreign direct investment (FDI) not only fell from 5.1% of GDP in 2005 to an estimated 3.1% in 2006, it has become lower than the mean levels of neighboring countries. Higher inflows of FDI, especially into the tradable sector, would support greater export volumes as well as upward labor mobility and international integration. Further efforts are needed to address corruption and other weaknesses (Box 2.1.1).

Economic prospects

Robust economic growth of the first few years of this century is providing the necessary support for building a coherent macroeconomic policy framework and pushing through wide-ranging structural reforms. It is expected that the PRSP update for 2007 and the recently released Medium-Term Expenditure Framework 2007–2009 (MTEF) will guide economic policy making in the coming years.

The average exchange rate is assumed to be stable in 2007–2008. The narrow export base will keep exports susceptible to changes in international prices. The general parliamentary election in May 2007 and presidential election in early 2008 are not expected to adversely influence the pace of economic reforms. Major bilateral donors, however, have stressed that proper conduct of the elections is an important concern. Prospect for securing an agreement with Azerbaijan in the long-standing dispute over Nagorno-Karabakh remain gloomy.

2.1.6 Budget balance



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 10 March 2007.

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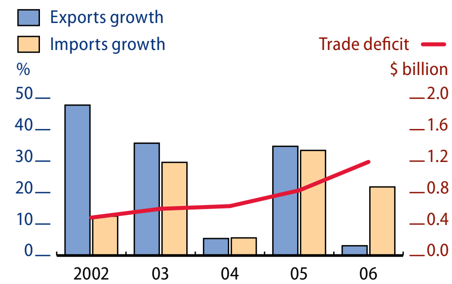
2.1.7 Trade indicators



Source: Ministry of Finance and Economy, available: http://www.mfe.gov.am, downloaded 12 March 2007.

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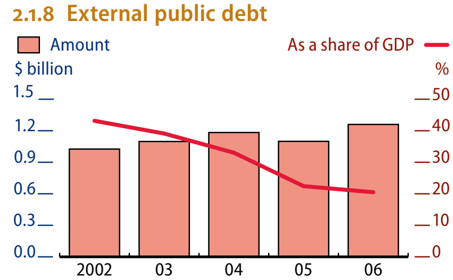
2.1.8 External public debt



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 12 March 2007.

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2.1.1 Selected economic indicators

	2007	2008
GDP growth	10.0	9.0
Inflation	4.0	4.0
Current account balance (% of GDP)	-5.0	-5.0

Source: Staff estimates.

The economic outlook is positive. However, growth momentum is expected to moderate, to 10% in 2007 and 9% in 2008, as a result of a high base and a deceleration in growth that has already begun in construction, services, and retail trade. The central bank forecasts falls in the growth rates of construction to 12.9% and services to 11.3% this year, and these declines are unlikely to be offset by higher production in agriculture and industry. However, output in these two sectors is set to rise on account of planned investments in irrigation, transport and communications, energy, mining, metallurgy, machine building, and chemicals, boosted by greater availability of private credit and external assistance. Higher public and private wages together with rising remittances will continue to support high growth in consumption spending.

Some inflationary pressures will result from growing domestic demand. Against this, the central bank's monetary program has set a 4.0% annual inflation target, which should be achievable if there is adherence to budgetary targets for financing, some recovery in the agriculture sector, and easing in international prices pressures. Further appreciation of the dram could damp inflationary pressures, though this outcome has not been assumed in the forecast.

Trade deficits will remain large in the forecast period as there will only be a slight improvement in export growth in the face of a continued rapid expansion in imports to support higher construction and investment activity as well as the necessary high volumes of food imports. Sugar importers will have to deal with higher world price while oil importers would benefit from the easing pressure of world prices.

The narrow base of the export basket will keep exports susceptible to changes in international prices. In particular, exporters will face mixed trends in global commodity prices as metal prices are expected to rise and the price of diamonds to fall. Export growth is limited because little relief appears in sight to end the structural problems in the diamond-processing sector and the narrow manufacturing base, though mining and metallurgy exports are expected to accelerate because of new investment.

If the trends of the last few years are maintained, increases in net income from abroad and large foreign transfers are expected to partly offset the trade deficit and contain the current account deficit at about 5% of GDP over the forecast period. Inflows of capital grants, FDI, and foreign development assistance are expected to be sufficient to allow a moderate increase in official reserves.

Fiscal deficits will widen from levels of the past few years to accommodate a rapid rise in defense spending and commitments to higher social and capital spending under the PRSP. This is also reflected in the MTEF. Based on a 9% assumed increase in GDP, the parliament has approved a 16% increase in 2007's budget spending, which includes a 40% rise in the military budget. More than one third of expenditures are earmarked for education, health care, social security, and other public services, with the average monthly wage of civil servants rising by 20% and full-time schoolteachers' salaries by 27%.

The proposed public investment program under MTEF will help streamline investment spending. Higher revenue collection through tax reforms and improvements in tax administration are expected to raise the

2.1.1 Poverty and corruption

The most important development challenges are high levels of poverty, especially in rural areas, and of corruption. Weak investment and productivity increases have led to low farm incomes and a high poverty risk in agriculture. With limited nonfarm employment opportunities, any trickle-down of economic growth to rural households through job hires and self-employment has been minimal.

The official unemployment figures mask the real situation as survey-based sources place unofficial estimates of national unemployment at 20–30%. This is largely due to low overall productivity and returns from farming activity, low growth in the off-farm rural sector, a dearth of well-paying jobs for the educated unemployed, and limited access and high cost of finance for rural enterprises. The public benefits and private transfers forming the bulk of rural households' income are inadequate. Lack of basic infrastructure and effective public services delivery are binding constraints.

Corruption is pervasive, especially in the public sector, and is encouraged by ineffective systems of accountability and weak tax administration in the civil service and the State Tax Service. It is manifested in bribery, tax evasion, and underreported profits. This has led to lower receipts from value-added, income, and profit taxes than in its neighbors, even with similar tax rates. Another stimulus is the stark disparity in wages between the public and private sectors, which too often encourages "inducements."

To its credit, the Government is improving tax administration and is considering performance-based pay system to retain high-quality staff in the civil service, and has signed up to various international anticorruption schemes. But the absence of legal sanctions against corrupt officials has left the public skeptical about the Government's capacity to curtail corruption. Deeper institutional reforms are key to moving forward.

tax-to-GDP ratio by about 1 percentage point, but this may not match the additional resource requirements. The budget deficit is targeted at 2.3% of GDP in 2007. This would be largely financed by external assistance and grants with a need for moderate deficit financing.

Until its initiatives generate adequate revenues, the Government will need alternative sources of financing to meet its rising spending commitments. While it is currently maintaining a zero limit on contracting new nonconcessional debt, robust economic growth and improved creditworthiness have strengthened its capacity for such borrowing. Its ability to repay external public debt is strong, as reflected in low and falling levels of the debt-to-GDP ratio and the debt service-to-exports ratio as well as in rapidly rising per capita incomes.

This observation is consistent with the positive results of the Government's debt-sustainability analysis. Improvements in sovereign credit ratings will promote Armenia's foreign partnerships and attract investment in large-scale projects. A favorable macroeconomic outlook and emerging investment opportunities bode well for the Government to borrow on nonconcessional terms.

The medium-term outlook clearly faces risks, among which external factors loom large. For example, heavy dependence on remittance flows, a limited export base, and a highly dollarized economy make Armenia vulnerable to shocks from external demand, international prices, and exchange rate fluctuations. Further appreciation of the dram poses difficult challenges for monetary management and, if sustained, could cause "Dutch disease," impinging on the international competitiveness of exports and import-competing goods. (These issues are discussed further in Box 2.1.2.)

The Russian Federation is the largest trading partner and a leading investor in energy. A 2006 bilateral agreement allows Armenia to pay the Russian company Gazprom a highly discounted price of $56 per 1,000 cubic meters of gas until end-2008, a trade-off for the sale of a power plant to Gazprom. However, the start of 2009 may bring with it considerably higher gas prices. The Government has, though, incorporated the impact of such a possible rise in designing the targets in its 2007 budget.

2.1.2 Dynamics of the dram-dollar exchange rate

Armenia is a highly dollarized economy. An estimated $1 billion is held in US currency notes by residents—about 16% of GDP and three times the value of dram notes in circulation. Close to 65% of bank deposits and 70% of bank loans are denominated in US dollars. Over 90% of total public debt (domestic and external) is denominated in foreign currency, increasing the vulnerability of public sector balance to exchange rate shocks.

Strengthening capital and financial accounts and rapidly growing remittances and foreign investments in real estate continue to fuel appreciation of the dram in a freely floating exchange rate regime. The dram has registered a substantial nominal appreciation in its dollar value since January 2004, rising by 15% in January–September 2006 alone. This has had a significant impact on trade and inflation.

A new law requiring certain transactions to be conducted only in local currency as part of the Government's drive toward dedollarization has led to an increase in the demand for dram, as has its recent marked appreciation. Given large foreign investment flows into real estate, a proposal to tax construction projects is expected to reduce the upward pressure on the currency.

The Central Bank of Armenia has been carrying out sterilization interventions since June 2006 to moderate short-term fluctuations in the exchange rate without trying to fix its level. The central bank's approach is to keep inflation low and the exchange rate floating without a predetermined path for the dram, which moves according to market forces.

International Monetary Fund estimates show that the real exchange rate against the dollar is now close to its market equilibrium level.

Azerbaijan

Phenomenal economic growth was recorded in 2006, powered by soaring production and exports of oil and gas. Foreign investment, primarily for hydrocarbons, is beginning to taper off as large projects in the sector become operational. The Government is bullish that much higher domestic public investment, especially non-oil, will partly offset this decline. Yet rapid and deep structural reform is imperative for such investment and—along with controlling inflation and preventing excessive exchange rate appreciation—is the key challenge.

Economic performance

GDP leaped by 32% in 2006 (Figure 2.2.1). The oil and gas sector, accounting for about 54% of GDP (a sizable rise from 42% in 2005), was the key contributor to the acceleration, as production and volume of exports surged by 48% and 60%, respectively. This was mainly due to a production upsurge at the Azeri-Chiraq-Guneshi (ACG) oil fields, operated by the Azerbaijan International Operating Company (AIOC). The Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which can transport up to 1 million barrels a day, was formally inaugurated in July. This pipeline greatly increased oil transportation capacity from the ACG fields to international markets—AIOC increased its oil production by 88% in 2006.

