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Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries

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the European II Department of the IMF
in consultation with the staffs of the
Asian Development Bank and the
European Bank for Reconstruction and Development

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Executive Summary

Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan are the poorest countries in the CIS, and their transition to market-based economies over the past decade has been extremely difficult. In many cases, the economic disruptions created by the break-up of the former Soviet Union were compounded by diverse shocks, including armed conflicts and massive changes in the terms of trade. For the group as a whole, real GDP fell by an average of almost 50 percent between 1990 and 1995, and poverty and inequality increased substantially. Since then, growth has resumed, but both financial and physical (life expectancy and nutritional status) indicators of living standards remain depressed or may have deteriorated in some countries. In several cases, a large volume of external debt has also been accumulated, undermining prospects for growth and poverty reduction.

Despite this alarming background, a great deal has been accomplished over the decade of transition in these poor countries. In most cases, important gains have been made in macroeconomic stability, fiscal consolidation, privatization and liberalization of economic activity, and development of the basic institutions required for the efficient functioning of market economies.

The challenge for these seven countries is to intensify their reform efforts, which, in the past, have typically been very uneven. This uncertain commitment to reform implementation has constrained external assistance and investment. Public policies also need to be oriented much more forcefully toward poverty reduction, both through reforms that increase economic opportunities, as well as more efficient and targeted allocation of public resources.

The countries differ significantly in terms of resource endowments and the progress achieved in their economic transformation, and their strategies and external assistance need to be tailored to individual country circumstances. All seven countries have recently undertaken to prepare Poverty Reduction Strategies that would provide the basic framework for their policy efforts and for donor assistance in the coming years. In general, moving forward requires that the governments consolidate macroeconomic stability and tackle difficult structural and institutional reforms, notably to address issues in the areas of public expenditures and social policies, utility and financial sectors and public administration. Finally, there are serious regional issues that currently constrain trade and economic activity, and can only be effectively addressed through improved cooperation among the countries.

To the extent these countries move forward resolutely on their varying agendas for adjustment and structural reform, the international community can and should do more to help through technical assistance, grants and other concessional financial support, and in some cases debt relief. There is also much to be gained from improved coordination in the international community's approach to these countries. It is with these considerations in mind that the IFIs propose a new initiative to encourage policy implementation by the countries, to enhance regional cooperation among them, to focus the attention of the international community on the plight of these countries and to improve coordination among donors.

I. INTRODUCTION

1. Economic transition has been more arduous than originally expected in most of the former socialist countries, especially for seven very poor countries in the Commonwealth of Independent States (CIS 7).[1] In these countries, output contraction and the related growth of poverty were much greater and of longer duration than initially expected, while rapid growth in the external indebtedness of some of them now threatens to undermine the economic recovery that is finally under way.[2]

2. These countries' prospects have long depended on inflows of concessional aid and FDI that were far from assured. In the period following September 11, the global slowdown and the countries' proximity to the military conflict in Afghanistan have further clouded their economic outlook. The direct impact of the Afghanistan conflict on the CIS 7 has not been severe; nevertheless, heightened investor uncertainty about political and security risks will likely dampen investment and trade flows to these countries in the near term and make it more difficult for them to solve their poverty, growth and debt sustainability problems.

3. This paper provides background information on the CIS 7, including a summary of key economic assumptions underlying ongoing IFI operations in these countries, and updates the debt sustainability analyses for five countries with relatively high external debt burdens. It aims to identify a set of key reform priorities in each country that could, if implemented consistently, help to underpin and sustain economic growth, and thus contribute to durable poverty reduction.

4. A companion paper presents proposals for a new initiative of the Fund, Bank, EBRD and AsDB aimed at bolstering the reform and growth prospects of the low-income CIS countries through a collaborative effort by all parties concerned. These two papers therefore provide a starting point for the joint IFI-sponsored conference in February 2002 on the economic prospects and policies of the CIS 7.

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[1] Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan are all IDA-eligible. (All but Uzbekistan are also PRGF-eligible.) The CIS 5 refers to the relatively heavily indebted countries in this list (all except Azerbaijan and Uzbekistan). In U.S. dollar terms, these countries are among the poorest in the world, with incomes per capita in 2000 ranging from $158 in Tajikistan to $652 in Azerbaijan.

[2] For example see IMF and World Bank, *Republic of Armenia, Georgia, Kyrgyz Republic, Republic of Moldova, and Republic of Tajikistan—External Debt and Fiscal Sustainability,* February 6, 2001, http://www.imf.org/external/np/eu2/2001/edebt/eng/index.htm.

II. TEN YEARS OF TRANSITION—ACHIEVEMENTS AND REMAINING CHALLENGES

A. The Record of Macroeconomic Stabilization and Structural Reform

The Role of Initial Conditions

5. **The transition process in the CIS countries has been more difficult than initially expected, particularly for those countries that are relatively poor in natural resources.** The increase in energy import prices to world levels was a massive terms-of-trade shock for the net energy importers among these countries, severely affecting production and welfare, given their inefficient energy consumption patterns. As energy and transportation costs reached market levels, the extreme specialization of industry in the Soviet economy—based on massive investments in power generation, irrigation and transport infrastructure—made many existing industries hopelessly uncompetitive. The emphasis of Soviet planners on domestic production also left producers poorly placed to find and exploit export opportunities. As a result, the structure of these countries' merchandise exports has been shifting towards lower value added products, such as primary commodities and agricultural goods.

6. **In addition, independence meant the loss to most of these countries of significant fiscal and quasi-fiscal subsidies.** Apart from Azerbaijan and Uzbekistan, all of these countries are relatively poor in natural resources, in particular energy, so the adjustment to world prices has been estimated to be equivalent to terms-of-trade shocks of up to 15 percent of GDP.[3] Large fiscal deficits emerged that initially could only be financed by nonpayment of some obligations, borrowing from Russia and other external creditors, or central bank credits. Most of the CIS 7 countries resorted to a combination of all these. Heavy central bank borrowing led to high, and in a few cases hyperinflation. To halt galloping inflation, it was essential to bring fiscal policy under control while creating modern institutions (tax administration, federal treasury, central bank) from scratch.

7. **Notwithstanding these shocks, much has been achieved over the past decade in terms of the transition to market economies.** Price and—in most countries—exchange rate liberalization were achieved early on, and were matched by considerable success in making budgets more comprehensive, and then financeable. Fiscal deficits and resort to monetary financing were gradually reduced, leading to much lower inflation. Although the fall in output was more severe than expected at the start, in recent years growth has rebounded robustly in most countries, while inflation has remained at low levels for the most part (Figures 1–3). In addition to macroeconomic stability, these countries have made significant progress in terms of structural and institutional reforms.

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[3] At the same time, new inflows of foreign aid fell far short of these amounts (see below).

Figure 1. Real GDP During Transition
(1989 = 100)

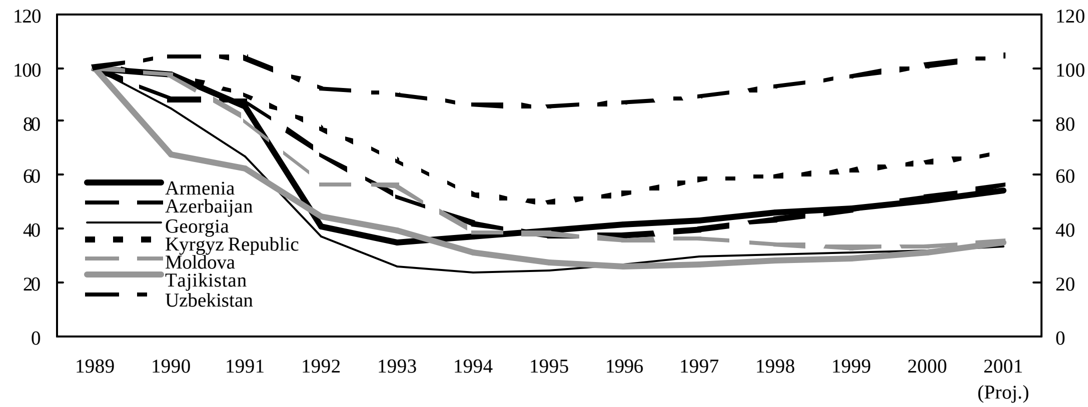


Figure 2. Inflation During Transition
(In percent)