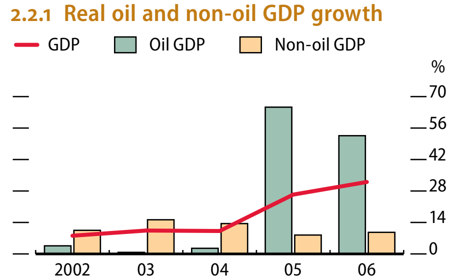
The huge growth in oil and gas completely dwarfed modest non-oil growth, and hydrocarbons' share of GDP is expected to rise further. Still, services grew respectably, at 12.6%, with communications and transport the main contributors. The former increased by 24% due mainly to tariff reforms and rapid expansion of services in the regions; the latter rose by 16%, predominately from transit activities through Azerbaijan and oil transport through the BTC pipeline, which is classified under transport. Construction activities decelerated to 14% from 16% growth in 2005, because of the completion of the BTC pipeline and tougher government regulations on residential construction.

Agriculture expanded by 9.5%, well above recent rates. The Government introduced concessional lending and assistance to the sector and established a state-owned agricultural leasing company to encourage adoption of new agricultural machinery.

In recent years, investment in hydrocarbons, most of it from foreign companies, has been the predominant driver in fast-growing total investment, which in turn has been the main stimulus to rapidly expanding GDP. In 2006, growth in total investment was 15%. With completion of the BTC pipeline and the scheduled completion of other major investment projects at the ACG oil field and the Shah Deniz gas fields in 2007, foreign direct investment (FDI) is expected to markedly scale down.

The Government, however, is optimistic that domestic public investment could cushion this fall. In 2006, such investment jumped

2.2.1 Real oil and non-oil GDP growth



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; *Asian Development Outlook* database; staff estimates.

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by 49% to $3.5 billion, of which 75% was from state-owned enterprises (SOEs), 12% from the state budget, and 8% from commercial banks.

Domestic private investment by local businesses and individuals is modest. In recent years, most of this has been in residential dwellings. And given the limited progress made in improving the business environment, it is unlikely that domestic private investment will rise significantly.

The Government ran an expansionary fiscal policy in 2006. Rising by 67%, state spending was mainly on public sector wages, pensions, social services, defense, and infrastructure development. With substantial gains in both world prices for oil and in domestic production, tax revenues (mainly associated with oil and gas) surged by over 80%. About one third of budget revenues come from the State Oil Company of the Azerbaijan Republic, and 17% from transfers from the State Oil Fund of the Republic of Azerbaijan (SOFAZ). The general budget deficit amounted to 3.3% of GDP (Figure 2.2.2), most of which is attributed to increased infrastructure investment.

Financial assets of SOFAZ reached $1.8 billion at the end of 2006. As well as outlays from the government budget, SOFAZ spent from the oil fund on infrastructure development, assistance to internally displaced persons, and investment in the BTC pipeline. SOFAZ derives its revenues mainly from oil sales, income from oil transport, bonuses paid by foreign oil companies, excess between market and projected oil prices, and income from financial investments. SOFAZ spends its oil revenues mainly on social programs and infrastructure, in compliance with the long-term strategy for managing oil and gas revenues.

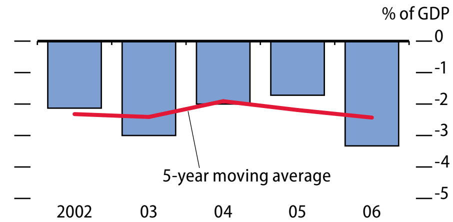
Average official consumer price inflation in 2006 was 8.3% (Figure 2.2.3). It accelerated over the year and averaged just over 11.3% year on year in the fourth quarter. However, independent analysts have suggested that it is much higher. Several factors ramped up prices, including the surge in petrodollars and the limited ability of the National Bank of Azerbaijan (NBA) to sterilize much of the inflow, leading to an excess supply of manat in the economy. M2 jumped by 87% (Figure 2.2.4); reserve money by about 130%; and M1, mostly currency in circulation, by 145%.

Buoyed by burgeoning oil-related revenues, the Government boosted spending on all fronts, putting further pressure on inflation. It issued several decrees to reduce subsidies for utilities services, such as electricity and gas. In response, public utility monopolies raised tariffs to consumers. While reducing subsidies was a positive step toward structural reform, the one-time price rise will pump up inflationary pressures this year. Private monopolies also took advantage of the strong economy to raise prices.

Recognizing the threat of accelerating inflation, the Government introduced various anti-inflationary measures, including agricultural product fairs and price controls on certain agricultural products. However, some of these measures are superficial in nature and distort the pricing mechanism. In addition, NBA tightened monetary policy, lifting the discount rate by 50 basis points to 9.5%. NBA also mopped up excess petrodollars by purchasing over $1 billion in the foreign exchange market. Despite these moves, the manat appreciated by 5.4% in 2006 (Figure 2.2.5).

NBA faces two formidable challenges in controlling inflation. First,

2.2.2 Budget balance



Sources: State Statistical Committee of Azerbaijan; Ministry of Finance.

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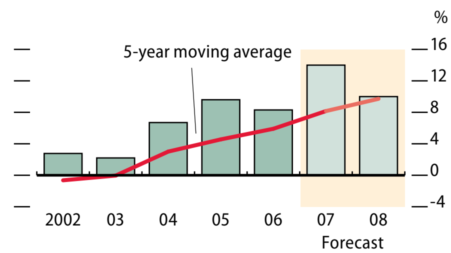
2.2.3 Inflation



Sources: State Statistical Committee of Azerbaijan; Ministry of Finance.

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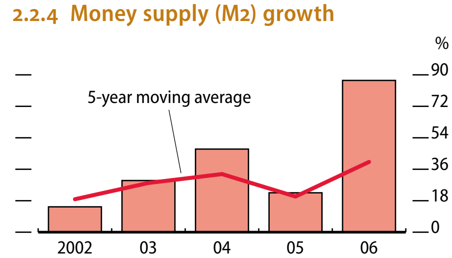
2.2.4 Money supply (M2) growth



Note: Includes foreign currency deposits.

Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 19 February 2007.

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Azerbaijan is still largely a "cash" economy, and therefore much economic activity will not be directly responsive to its measures (outstanding banking system credit is less than 15% of GDP). About two thirds of the monetary base is held as currency outside the banking system, mainly in the informal economy (which may account for as much as 60% of officially recorded GDP). Second, NBA has only limited capacity to conduct open-market operations, because of the rudimentary nature of domestic financial and capital markets. Given the limited monetary policy options, the authorities need to ensure closer coordination between monetary and fiscal policies, and to pay closer attention to expenditures of SOEs and SOFAZ.

Many analysts have called for a reduction in fiscal spending in the non-oil sector to a more sustainable level to combat the threat of escalating inflation, which could seriously jeopardize the good record of macroeconomic stability.

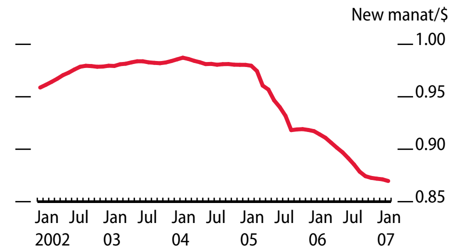
The trade account registered a record surplus of $7.9 billion (Figure 2.2.6) in 2006, propelled by burgeoning oil exports, which contributed 84% of total exports. Total exports surged by 60.7%. Growth in imports slowed to 4.5% in 2006, as machinery and equipment imports eased and investment in major projects wound down. However, strong domestic demand kept growth in consumer goods imports on the rise. The current account recorded a surplus of $1.8 billion (9.0% of GDP) in 2006. The capital account surplus fell significantly because of the steep drop in oil-driven net FDI. Gross official reserves more than doubled to $2.5 billion (Figure 2.2.7).

The major structural issues are similar to those of previous years, including market distortions from anticompetitive behavior of SOEs, lack of corporate governance of SOEs, a weak banking and financial system, and a poor business environment. Most of the SOEs operate as monopolies in their respective markets, such as electricity and gas, agriculture, and sea and air transport. In addition, most operate inefficiently, and, as in the power sector, incur heavy losses that are subsidized by the Government.

The financial and business practices of SOEs need to be reformed urgently, including corporate governance reform, to ensure greater transparency and accountability. There have been positive steps taken to improve this situation; for example, the Government has recently reduced the subsidies to SOEs. SOEs such as the State Oil Company have begun to implement measures under the Extractive Industries Transparency Initiative to improve corporate governance.

Moreover, the banking and financial segment faces an urgent need to reform, so as to promote confidence and efficiency in mobilizing savings for investment, and ultimately to enhance economic growth. Banking is dominated by two state-owned banks: International Bank of Azerbaijan and Kapital Bank, which together control over half of the assets in the sector. They are significantly undercapitalized and not interested in playing a part in modernizing the banking system. One encouraging sign is that major commercial banks have begun to adopt the principles under Basel II. The market dominance of International Bank of Azerbaijan and Kapital Bank is being slowly whittled away through rapid growth of private banks, which are supported by foreign institutional investors

2.2.5 Nominal exchange rate



Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 8 March 2007.

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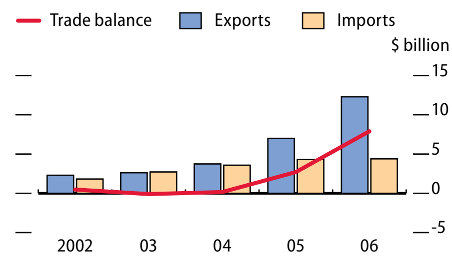
2.2.6 Trade indicators



Sources: Ministry of Economic Development; National Bank of Azerbaijan, available: http://www.nba.az, downloaded 30 January 2007.

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2.2.7 Gross international reserves

Source: National Bank of Azerbaijan.

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and multilateral development banks. Still, their market share and power remain largely intact.

Improving business conditions and the investment climate in the non-oil sector is crucial. While the business environment has improved slightly, according to the 2007 *Doing Business* report, the business climate in neighboring countries has improved much faster. In addition to other reforms required, intellectual property rights also need to be secured.

Economic prospects

Forecasts of key economic variables are based on the following assumptions: NBA monetary policy will aim to keep inflation in check and continue a flexibly managed exchange rate policy; petrodollars will continue to flow into the country; and production and exports of hydrocarbons will make another jump. Given the exceedingly large government spending in previous years, huge growth of money supply from oil revenues, and capacity constraints in the domestic economy, raising government spending to an excessively high level in 2007 and beyond may put at risk macroeconomic stability.

Growth peaked in 2006. It is forecast to grow by a still-sizzling 25% in 2007 (Figure 2.2.8), driven by oil production (from the ACG fields) and expected gas output (coming on stream from the Shah Deniz field) and their export, as well as an expansionary fiscal policy. It is seen slowing further in 2008 to 17%, as growth in production of oil and gas moderates and FDI falls, as hydrocarbons move to a less intensive phase of development. Some of this deceleration will be offset by increased inflows of development assistance.