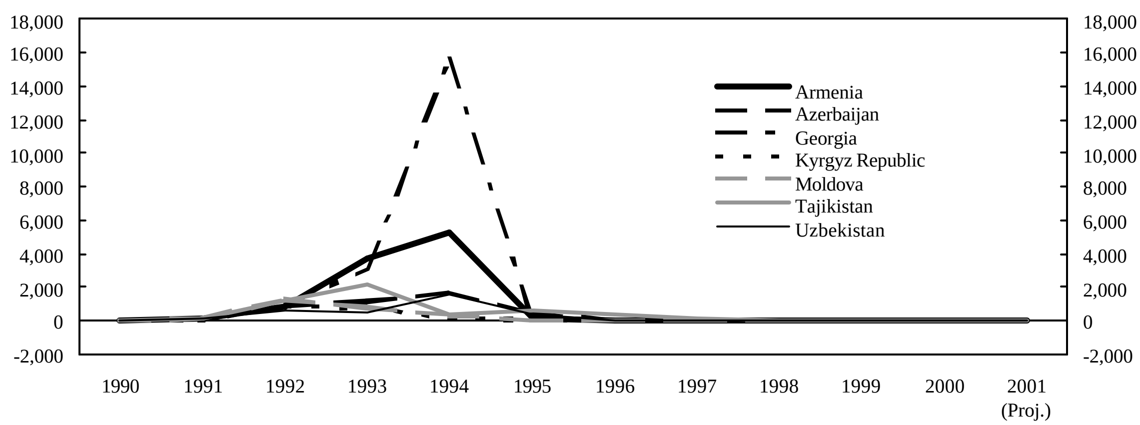
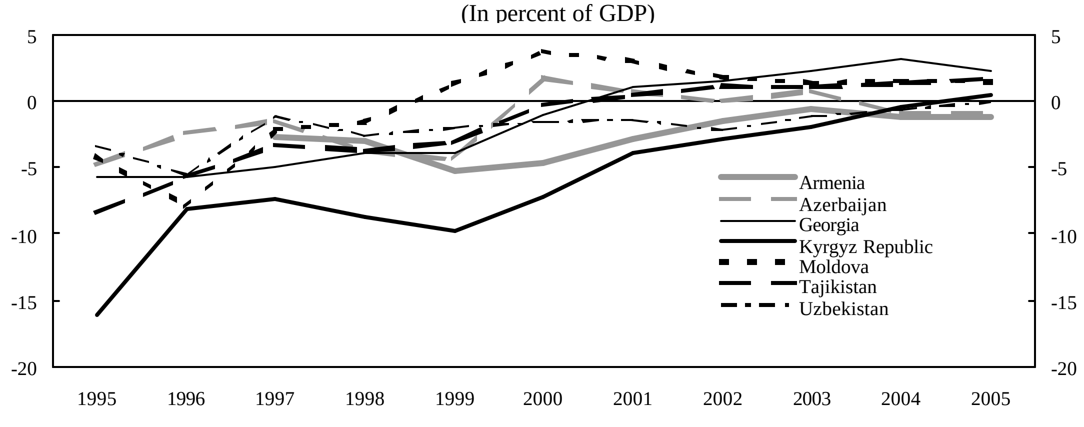


Figure 3. Primary Fiscal Balance
(In percent of GDP)



8. **The CIS 7 economies have now begun to recover.** During the latter half of the 1990s, real GDP growth averaged 4 percent per annum, well above the average for the CIS as a whole, though Moldova tended to lag behind the others.[4] Much of the strong growth performance since 1999 – including average real growth of around 6 percent in 2001 – can be attributed to the robust economic activity in Russia and Ukraine (Tables 1 and 2).

9. **Arguably, economic recovery could have started sooner—and proceeded more rapidly—had countries pursued structural and institutional reforms more forcefully and consistently.** The halting pace of policy implementation inhibited donor support and foreign investment. While significant progress was made toward macro stability, and many important institutional and structural reforms were accomplished (such as small and medium-scale privatization or the establishment of state treasuries), a number of fundamental reforms necessary to limit the role of the state and to make the institutions of a market economy function efficiently have been lagging. Corporate governance and investor protection are wanting, and the business climate remains mixed at best. Corruption and weak administrative capacity are problems in all these countries. Banking sectors have not been able to intermediate between savers and investors, and major distortions remain in key productive sectors such as energy and agriculture.