The Government envisages, optimistically, domestic public investment as a key driver of growth in the coming years (the Ministry of Economic Development foresees it rising by one third a year). Growth in domestic private investment will likely remain modest. To boost it substantially, the Government will need to advance the pace of structural reforms. It forecasts the non-oil sector growing at an average rate of about 9.6% a year through 2009.

Parliament approved the state budget for 2007 in autumn 2006. State spending is projected to increase by up to 42% in 2007. A large portion of the increase is to be spent, as in 2006, on public sector wages and on pensions, as well as defense and infrastructure. The share of military spending is also rising rapidly.

The general budget deficit is planned to be 1.5% of GDP in 2007. A major concern is whether the economy has the capacity to absorb this increase. However, due to the lagged impact of fiscal policy, the decision to reduce expenditure when inflation accelerates may be too late to combat the threat of a marked increase in inflation. The announcement of increases in the prices of utility services—such as electricity, gas, water, and public transport—by up to 50% will add considerable pressure to inflation in 2007, expected to be 14%.

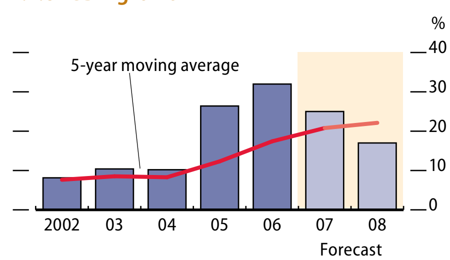
With the substantial increase in oil and gas export revenues, and as import growth is expected to ease, the current account surplus is set to rise to 20.5% of GDP in 2007 and 24.6% in 2008 (Figure 2.2.9). In addition, the authorities have said that there will be no imports of natural

2.2.1 Selected economic indicators

	2007	2008
GDP growth	25.0	17.0
Inflation	14.0	10.0
Current account balance (% of GDP)	20.5	24.6

Source: Staff estimates.

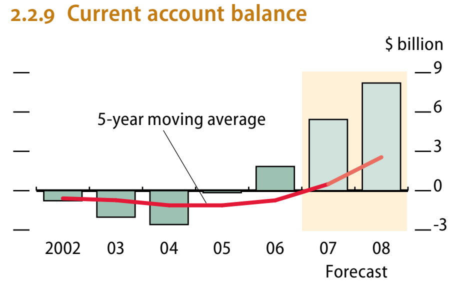
2.2.8 GDP growth



Sources: State Statistical Committee of Azerbaijan; staff estimates.

Click here for figure data

2.2.9 Current account balance



Sources: Ministry of Economic Development; National Bank of Azerbaijan, available: http://www.nba.az, downloaded 30 January 2007; staff estimates.

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gas from Gazprom (a state-owned Russian gas company) in 2007, having rejected an increase in the price of natural gas from that company.

The income balance will likely deteriorate as rising oil and gas profits are repatriated. Moreover, the Russian Government issued a decree in November 2006, which restricts activities of migrant workers in its territory. With over 2 million Azerbaijani migrant workers there, this will likely stanch remittances from the Russian Federation.

While prospects remain positive, GDP growth is expected to trend downward to a less abnormal level, but still rely on oil and gas, and on transit activities. However, large and unfettered increases in government expenditures will likely stoke inflationary pressures if supply-side factors are not tackled—production capacity needs to be enhanced and productivity improved. The Government's key challenge is to create an enabling environment to attract private sector investment to the non-oil sector. To do this, it would need to lift the pace of domestic reform.

The major risk to the bright economic outlook centers on properly managing oil revenues to maintain macroeconomic stability and avoid excessive appreciation of the exchange rate. The latter would damage competitiveness in the non-oil sector and limit its development. A very sharp downturn in oil prices would put pressure on both the budget and the current account, and would constrain the rapid economic transformation needed to reduce unemployment and poverty.

Development challenges

The country is now at a crossroads—the Government recognizes that it has to implement the necessary reforms and policies that would allow the economy to grow after the oil reserves are depleted. Expectations among the local populace are high, as the Government attempts to deliver on its promises for improved standards of living within the context of limited institutional capacity, highly centralized decision making, and an ineffective legal system. The presence of monopolies and corruption pose further challenges. With a severe gap between those living in Baku and the regions, the country faces the risk of immeasurable wealth with limited development.

Kazakhstan

Strong prices for oil and gas, rapid growth of domestic consumption, and a rebound in investment continued to propel the economy. But these very strengths carry within them the seeds of future challenges—immediately, keeping rising inflation in check, and improving banks' risk management of their loan portfolios; further out, diversifying the economy, pushing through structural reforms, enhancing competitiveness, and ensuring more equitable development. These measures, plus fiscal and monetary policy coordination, are needed to ensure sustainable growth.

Economic performance

The economy continued to expand at a high and steady rate in 2006. Soaring minerals prices (i.e., oil, gas, and mining), as well as robust private and public consumption and investment, were the main drivers of 10.6% GDP growth (Figure 2.3.1). The oil sector increased at around 5% year on year, after an average rate of about 14% in 2000–2004. Oil and gas play a crucial role in the economy, although growth in the non-oil sector has been faster over the last couple of years.

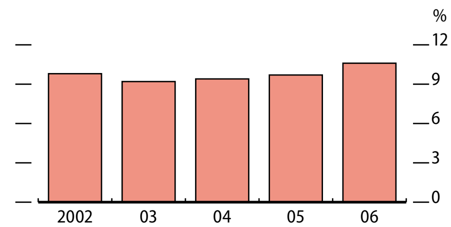
Wage increases and substantial expansion of bank credit fueled private consumption spending. Investment in the resources sector recovered from a recent slowdown and fixed capital investment rose by 18.0% in 2006. Most of this investment consisted of foreign direct investment in minerals, especially in the Kashagan oil and gas field. Fiscal expenditures were augmented to fund increases in minimum wages, pensions, and allowances as well as infrastructure development and social programs. High commodity prices for oil, gas, and metals have significantly raised the value of exports and contributed to raising aggregate demand.

On the supply side, industrial value added rose by 7.0% in 2006 (against 4.6% in 2005), mainly because of mining, industrial processing, and production and distribution of electricity, gas, and water. Construction expanded by 38%, largely in residential dwellings. In manufacturing, real appreciation of the domestic currency, the tenge (T), affected some industries, and capacity constraints in others.

Services, now constituting slightly over 50% of GDP, continued powering ahead at 10.7%, underpinned by a surge in finance (35%), telecommunications (26%), and transport (6.7%). Agricultural production was also buoyant at 8.0%, much higher than the 5-year average of 6%. The sector seems to have benefited from higher productivity arising from investments made in earlier years. Grain and animal husbandry were the two largest contributors to agricultural production growth, picking up by 9.4% and 4.3%, respectively.

Expansionary fiscal policy was another contributor to the surge in demand last year. The budget deficit was T126.2 billion, or 1.3% of GDP (Figure 2.3.2). Rising commodity prices boosted tax revenues from the

2.3.1 GDP growth



Source: Agency of Statistics of the Republic of Kazakhstan.

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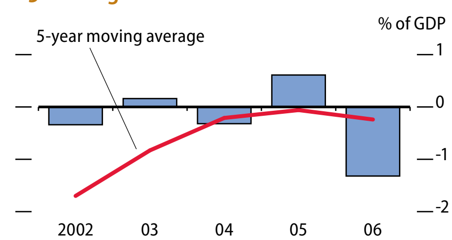
2.3.2 Budget balance



Sources: Agency of Statistics of the Republic of Kazakhstan; Ministry of Finance.

Click here for figure data

resources sector. Fiscal revenues amounted to T1.53 billion in 2006, or 16.1% of GDP, while public expenditures came in at T1.66 billion, or 17.4% of GDP. The major expenditure items were public sector wages and pensions, and public investment programs. High oil prices also helped lift the assets of the National Fund of the Republic of Kazakhstan (NFRK), which rose by $6 billion over the year to $14.7 billion.

Inflation intensified in 2006, and the consumer price index was up by 8.6% for the year (Figure 2.3.3). Several major sources stoked inflationary pressure: a substantial influx of oil revenues; greater public spending on wages and pensions and social programs; and excessive domestic demand largely due to a hefty expansion of credits from commercial banks (up 82%). Structural rigidities that limit competition in certain segments of the market for goods and services as well as capacity limits also contributed to rising inflation.

In its quest to control inflationary pressures, the National Bank of Kazakhstan (NBK) took steps to reduce excess liquidity: it raised the refinancing rate in 2 steps from 8% to 9%; strengthened the minimum bank reserve requirements; issued short-term notes to partly sterilize petrodollar inflows; and allowed nominal appreciation of the tenge. These measures have not been effective as reserve money increased by 131% and broad money surged by 80% in 2006 (Figure 2.3.4). Increasing the refinancing rate may have limited impact because most domestic banks borrow from abroad.

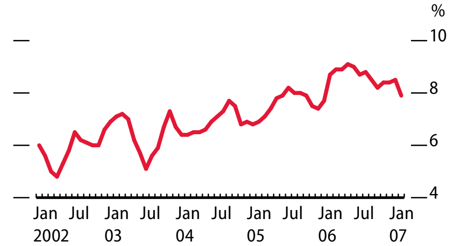
Soaring world commodity prices helped ramp up the value of exports by 35.2% to $38.3 billion in 2006. Crude oil and oil-related products made up just over two thirds of total exports, and metals and metal-related products about one sixth. Imports leaped by 31.7%, largely driven by purchases of machinery and equipment, nonprecious metals, and petrochemical products. The trade surplus increased by 41%. But the deficit on the services, income, and transfers account widened sharply. This stemmed from greater payments for construction, freight, insurance, and information technology services, as well as a near doubling of income payments to foreign direct investors. Nearly all income payments were associated with oil sector development. The current account surplus in 2006 was about $400 million (Figure 2.3.5).

The official reserves at NBK more than doubled to total $19.1 billion at end-2006 (equivalent to 5.4 months of imports of goods and services) while foreign assets of NFRK were $14.1 billion (Figure 2.3.6). The stock of foreign debt stood at $59.6 billion in September 2006 (Figure 2.3.7). Private sector external debt (excluding oil and gas intracompany debt) increased sharply by $11.1 billion to $35.5 billion. The upsurge in private debt in recent years—mainly local bank borrowing for onlending—has largely been in response to the differential between available foreign borrowing rates and domestic lending rates.