B. Poverty in the Low-Income CIS Countries

10. **Poverty in the CIS 7 has increased significantly in the past decade.[5]** A sizeable part of the population now lives in absolute poverty. Physical indicators of poverty—such as malnutrition—have steadily worsened, and the social safety net has deteriorated greatly, mainly because of the limited resources available for poverty reduction.

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[4] At an annual average of 4.7 percent, growth in Tajikistan would not be an exception if measured since 1997, the final year of the civil war. Also there are unresolved data issues in the case of Uzbekistan.

[5] This section draws on World Bank, *Poverty and Inequality in Europe and Central Asia*, (2000), individual PRSPs and country poverty assessments. Pre-1991 data are from M. Alexeev, and C. Gaddy, "Trends in Wage and Income Distribution under Gorbachev: Analysis of New Soviet Data," Berkeley-Duke Occasional Paper No. 25 (February 1991). Comprehensive data for Uzbekistan, are not available. The limited available data are taken from a pilot World Bank Living Standards Assessment Study that covered only Fergana Oblast—one of Uzbekistan's wealthier regions—suggesting that comprehensive poverty indicators would be worse.

Table 1. Gross Domestic Product, 1990-2001

	Real GDP Growth			2000		
	1990-95 Average In percent	1996-2000 Average In percent	2001 Forecast In percent	Nominal GDP per Capita In U.S. dollars	PPP GDP per Capita In U.S. dollars	Real GDP Index 1989=100
Armenia	-11.5	5.2	7.5	505	2,713	51
Azerbaijan	-14.9	7.1	8.5	652	2,602	52
Georgia	-19.7	5.8	3.9	567	4,285	32
Kyrgyz Republic	-10.8	5.6	5.0	263	2,524	65
Moldova	-13.9	-2.5	5.0	360	1,916	33
Tajikistan	-18.9	2.9	10.0	158	1,082	31
Uzbekistan	-2.5	3.3	3.8	561	2,363	101
Average CIS7 (unweighted)	-13.2	3.9	6.2	438	2,498	52
Russia	-8.5	1.3	5.8	1,720	7,474	61
CIS (unweighted)	-11.3	3.3	6.6	738	4,165	…

Source: WEO.

Table 2. Inflation, 1990 - 2001
(In percent)

	1990-95 Average	1996-2000 Average	2001 Forecast
Armenia	1,685.4	8.3	3.4
Azerbaijan	705.2	3.2	2.5
Georgia	3,310.6	14.6	4.8
Kyrgyz Republic	324.4	24.1	9.1
Moldova	432.0	22.7	12.8
Tajikistan	738.2	122.0	38.5
Uzbekistan	527.7	41.6	27.1
Average CIS7(unweighted)	1,103.4	33.8	14.0
Russia	536.0	39.4	21.6
CIS (unweighted)	1,028.4	56.7	18.8

Source: WEO.

11. **Poverty levels vary significantly across the CIS 7, and between regions within each country.**[6] While definitive information is not available, existing data indicate that, using the international poverty line of $2.15 per day per person,[7] poverty is lower in Azerbaijan, Georgia and Uzbekistan than in the other four countries (Table 3). However, national poverty lines suggest that more than half of the population in all seven countries lived in poverty in 1999. Social infrastructure, access to health care and the quality of education are especially poor in villages and small towns.

Table 3. Income-Based Poverty Indicators
(percent of population)

Country	Below the national poverty line[1]		Below $2.15 per capita per day
	1988	1999	1999
Armenia	18	55	44
Azerbaijan[2]	33	62	24
Georgia	16	60	19
Kyrgyz Rep.	37	55	49
Moldova	13	80	55
Tajikistan	59	83	68
Uzbekistan	45	n.a.	22

Source: World Bank staff estimates
[1]The national poverty line is defined as percentage of population earning a per capita income lower than the minimum consumption basket. For 1988, a per capita income of 75 rubles per month was used as the conventional poverty line.
[2]For 1995, and consumption based.

12. **In addition, income inequality has increased sharply in the CIS 7,** with the income-based Gini coefficients doubling from 0.2–0.3 to 0.4–0.6 since 1990 (Figure 4). Consumption-measured inequality is lower, suggesting that the poor may be dissaving.[8] Armenia stands out as having the highest income inequality.

13. **Some social groups are more vulnerable to poverty than others**, due to their limited earning potential, dependency, and marginalization. Internally displaced persons

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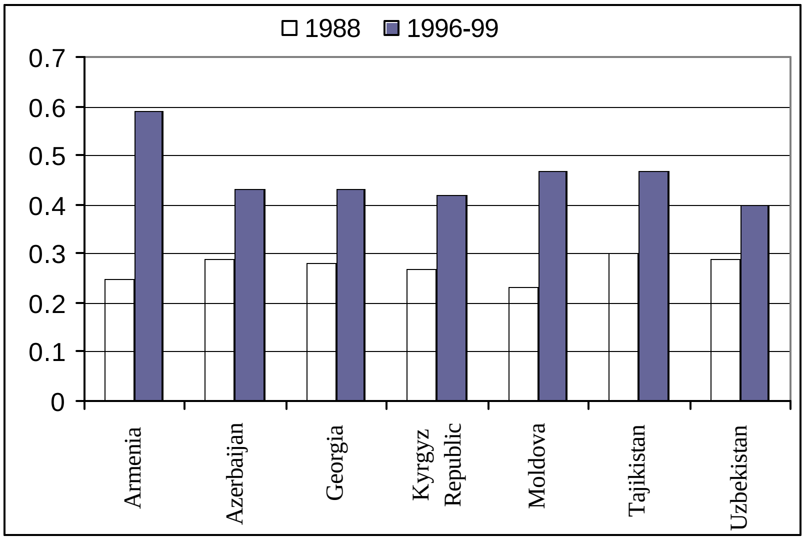
[6] Given the output recovery, preliminary data suggest that the spread of poverty may have begun to be reversed—albeit modestly—during 1999–2001.

[7] To insure a consistent cross-country comparison a single international poverty line is used. Normally, $1 line is commonly used to denote absolute poverty in low-income countries. However, the $2.15 per capita per annum line used here is substantiated by much higher heating and clothing needs of the households in the CIS countries.

[8] Measurement error (underreporting) could also contribute to this discrepancy.

(IDPs) and refugees are one such group, both in the Caucasus and in Tajikistan. Azerbaijan has over 0.5 million refugees, and in the late 1990s, Georgia allocated over 20 percent of its development budget to support IDPs. Other vulnerable groups are the elderly, children, and families with many children.

Figure 4. Income based Gini coefficients[1]



[1]The 1996–99 indicators for Azerbaijan and Uzbekistan are consumption based.

Source: World Bank staff estimates

14. **While the growth in poverty is mainly attributable to the collapse in output, other factors have played a role.** Inflation and depreciation have disproportionately affected the poor, including by undermining the real value of pensions and savings deposits. Government efforts to provide social protection were constrained by the collapse of fiscal systems and the limited ability of governments to target spending.

C. External Debt

Origins of the Debt Problem

15. **As the Soviet Union broke up, output collapsed and enterprise arrears built up in the early 1990s.** Fearing social upheaval, the authorities of these countries were unwilling or unable to introduce corrective measures quickly. In particular, they did not let domestic energy prices move to world levels, despite higher energy import costs, and did not impose hard budget constraints on state enterprises to promote reforms and encourage efficient energy consumption. As energy sector payments arrears accumulated rapidly, the authorities in some countries might have assumed that–as in the Soviet period–they would not be expected to settle these obligations. In several cases, these arrears were ultimately

consolidated into official debt, owed particularly to Russia and Turkmenistan.[9] In several countries, arrears connected to inter-governmental trade agreements that accumulated on central bank correspondent accounts during 1991–93 were also converted to official government debt to Russia.