The tenge continued to strengthen against the US dollar in 2006, reflecting high export earnings, augmented foreign direct investment, and a surge in private external borrowing. It appreciated by 5.5% over the year, breaking the psychological threshold of T120/$1 in June 2006. It remained below this level in July before NBK intervened and induced a depreciation to around T125–130/$1 (Figure 2.3.8).

Increased credit risk has accompanied the rapid credit growth. Based

2.3.3 Monthly inflation



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 7 March 2007.

Click here for figure data

2.3.4 Money supply (M2) growth

Note: Includes foreign currency deposits.

Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of Kazakhstan, available: http://www.nationalbank.kz; both downloaded on 7 March 2007.

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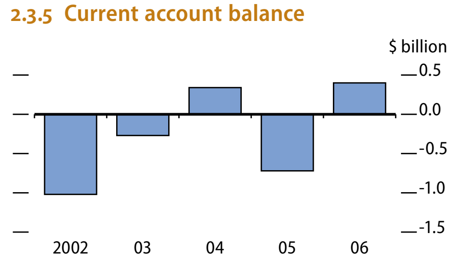
2.3.5 Current account balance



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 28 February 2007.

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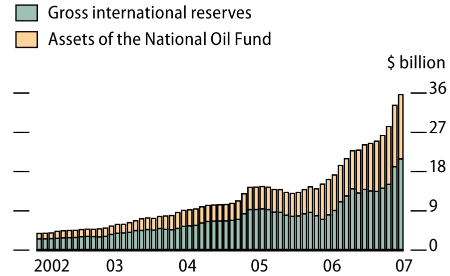
on data from the Agency on Regulation and Supervision of Financial Market and Financial Organizations (AFN), the proportion of bank loans of second-tier banks classified as doubtful loans and bad debts remained extremely high in 2006 at 46%, only down slightly from 48% in 2005. Recognizing the potential problem in the banking sector, NBK and AFN implemented several measures to reduce excessive liquidity and to mitigate risks associated with the deteriorating quality of banks' loan portfolios. The banks' liquidity ratio was increased and asset classification requirement was tightened.

The speed of progress in structural reforms has varied. Robust economic growth seems to have induced some complacency, but new efforts to put Kazakhstan on a more competitive footing and create a favorable environment for business were launched in 2006, including the Kazyna Fund for sustainable development, and Samruk, a new holding company to oversee effective management of state assets (Box 2.3.1). Other measures to improve the business environment included revisions to the law on monopolies and greater powers for the agency regulating them. Substantial progress was made toward joining the World Trade Organization.

2.3.6 Official reserves and assets of the National Oil Fund



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 22 February 2007.

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Economic prospects

The economic outlook remains positive but rests heavily on continued high world commodity prices; a sustained increase in oil and gas and minerals production and export; strong domestic consumption; and continued government commitment to prudent macroeconomic management and market-oriented policy reforms.

GDP is expected to grow at 8.6% and 8.9% in 2007 and 2008, respectively. The major contributors to growth will remain unchanged. The non-oil economy is expected to expand at an average of around 10% a year, driven mainly by key sectors such as construction and services.

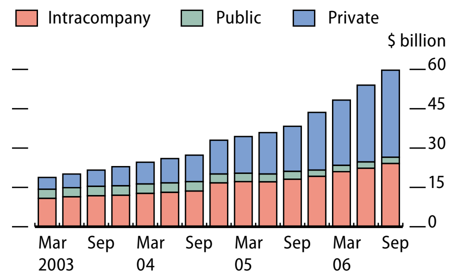
In December 2006, Parliament approved the budget for 2007, and the Government will continue to run an expansionary fiscal policy. Government revenues are expected to be the equivalent of about 17.9% of GDP, and expenditures about 19.2% (the latter an increase of 30%, primarily to fund increases in public sector wages and pensions).

In July 2006, the NFRK was fully integrated into the budgetary system; receipts from all extractive companies will first be accumulated in the NFRK, which will be drawn on as required to fund public investment and government development programs. This will help ensure transparency by demonstrating how the oil fund is being used and separating oil and non-oil transactions.

As part of the Government's initiative to raise the competitiveness of the economy, a variety of tax incentives were introduced to boost the non-oil economy. The VAT rate will be reduced from 15% to 14% in 2007, and a further 1% reduction is scheduled in 2008 and 2009. New tax concessions were introduced to encourage the development of high-value added industries and capital investment. The Government also plans to introduce a flat 10% personal income tax and cut payroll taxes by up to 30% in 2008.

Exports are projected to rise by 15.0% and 9.3% in 2007 and 2008, respectively, largely on higher production from existing oil fields and

2.3.7 External debt



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 22 February 2007.

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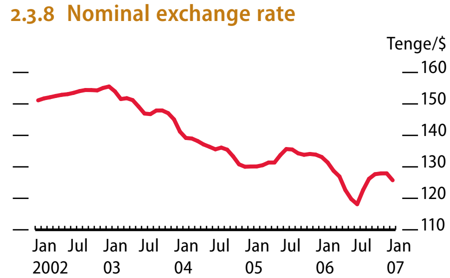
2.3.8 Nominal exchange rate



Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of Kazakhstan, available: http://www.nationalbank.kz, both downloaded 17 March 2007.

Click here for figure data

new production from the Kashagan oil field in 2008 as well as increased export transport capacity through the Baku-Tbilisi-Ceyhan oil pipeline. Non-oil exports are also expected to increase, mainly on metals and metal-related products, as well as grain.

Rising incomes and excess domestic demand will spill over into imports, projected to rise by 20.4% and 13.3%, largely due to purchases of machinery and equipment for ongoing oil investment projects. Strong exports will keep the trade account in surplus. With the deficit rising in services, income, and current transfers as payment outflows grow, the current account is expected to be in deficit, though it will be readily financed by foreign direct investment and external borrowings. The liberalization of capital account on 1 January 2007—full convertibility of the tenge—will likely take some of the upside pressure off the currency as domestic investors seek out overseas investments.

Inflation is put at 8% in 2007 and 2008, despite NBK's efforts, and the inflationary pressures remain the same.

Over the medium term, the hydrocarbons sector will remain a key locomotive of growth. Its share in GDP will increase as large projects in the Kashagan oil field come on stream in 2008. The Government is likely to continue developing the nonextractive sectors, and construction and services will be key drivers of growth. The Government is also expected to carry on implementing measures to improve competitiveness—including developing Samruk and Kazyna.

In view of large oil-related cash inflows in the coming years, risks are associated mainly with an overheating economy. The focus of monetary policy should be to minimize inflationary pressures. Effective monetary and fiscal policy coordination is also needed to damp excess demand. While the rapid expansion of domestic credit demonstrates confidence in the domestic financial system, it also creates a potential risk in terms of the quality of the loan portfolio of local commercial banks. NBK and AFN recognize this risk, though, and are developing appropriate measures.

Development challenges

Diversifying from oil and mining is a high government priority, though the prospects for developing business services around these industries should not be underestimated. The potential for maturing industries (mostly private but some state owned) to invest in neighboring countries is likely to continue. This will provide a natural incentive for improving competition and productivity of domestic companies.

The private banking sector with major investments in the Kyrgyz Republic and the Russian Federation is leading the way. The efforts to develop Almaty as a regional financial center is praiseworthy but activities need to be carefully thought out. Priority needs to be given not only to the development of laws and regulatory procedures but also, more importantly, to upgrading that city's aging physical infrastructure.

Finally, sustainable and balanced development of the Caspian region represents a major challenge as past significant investment has not translated into efficient utilization of the labor force in the region. Regional cooperation is also important to promote cross-border business activities.

2.3.1 Selected economic indicators

	2007	2008
GDP growth	8.6	8.9
Inflation	8.0	8.0
Current account balance (% of GDP)	-1.6	-2.1

Source: Staff estimates.

2.3.1 Kazyna and Samruk

The Kazyna Fund for sustainable development was established in April 2006. Its objectives are to effectively manage state investments, stimulate investment and innovation activities, and increase the economy's competitiveness. Kazyna identifies and implements investment projects in non-extractive sectors through coordinating various institutions involved in national development. Kazyna identifies investment opportunities and local partners as well as provides administrative support and long-term financing in the form of debt and equity.

Samruk was established in early 2006 to improve the government asset-management efficiency and set a new benchmark for corporate governance. It will act as an active shareholder in the following state corporations: KazMunayGaz, KazakhTelekom, Kazakhstan Temir Zholy (railways), KazPost (post), and KEGOC (electricity). The intention is to expand the coverage to include an additional 17 state companies, including Air Astana and Kazmortransflot (shipping).

Such state-driven industrialization may, though, carry risks in terms of favoring certain firms, unless mechanisms are developed for transparency and accountability for these two entities.

Kyrgyz Republic

Nearly 2 years after the Tulip Revolution, political stability remains elusive. Although the new Government made real efforts to maintain macroeconomic stability, tensions between the different power centers have distracted the authorities and hampered structural reforms, including the passage of key economic legislation. In addition, an accident at the Kumtor gold mine, the largest industrial contributor, has slowed growth. The medium-term outlook, though positive, is clouded by governance concerns, a poor business climate, and political uncertainty.

Economic performance

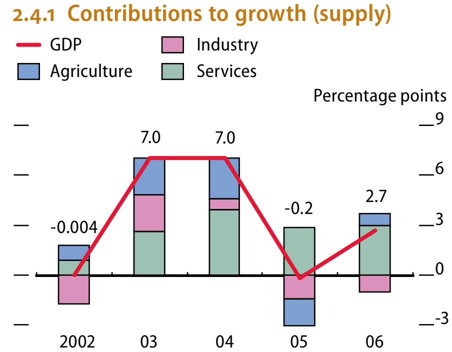
One of the least geographically accessible, and least endowed, countries in Central Asia, the Kyrgyz Republic faces challenging conditions. This partly explains its inadequate physical infrastructure. Recently it has also been buffeted by political turbulence, and almost 2 years after the Tulip Revolution of 2005, political stability has yet to be achieved, which is undermining economic development. A high level of political activity marked 2006, including major protests, government resignation, and two changes of the constitution.

Despite the challenging political environment, the Government managed to maintain macroeconomic stability and keep the Poverty Reduction and Growth Facility (PRGF) program with the International Monetary Fund (IMF) on track. Yet an accident (much less serious than the previous year's) in July at Kumtor—the country's largest gold mine and accounting for about one third of industrial output and 5% of GDP—resulted in gold output falling by about a third, to about 9 tons. This slowed economic growth to 2.7% (Figure 2.4.1), well below the authorities' earlier forecasts of 5–8%. Excluding gold production, GDP grew by about 5%.

On the demand side, private consumption continued to be the driving force of growth, financed by higher incomes (a significant amount of which comes from the shadow economy, with some estimates placing it at up to 60% of recorded GDP); rising workers' remittances from abroad; and higher wages. A positive development was a sizable increase in fixed investment year on year. This stemmed from augmented investment in transport (mainly roads), mining, and construction. Strengthened exports to the traditional destinations of People's Republic of China, Russian Federation, and Kazakhstan provided further impetus.

Sectorally, the drivers were services, construction, and agriculture. Services grew robustly at 8.4%—driven by trade, tourism, catering, and other retail services—and it still has significant room for expansion, given its narrow and low base. Tourism rebounded in 2006 with a record 1 million tourists visiting the Issyk-Kul Lake, the country's main tourist destination. Agriculture—accounting for about a third of the country's GDP and a half of employment—recovered from a fall in output in the previous year, posting a moderate 1.5% expansion. A reported drop

2.4.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic.

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in crop productivity together with an outbreak of contagious animal diseases accounted for the sector's modest rebound in 2006. Industry overall experienced a contraction of about 7.4%, reflecting the drop in gold production, but nongold output was encouraging, bolstered by construction (up 8.5%), garments (19%), and some processing industries. The food-processing industry is still undeveloped, with most agricultural output processed in Kazakhstan and the Russian Federation.

Increases in world oil and commodity prices (partly mitigated by a stronger currency) and price hikes of communal services, as well as higher personal incomes and money supply growth, gently stoked price pressures in 2006. Consumer price inflation rose moderately, averaging 5.6% for the year (Figure 2.4.2). Monetary growth, however, expanded by more than 50% (Figure 2.4.3). This came both from a rise in net foreign assets, as a result of higher remittances and increased foreign capital flows, and from more dynamic activity by the private sector, which was reflected in credit expansion of 48%.

The inflationary impact of this large increase in the money supply was partly softened by continuing exchange rate appreciation, by 8.3% against the US dollar (Figure 2.4.4). This occurred despite interventions by the National Bank of the Kyrgyz Republic (NBKR) in the foreign exchange market throughout the year, which lifted gross international reserves by an estimated $205 million. Overall, however, given the low level of monetization of about 22% of GDP, and with adherence of NBKR to a policy of price stability, the monetary expansion experienced in 2006 is unlikely to lead to significant inflationary risks this year.

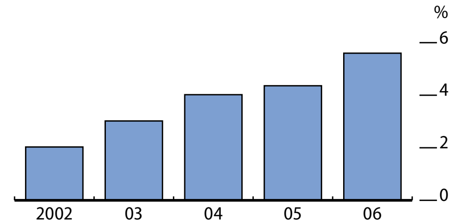
Wages rose by 12% in real terms, with mining seeing the largest gains, but with sizable movements also in public sector wages. Nevertheless, in absolute terms, the average monthly wage (excluding small enterprises) of $76 a month is still low, not much above the government-set minimum consumption budget.

In this low-wage setting, migration has become a growing issue, with estimates of people working abroad varying widely from 0.5 million to 1 million, attracted by the higher incomes in Kazakhstan and the Russian Federation. Increasingly, skilled workers such as doctors and teachers are working abroad, which may lead to a "brain drain" if the issue is not addressed.

According to Ministry of Finance estimates, remittances in 2006 were substantial, in the range of $520 million–750 million, or 20–25% of GDP; the two ex-Soviet countries account for about 80% of the total. Although an important cushion for maintaining living standards and for poverty reduction, migration involves high social costs, as evidenced by the separated families and the children cared for by others than parents.

In 2006, the authorities continued to implement prudent fiscal policy. According to preliminary estimates, all quantitative fiscal performance criteria under the PRGF program were met, including the budget deficit target of 3.2% of GDP (as compared with 4.0% in 2005) (Figure 2.4.5). Although total revenues decreased in relation to GDP (to 22.2% compared with 24.1% in 2005), they increased in nominal terms by about $20 million, mainly as a result of the continued improvements in tax and customs administration and higher import volumes. Revenue performance reflected important tax changes adopted for 2006 to lower

2.4.2 Inflation



Sources: National Statistics Committee of the Kyrgyz Republic; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 4 March 2007.

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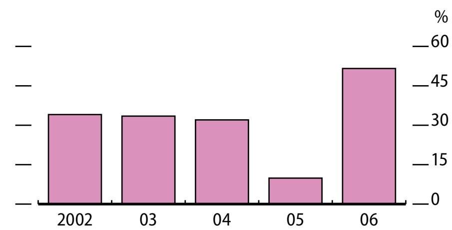
2.4.3 Money supply (M2x) growth



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 28 February 2007.

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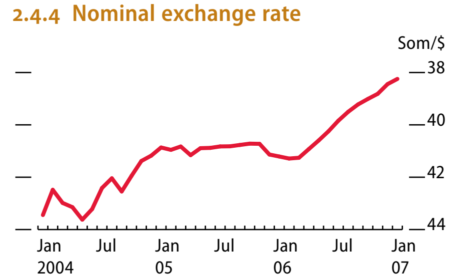
2.4.4 Nominal exchange rate



Sources: International Monetary Fund, *International Financial Statistics* database; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg; both downloaded 4 March 2007.

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the burden on labor and capital, so as to promote private sector growth and to lessen incentives for taking part in the informal economy. These changes included a flat corporate and personal income tax of 10%, value-added tax exemption for agricultural products and imported basic capital goods, a reduction of payroll taxes from 31% to 29%, and abolition of eight inefficient local taxes.

Total expenditures picked up by about 12% in 2006. However, an important shift took place toward greater social outlays and some economic subsidies. Spending on education, health care, and social security all rose by around a quarter (year on year) in nominal terms, and expenditures on utilities and housing by about a third. Public investments stayed tightly constrained (to 3.1% of GDP) due to limitations on external borrowings for debt-sustainability reasons.

The authorities managed to resist parliamentary pressure to lower the retirement age, and are planning to design a comprehensive pension strategy. Preparatory work has also continued on a transition from a four-tier to a two-tier budgetary system, which would comprise the center and local communities (i.e., bypass the provincial and municipal authorities). The aim is to strengthen decision making at the grassroots level. Introducing the new system will face some challenges in the coming years, and will require simultaneous capacity building in local governments.

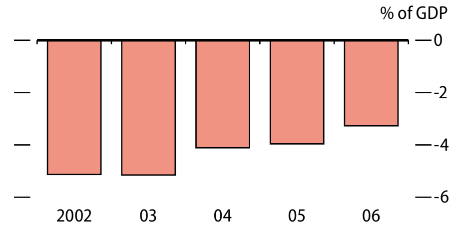
The current account deficit increased sharply (Figure 2.4.6) from 8.3% of GDP in 2005 to an estimated 14.7% in 2006 (or $414 million), mainly due to the widening trade gap (although improvement in the statistical coverage of the significant "shuttle trade" may also have played a part). Imports of investment goods increased as a result of value-added tax exemption of basic capital assets; other factors were rising energy prices, stronger domestic demand, and speculation (e.g., reexports of fuel resources).

Import growth vastly outpaced that of exports, largely due to decreased production of gold at Kumtor. However, gold remains the largest export item (with about one quarter of the total). Nongold exports were underpinned by greater sales of fruit and vegetables, reexported oil products, and construction materials, spurred by robust demand in neighboring countries.

The trade gap was partly offset by inflows of remittances. The current account deficit was financed by a rise in net foreign direct investment (FDI) and by foreign loans. These capital account inflows have allowed a strong buildup of gross official reserves to $817 million at the end of December (Figure 2.4.7). FDI expanded rapidly after the 2005 revolution, and was estimated at $109 million (for the first 9 months of 2006), directed mainly into finance, telecommunications, and food-processing. The largest inflows came from Kazakhstan (30%), UK (19%), Canada (7%), and Turkey (6%).

Though coming down (Figure 2.4.8), the country's external debt is still the highest relative to GDP among the Commonwealth of Independent States countries, at about 70% of GDP. The 2002 and 2005 reschedulings of the country's debt by the Paris Club of official creditors has not alleviated the external debt burden. As part of the debt-reduction strategy, the authorities refrained from borrowing or guaranteeing external loans

2.4.5 Budget balance



Source: National Statistics Committee of the Kyrgyz Republic.

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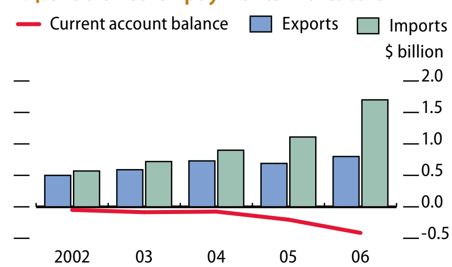
2.4.6 Balance-of-payments indicators



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 30 January 2007.

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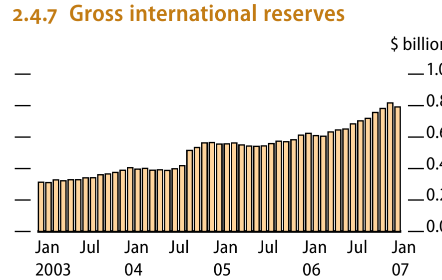
2.4.7 Gross international reserves



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 10 March 2007.

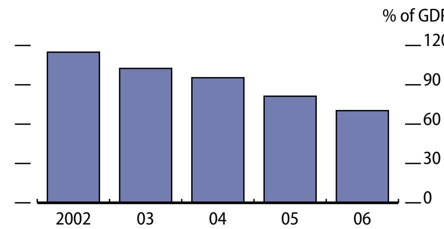
Click here for figure data

on nonconcessional terms. In mid-October 2006, IMF formally declared the country eligible to participate in the enhanced Heavily Indebted Poor Countries initiative. This prompted national debate and general public and political resistance, in view of what was taken to be loss of "face" and erosion of the country's sovereignty. In February 2007, the new Government made a decision not to pursue further interest in the initiative.

Progress on structural reforms has been uneven (Box 2.4.1). Delayed passage of key legislation hampered several government initiatives. For example, the new tax code and regulations on enhancing central bank independence, among others, are still awaiting parliamentary approval. The slow pace of reform largely stems from preoccupation with political issues, but also reflects weakened coordination between the different branches of government in implementing core reforms.

Banking sector reforms remained largely on track, except for the delays with privatization of the Kyrgyz Agricultural Finance Corporation. The central bank made some progress in modernizing the payments system; upgrading its accounting and internal controls; and enhancing bank supervision, with the creation of the Agency for Financial Surveillance and Reporting to assess market, operational, country, and foreign exchange risks. Parliament passed legislation to combat money laundering and terrorism financing. To improve stability in the banking system, the central bank upped the minimum capital requirement for banks to $1.5 million, which is to be raised further to $2.5 million by the end of this year.

2.4.8 External debt



Source: National Statistics Committee of the Kyrgyz Republic.

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Economic prospects

The underlying assumptions for economic projections are as follows: the political situation stabilizes as both the Government and Parliament make headway to resolving the prolonged standoff; key legislation is passed quickly; structural reforms are carried out soon; two promising gold deposits, Jerui and Taldy-Bulak, start mining production; growth stays strong in People's Republic of China, Russian Federation, and Kazakhstan; the price of gold stays favorable; and, importantly, the new Cabinet will demonstrate commitment to announced economic policy goals and reforms.

In this scenario, GDP growth is projected to be around 4% in 2007 and 5% in 2008 (Figure 2.4.9), underpinned by the rebound in Kumtor gold output and the launch of the new mines, and by a sustained increase in nongold industry and services. Needless to say, this scenario will only unfold if the political situation stabilizes, before all else.

With continuing government efforts in improving the tax administration, and greater compliance encouraged by reduced tax rates and some "formalization" of the shadow economy, it is expected that the fiscal balance will remain within limits agreed with IMF—3% of GDP and to be covered by external resources and privatization proceeds. The draft state budget for 2007 envisages a further reduction in the payroll tax from 29% to a medium-term target of 25%, with the associated revenue losses to be offset by the results of greater efforts to curb tax and customs evasion.

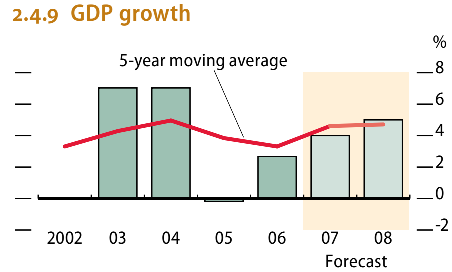
Given the currently low levels of public salaries, and in its efforts to

2.4.1 Selected economic indicators

	2007	2008
GDP growth	4.0	5.0
Inflation	5.0	5.0
Current account balance (% of GDP)	-12.2	-10.7

Source: Staff estimates.

2.4.9 GDP growth



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

Click here for figure data

deliver the promised improvement in living standards, the Government plans in the coming year to lift state sector wages and pensions by a further 10%, and social spending to about 16% of GDP. These moves are to be funded from public services and administration streamlining, and cuts in the number of public officials. Other priorities in the fiscal area include passage of the tax code, further improvements in tax and customs administration, a strengthening of the Large Taxpayers' Unit, enhanced public financial management, and increases in nonagricultural land taxes.

Inflation should remain manageable. Further gains in remittances, as well as the increase in the price of gas imports from Uzbekistan (to $100 per 1,000 cubic meters, from $55 previously) may exert additional price pressures in 2007. However, continued prudence in monetary and fiscal policies is expected to keep inflation at about 5%. The current account deficit is estimated to narrow to around 10–12% of GDP in the next 2 years, aided by an upswing in export volumes. The deficit is to be financed by FDI, other private inflows, and concessional assistance. The domestic currency is set to appreciate in both nominal and real terms in the medium term.

The overriding risk to the economic outlook is continued political uncertainty. Another relates to evolving intentions of the authorities to boost development spending to seek higher rates of investment and employment creation to meet the expectations—still largely unrealized—brought about by the March 2005 revolution.

The second Cabinet, formed in February 2007 after a long bout of political horse-trading, faces a formidable task of stimulating aggregate demand while maintaining high-quality standards for investment, and keeping inflationary pressures in check. This task is exacerbated by the current context of widespread governance issues, and a strong public resistance to foreign-funded aid. Policy stimulation for economic growth is understandable, but entails the risk of excessive state intervention, including through aggressive industrial policy.

2.4.1 Reforming the business environment

The new Government announced improvement of business environment and combating corruption as priority issues. A Country Development Strategy for 2007–2010 was submitted to Parliament for consideration.

The authorities' efforts to stimulate the economy and attract FDI include, for example, cuts in profit and income tax rates and efforts to establish a national development fund. However, tangible advances in improving the investment climate and the business environment, and in fighting corruption, is less evident. Poor public and corporate governance, bureaucratic and administrative constraints, a weak financial sector, and a pliable judiciary remain major obstacles to private business activities.

The country continues to face major challenges in resolving governance weaknesses and stamping out bribery, both of which have diverted scarce resources and depressed productivity growth over the years.

Although the Government has kept the macroeconomic backdrop stable, attracted certain foreign investment over the past year, and announced and initiated wide-ranging reforms, progress in actually pushing through reforms has been slow, again because of political diversions.

Tajikistan

The economy expanded at a robust rate despite higher costs of oil and gas in 2006. Burgeoning remittances spurred demand, as supply shocks from higher oil, utility, and food prices pushed inflation back into two-digit territory. Medium-term economic prospects are promising, if the expansion in externally financed infrastructure projects is supported by the broad reforms of the development strategy, so creating a favorable environment for private sector-led growth.

Economic performance

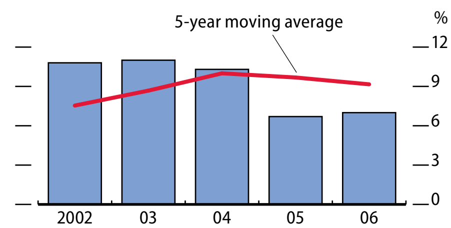
Aluminum and remittances, the mainstays of the economy, continued to drive growth (of 7.0%) in another strong year (Figure 2.5.1). Buoyed by spending of soaring workers' remittances, the subsectors of retail trade, transportation, and finance boosted services, though these inflows were strong disincentives for their recipients to continue working in their traditional occupation, agriculture. The protracted land-reform process and the long-standing issue of reforming cotton farmers' debts compounded the problem. The upshot is that agriculture in 2006 accounted for only 22% of GDP, down from 36% in 1991. Services and industry accounted for 50% and 28% of GDP, respectively.

A pickup in foreign direct investment financing for infrastructure projects and other construction investments, including a boom in private housing, lifted domestic demand, while a surge in aluminum exports (the main export commodity) underpinned strong export growth. More important, aggregate demand was driven by higher private consumption expenditure that, in turn, drew strength from the higher workers' remittances as well as a hike in domestic wages. The number of people finding better work opportunities outside the country and migrating, mainly to the Russian Federation, is on the rise, and the poor especially have benefited from remittances in terms of being able to afford a better standard of living. However, increasing dependence of family members on remittances, alongside sluggish private sector reforms, especially in agriculture, is hampering productivity improvements and risking failure to realize the country's economic potential.

The wave of remittances has not led to growth in the domestic savings or investment rates. Private investment is chronically low at 5.4% of GDP; public capital investment (mainly infrastructure projects) is also low. These levels are insufficient to sustain high growth. Incentives to channel remittances toward private investment are therefore needed to stimulate broader-based growth.

Inflation accelerated in 2006 into double digits after 18 months below that threshold (Figure 2.5.2). The preliminary estimate is a high 11.9%, from 7.1% in 2005. Supply shocks emanating from higher fuel prices and regional food prices, higher private spending, and increases in utility and transport tariffs, all played a part. Core inflation for 2006, as

2.5.1 GDP growth



Source: State Statistical Committee of the Republic of Tajikistan, available: http://www.stat.tj, downloaded 30 January 2007.

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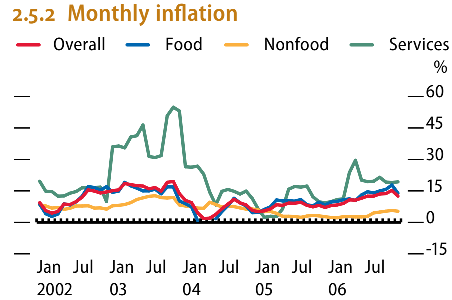
2.5.2 Monthly inflation



Source: National Bank of Tajikistan, available: http://www.nbt.tj/en, downloaded 27 February 2007.

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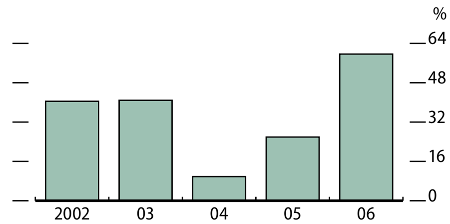
calculated by the National Bank of Tajikistan (NBT, the central bank), which excludes major food items and utilities, was lower at 7.3%. Higher incomes and greater demand for staple foods and lower grain production contributed to a surge in food prices.

NBT signaled its concern about growing inflationary pressures by raising its refinancing rate in steps from 8.5% in August to 12% in December. Prior to this, it had lowered banks' reserve-requirement ratio from 15% to 12% in April in an attempt to reduce the cost of attracting deposits by commercial banks, increasing banks' liquidity. Reserve money grew by about 17%, adding even further to banks' ability to expand credit, helping to push up the money supply by 60% (Figure 2.5.3).

2.5.3 Money supply (M2) growth



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 28 February 2007.

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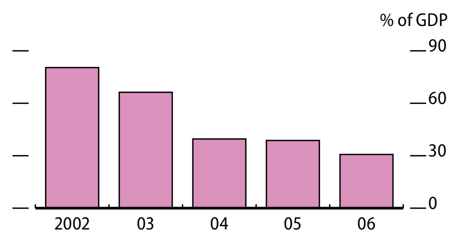
Weak institutional capacity and the underdeveloped nature of the financial sector severely hinder the conduct of monetary policy. NBT started to give more attention to managing growth of reserve money by holding frequent and regular meetings at the operational and policy levels.

The fiscal situation was healthy in 2006, despite elections, as robust economic growth and better tax administration helped revenues exceed their targets and showed a 0.4% of GDP surplus (excluding the foreign-financed public investment program). Measures for enhancing tax collection introduced in 2006 included replacement of the sales tax on aluminum exports with a tax on aluminum processing, a higher value-added tax (VAT) threshold, and elimination of tax exemptions. But fiscal space is still tight. Expenditures on the social sector are rising, albeit from a very low base (8% of GDP in 2006 as against 5.5% in 2002). One way to enlarge the fiscal space is through improvements in expenditure efficiency and revenue measures.

Other sources of resource mobilization hold little promise. Grants are constrained because of heightened global competition for such funds. The scope for higher domestic borrowing is very limited and external borrowing is also restricted as the country is close to the sustainable ceiling for external debt. After a debt-equity swap with the Russian Federation in 2004 and a debt write-off by the International Monetary Fund (IMF) of $99 million in 2006, outstanding external debt was brought down to 31% of GDP at end-2006 (Figure 2.5.4), from 108% in 2000. New borrowings for infrastructure point to the ratio rising again, offering little room for taking on additional debt if the authorities are to keep debt at sustainable levels.

2.5.4 External debt



Source: National Bank of Tajikistan.

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IMF in September 2006 projected the deficit on the trade account for 2006 to be unchanged from the previous year, at $0.5 billion. A higher import bill offset the export gain, reflecting higher oil and gas prices and imports for building the Sangtuda 1 hydropower plant. Exports strengthened mainly because of large price and volume increases for aluminum, even though Tajikistan did not benefit fully from international price rises due to production cost-sharing arrangements. In 2006, remittances leaped to an estimated $1.2 billion from $0.6 billion in 2005. IMF estimated the current account deficit at 4.2% of GDP (3.4% in 2005; Figure 2.5.5).

The somoni depreciated by 6.6% against the US dollar in 2006 (Figure 2.5.6). Despite the strength of the ruble and the euro—the currencies of the country's major trading partners—the somoni recorded a moderate depreciation of 3.8% in real effective terms due to inflation

differentials. As a result, the country retained competitiveness in the European and Russian export markets.

The Government has a wide-ranging reform agenda. It is about to finalize a 10-year national development strategy, and, pursuing that strategy's vision, is drafting a poverty reduction strategy for 2007–2009. The latter strategy identifies as priorities promoting private sector development, strengthening public sector management, and improving health and education services.

The Government had public administration reform high on its agenda in 2006, and it took some steps to put through various measures, including reducing the number of ministries. It also made some headway with key reform measures that represent a fundamental shift for budgeting systems. The Medium-Term Budget Framework, to be pilot tested in 2007, allocates the state budget to sectors on the basis of strategic sector priorities. The central treasury established a cash management unit in April 2006 to enhance the efficiency of budget execution. In July, the Government launched public expenditure tracking surveys, with World Bank support. The authorities continued, slowly, to strengthen tax administration so as to bolster revenues and bring more of the informal economy into the tax net.

In the power sector, the utility attempted to improve payment collection, but low tariffs still make it difficult for it to allocate resources for operations and maintenance. Current steps to tackle the problem include gradually raising electricity tariffs to eliminate large operating losses at the utility and providing a compensatory mechanism for the poor against power hikes.

Banking supervision was further strengthened, and, in line with World Trade Organization commitments and to enhance competition in the sector, the authorities lifted legal restrictions on foreign banks. Minimum capital requirements for banks were increased to $5 million and those that did not comply were merged or reorganized into nonbank credit institutions. Competition among nonbank financial institutions also improved, widening people's access to microcredit.

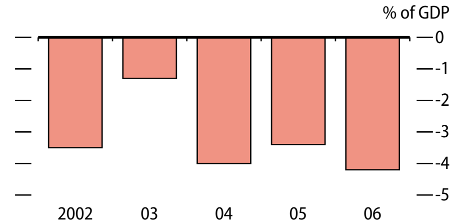
Economic prospects

Mixed price trends are predicted for the main traded commodities. Prices of aluminum have been supported by high demand but are expected to fall. Global prices for cotton, the second-largest export, are expected to rise by 18% cumulatively over the next 2 years. Prices for natural gas from Uzbekistan, the main supplier, were increased to $100 per 1,000 cubic meters in early 2007 and this will have a marked impact on the import bill and domestic prices.

The economy is forecast to expand by 7.5% and 7.1% in 2007 and 2008. Externally funded investments in infrastructure, including energy and transportation, will boost aggregate demand, though the major source of growth will continue to be remittance-backed consumption.

On the supply side, services will continue to be an important source of growth, partly as a spillover from greater investment activity but mainly because of rising consumption. Aluminum production will continue to drive industry's contribution to overall growth, but cotton's

2.5.5 Current account balance



Source: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006.

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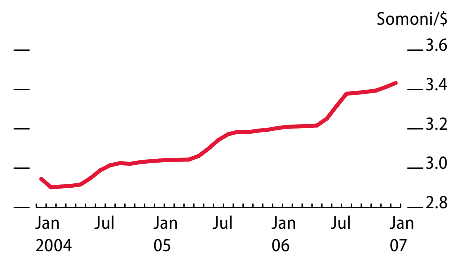
2.5.6 Nominal exchange rate versus US dollar



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 10 March 2007.

Click here for figure data

contribution to agricultural growth is expected to diminish, despite favorable price dynamics. The timely resolution of cotton debt by implementation of the Road Map for the Farm Debt Resolution Strategy will be crucial to releasing agriculture from outmoded central planning-era practices.

To bring inflation back to single digits, NBT will work within the macroeconomic framework of IMF's policy support instrument (under discussion). However, the targets are ambitious and remain vulnerable to shocks in terms of trade, in particular from prices on energy and foodstuffs.

Fiscal policy will adhere to the budget framework that envisages a deficit of 1% of GDP in 2007 and 2008, excluding the externally financed public investment program. Tax reforms are likely to raise revenues but modest domestic borrowing will have to be made to offset the higher spending in the budget for 2007. Spending on infrastructure is set to rise due to cofinancing of large-scale infrastructure projects, while expenditures on social sectors will also increase (but at a slower pace than in 2006).

The size of externally funded projects will rise in the medium term to accommodate the new bilateral loans contracted in 2006 from the People's Republic of China. The loans finance construction of the north-south power transmission line and rehabilitation of the road that connects the major industrial cities of the country with Uzbekistan.

The external debt-to-GDP ratio is set to rise to 46.1% and further to 52.4% of GDP, in 2007 and 2008. The space for new borrowing is very limited as the external debt indicators are now hitting sustainability levels.

2.5.1 Selected economic indicators

	2007	2008
GDP growth	7.5	7.1
Inflation	7.0	5.0
Current account balance (% of GDP)	-4.8	-5.0

Source: Staff estimates.

Development challenges

The main challenge is increasing savings and productive private investment to sustain economic growth. There is hope though, since some recent developments seem to offer scope for greater private investment, including macroeconomic stability; surging remittances; the elimination of high fees on money transfers and so greater remittances channeled through banks; government attempts to attract foreign capital to infrastructure projects; and business regulatory reforms (including cutting much red tape).

Risks remain of course: macroeconomic stability is highly vulnerable to external shocks due to the economy's openness and narrow import dependence; spiraling remittances may create disincentives to work, especially in agriculture; and infrastructure projects may entail higher taxes on the private sector, possibly hurting its willingness to invest.

Turkmenistan

The economy continued to grow rapidly in 2006, but the exact figure for actual growth was likely lower than the official estimate. It is uncertain whether the newly elected president will embrace reform and engage with the international community. The country is heavily dependent on exports of gas and oil, a situation that is likely to continue over the medium term. The key development challenges are to effectively channel oil and gas revenues toward productive investment, implement market-oriented reforms, and rebuild human capital.

Economic performance

The economic situation stayed very healthy in 2006, with GDP growth of over 20% (based on official data). However, official statistics tend to overestimate growth, and actual rate was likely around 9%, according to staff estimates. Either way, growth was sustained by increased gas prices (renegotiated with the Russian Federation) and exports. While the gas and oil industry grew rapidly in 2006, the cotton crop experienced shortfalls for the sixth consecutive year.

Official estimates for inflation are unavailable, but according to figures from the International Monetary Fund, it moderated somewhat from 10.7% in 2005 to 9.0% in 2006 (Figure 2.6.1). This was achieved through wage freezes, cuts in pension payments, price controls, and restrictions on cash withdrawals from banks, resulting in a situation of repressed inflation. A dual exchange rate regime exists: one dollar buys 5,200 manats at the official rate, but 24,000 on the black market.

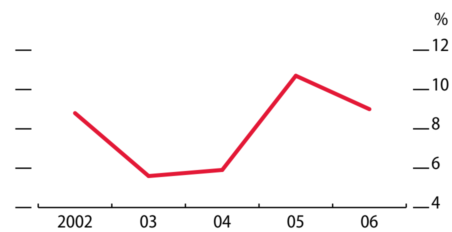
The fiscal surplus edged up from 0.9% of GDP in 2005 to 1.1% (Figure 2.6.2), reportedly due to improved revenue collections, but the non-oil fiscal deficit as a share of non-oil GDP was estimated at 9.5% (2005). There are unofficial reports of a budget contraction, causing the accumulation of public sector wage arrears and education spending cuts. Public sector revenues are largely from oil and gas incomes that are off-budget, and these are managed with other funds directly by the president. These off-budget funds go unreported in the official statistics.

Another large surplus ($1.5 billion) on the trade balance account was estimated due to booming oil and gas export revenues. Although both exports and imports grew in 2006, exports grew much faster, propelled by surges in both volumes and prices of natural gas. The current account surplus was estimated to have grown to 5.7% of GDP (Figure 2.6.3), while gross official international reserves were estimated at $6 billion, equivalent to some 15 months of merchandise imports.

Although there are no official labor statistics, unemployment is likely to be high because many school graduates are unable to find jobs, as opportunities are few and they lack the necessary skills.

A central element of the social protection system remains the provision to the entire population of basic consumer goods and

2.6.1 Inflation



Source: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006.

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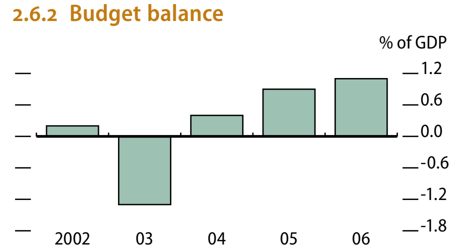
2.6.2 Budget balance



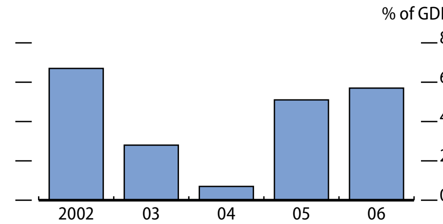
Source: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006.

Click here for figure data

utilities free of charge or at subsidized rates. While this enables people to meet a minimum subsistence level and alleviates income poverty, non-income poverty indicators continue to worsen. Social services, including education and health, have been hit by underfinancing, a shortened compulsory education period, excessive state intervention in school curricula, a reduction in the number of university students, and deteriorating health services. Following the death of President Niyazov in December 2006, the new president has announced some reforms in the social sector.

Key areas for reform that the new Government now needs to carry out include a reduction of state intervention of economic activities, liberalization of the domestic market, a shift from setting agricultural and industrial production targets to market-determined production, liberalization and privatization of the banking sector, and unification of the exchange rate. Oil and gas revenues should be managed transparently and incorporated in the national budget.

2.6.3 Current account balance



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; staff estimates.

Click here for figure data

Economic outlook

While there is currently some uncertainty about the likely direction of the post-Niyazov economy, it will likely maintain its heavy reliance on exports of natural gas and cotton. With potential discovery of new gas fields (though not proven), Turkmenistan would both increase exports of natural gas to the Russian Federation and Ukraine, at the same time as attempting to diversify its gas export destinations, to include, most likely, the People's Republic of China and, possibly, Afghanistan, India, and Pakistan.

Three growth scenarios can be formulated for 2007–2008. With political turmoil, growth could decelerate to 3–4%. Without it, two possibilities emerge. Under a "no reform" scenario, GDP could grow by 8–9% a year on the back of higher exports of natural gas with continued stagnation in agriculture. Under a "with reform" scenario, growth could increase to 10–11%. Reforms in this context would include liberalizing prices, eliminating subsidies, improving the business environment, revamping the education and health sectors, upgrading delivery of other basic services, and developing rural areas.

2.6.1 Selected economic indicators

	2007	2008
GDP growth	8.5	8.5
Inflation	8.0	8.0
Current account balance (% of GDP)	7.4	6.3

Source: Staff estimates.

Uzbekistan

Continued strong—but narrowly based—growth was driven by increased net exports, a pickup in workers' remittances, and productivity gains in agriculture. Major challenges over the medium term are to continue managing monetary and fiscal policies to cope with inflationary pressures, integrate the economy with the rest of the region (and world) via more open trade and investment policies, advance structural reforms in banking, restructure state enterprises, and remove state controls hindering private sector development. Further diversification away from the commodity and energy sectors would also help sustain growth.

Economic performance

The economy has shown robust performance over the past 3 years, and continued to do so in 2006, turning in GDP growth of 7.3% (Figure 2.7.1). Exports, too, showed real vibrancy, fueled by favorable price movements in international commodity markets (Figure 2.7.2), and to a degree, heady growth of noncommodity exports.

Productivity gains in the agriculture sector also contributed. The transformation of large, agricultural cooperatives, *shirkats*, into private farms nearly finished, with 666 of them becoming 74,000 small private farms during the year. This change has improved the incentive structure for production—and so productivity—especially in fruits and vegetables.

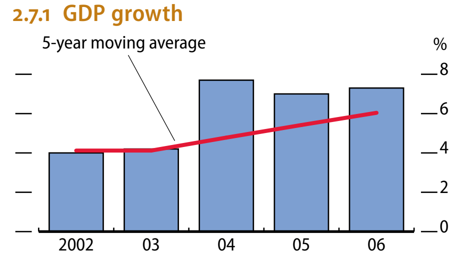
Vigorous export performance coupled with surging remittances has led to a huge current account surplus of 19.5% of GDP (Figure 2.7.3). Gross official reserves are reported to be equivalent to 12 month of imports.

The authorities have maintained a conservative fiscal stance over the past few years. In 2006, the consolidated state budget posted a small surplus at 0.5% of GDP compared to the planned deficit of 3% GDP. Continuation of the conservative external borrowing policy ("zero net borrowing"), has helped improve debt indicators.

Despite their cautious fiscal stance, the authorities have to tackle the risk of higher inflation due to the mounting foreign exchange inflows and rapid reserves accumulation. In 2005, partial sterilization led to a sharp increase in broad money supply of over 50%. In 2006, in order to tighten monetary policy, the central bank conducted sterilization operations using its own paper and treasury bonds. This brought money supply growth down to about 35% (Figure 2.7.4). Nevertheless, controlling money aggregates and associated inflationary pressures remain substantial challenges.

The Government established the Uzbekistan Reconstruction and Development Fund (URDF) in 2006 to absorb the excess liquidity. The total authorized capital for URDF is $1 billion, with $500 million already in place. The establishment of URDF is intended to help buffer the economy from price shocks stemming from volatile foreign exchange inflows. The remaining challenge now is how to channel the fund toward productive investments.

2.7.1 GDP growth



Sources: State Statistical Committee of Uzbekistan; staff estimates.

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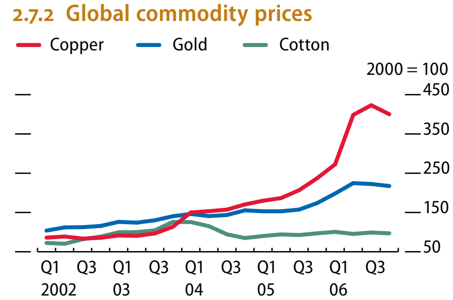
2.7.2 Global commodity prices



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 30 January 2007.

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Official data indicate that consumer price inflation has declined since 2004, with the official inflation rate estimated to be at 6.8% in 2006. However, this is an area for debate, created by the gap between official and International Monetary Fund estimates for consumer price inflation (though the gap reportedly fell slightly in 2006). A technical assistance agreement recently reached between the Government and the Fund should help resolve the issues of inflation estimate.

Fiscal reforms continued in 2006 in the development of a treasury system. Steps were made to establish a consolidated Treasury Single Account for improvements in budget execution efficiency. The Treasury Law took effect in January 2006. A pilot treasury program introduced in 2005 in the region of Samarkand and Tashkent was extended to cover a total of six regions (*oblasts*). Many banking accounts in the commercial banks held by executing budgetary organizations were closed. As a result, this has eliminated the function of these commercial banks in budgetary execution.

Tax reform continued, to ease the burden on enterprises, broaden the base, and strengthen administration. Tax rates for personal income, corporate profits, dividends, and small and medium enterprises were further reduced, yet despite this, total tax receipts rose.

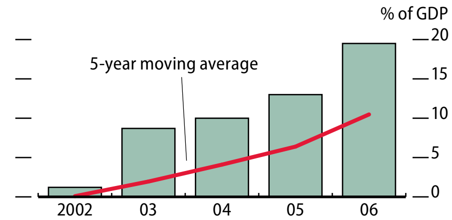
Banking sector reform could be faster, especially in privatizing large stated-owned banks. Total banking deposits are very low, reflecting the population's low confidence in the system. Banking regulations need to be further simplified and clarified to allow banks to operate commercially.

Despite official commitment to currency convertibility, it is reported that enterprises still face difficulty in converting local currency into foreign exchanges for trade. The authorities argued that the current convertibility continued, however, the introduction and implementation of the recently approved antimoney laundering policy imposed additional reporting requirements, and these may on occasions have delayed the process of meeting requests for foreign exchanges.

The Government is developing a comprehensive financial sector reform program. One component is to eliminate the distinction between cash and noncash payments. Currently, the civil code requires all transactions between enterprises to be settled in noncash form (bank transfers). Intended to combat the shadow economy, money laundering, and tax evasion, this requirement may have hit normal business activities.

The trade regime remains restrictive, ostensibly to protect domestic industries. Relatively high effective rates of protection for consumer goods, including discriminatory excise taxes and administrative restrictions on imports, have suppressed imports and encouraged informal trade—partly explaining the large current account surplus.

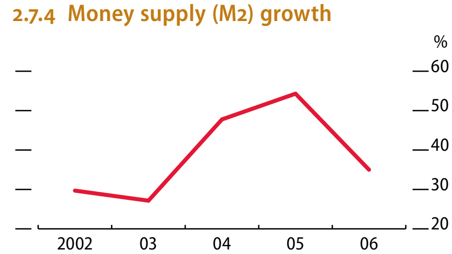
2.7.3 Current account balance



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; *Asian Development Outlook* database; staff estimates.

Click here for figure data

2.7.4 Money supply (M2) growth



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; *Asian Development Outlook* database; staff estimates.

Click here for figure data

Economic prospects

International prices of the country's major exports look favorable for the next couple of years. Following an estimated 7% increase in 2006, the cotton price is expected to continue climbing, reflecting a rundown of global stocks. Gold prices, too, seem set to rise further. In addition, the economy will likely continue enjoying the benefits of higher energy prices, after securing a significant increase in the export price of its gas.

External demand for exports should remain favorable, especially with the likely continued strong economic performance of the Russian Federation and neighboring transition economies. In the absence of major shocks, buoyant exports are seen boosting the economy. Growth in the forecast period is penciled in at over 7%. Trade and current account balances will likely maintain hefty surpluses. The associated increase in foreign exchange reserves will remain a major source of monetary expansion and an inflationary risk.

The Government is targeting inflation of 5–7% this year. The central bank intends to limit broad money supply growth to about 30% through sterilization and use of other indirect monetary instruments. The authorities intend, too, to maintain a prudent fiscal policy to combat inflation. Still, it will be difficult to achieve the inflation target, given the early stage of treasury debt market development, limited sterilization options, and rising pressures from wage and social expenditure increases.

Monetary control is rendered more difficult by exchange rate policy, because the authorities have allowed the domestic currency to depreciate in real terms to stimulate exports. In combating inflation, the Government may want to consider adopting a more flexible foreign exchange rate system, allowing nominal appreciation to resolve the difficulty of monetary control.

Over the medium term, the economy faces many challenges. Certainly, it has yet to realize its full potential. And to sustain current rates of expansion, more investment, especially from the private sector, will be required. The economy also needs to diversify to create the jobs needed by its relatively young and growing population.

Structural reforms are crucial, and will require the Government's continuing to open up the economy and integrate it with the rest of the world. This should introduce more competition, and improve productivity and efficiency. It is also crucial to establish a stable environment in which to attract investments from all possible sources. Banking reforms need to be accelerated, since the economy's full potential will only be achieved when banking mobilizes domestic savings and puts them to productive use. In this regard, it is crucial to build, and then keep, the trust of the population in the system.

The current favorable economic environment provides an opportunity to push through structural reforms. However, the same environment could also lead to a sense of complacency among policy makers. Commitment to economic reforms and transition to a market-based economy are crucial to sustaining the country's long-term development.

The Government's poverty strategy aims to reduce the poverty rate to 20% by 2010, to meet the Millennium Development Goals. Expected strong export growth may well help achieve the objective, but growth should shift from overdependence on external demand to investment. Both the quantity and quality of investments need to be raised, since public investment cannot do the job alone. Both domestic and foreign private investment will need to be welcomed.

The availability and quality of economic data provides a sound basis for economic management. Further improvements are necessary in access to and quality of the data. Improved economic data compilation and analysis will help provide a reliable picture of underlying performance.

2.7.1 Selected economic indicators

	2007	2008
GDP growth	7.4	7.1
Inflation	9.0	8.2
Current account balance (% of GDP)	10.0	9.2

Source: Staff estimates.