16. **A mixed record of economic reforms also contributed to the accumulation of external debt, particularly to multilateral creditors.**[10] Despite delays, financial stabilization was generally achieved, but slow progress in implementing priority structural reforms—often hindered by lack of ownership and the influence of vested interests—undermined sustainability of this achievement and the recovery of growth. With only partial success, the IFIs and others have increasingly urged institutional development—including attention to corruption and governance problems—to promote private investment.

17. **These countries have been hit by repeated shocks as well,** including the break-up of the U.S.S.R., military conflicts, drought, rising energy prices, the Russian financial crisis of 1998, the recent decline in commodity prices and the global economic slowdown, and the indirect effects of September 11. In retrospect, the Russia crisis highlighted a feature of early stabilization programs—the exchange rate/stabilization strategy—that was understood to be a risk from the start. Nominal exchange rate stability helped to boost confidence in the economic policies of countries that were in the midst of high or even hyperinflation.[11] *Ex post*, however, sharp depreciations vis-à-vis the dollar in all of these countries (save Armenia) resulted in a dramatic deterioration of the debt ratios in the CIS 5, while the much sharper depreciation of the ruble made the exports of all seven less competitive.

18. **In retrospect, the international community, including the IFIs, initially had unrealistic expectations about the speed with which the economic transition from communism and recovery of growth and living standards could be achieved.** While true for all of the transition countries of Central and Eastern Europe, this was particularly the case for these newly independent, landlocked and poorly endowed countries. While the depth of the output collapse was unprecedented a considerable part of it was probably unavoidable.

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[9] External debt that arose from arrears on energy imports was estimated at end-2000 at 9 percent of the total, but comprised almost 40 percent of the bilateral debt owed to the CIS creditors

[10] By end-2000, the IFIs together held over 50 percent of the external public debt of the five relatively more indebted countries.

[11] Indeed, it was expected that successful transition countries would experience some real appreciation over time, reflecting the perception that exchange rates had overshot at the start of transition. See *External Debt and Fiscal Sustainability* (2001), op. cit.

III. Policy Priorities to Reduce Poverty and Promote Growth

A. PRSPs and Country Ownership of the Reform Agenda

19. **The rise in poverty levels has led the CIS countries to critically re-examine their policies and to embrace the Poverty Reduction Strategy Paper (PRSP)** as a new and more efficient way to build domestic ownership of reforms and to mobilize external resources for poverty reduction.[12] Currently these countries are formulating national poverty reduction strategies that promise to improve the poverty impact of public expenditures, including those financed by external partners. Six among the CIS 7 countries have completed Interim PRSPs and are planning to produce full PRSPs by late 2002; Uzbekistan is currently completing an Interim PRSP. These strategies vary from country to country, but all focus on understanding the nature of poverty and its causes, identifying obstacles to sustainable pro-poor growth and ascertaining how policies and programs can be directed to reduce poverty.

20. **The starting point in formulating the PRSPs has been to strengthen the poverty monitoring procedures,** by recognizing both monetary and non-monetary dimensions of poverty, such as education and health status, vulnerability to shocks, and disempowerment, and by investigating the incidence of poverty by gender, region and ethnic group. On the basis of available—admittedly weak—data and monitoring systems, the CIS7 countries have begun to analyze the poverty impact of their policies and of exogenous shocks, and to formulate approaches to increase the pro-poor focus of these policies.

B. The Challenge of Poverty Reduction

21. **In order to make better progress in poverty reduction, these countries need to tackle a broad agenda of fiscal, structural, social and institutional reforms**. Sustained rapid economic growth is the basic requirement for poverty reduction, creating economic opportunity and permitting action to address both income and non-income dimensions of poverty.

22. **Loss-making enterprises and some local governments have tended to seek ways to escape hard budget constraints** (Box 1). Looking ahead, it will take political resolve to ensure that the fiscal adjustment of the past decade is consolidated and extended beyond the central government budgets to control various contingent liabilities, and thereby create a level playing field for private investment (Box 2). The records of Poland, China and other successful transition countries suggest that rapid economic growth is essential to maintain political commitment. Sustained growth in turn will require deeper structural reforms at home and enhanced economic cooperation at a regional level.

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[12] World Bank, *World Development Report 2000/01* and *PRSP Sourcebook*, 2001.

Box 1: Quasi-fiscal activities in the CIS7

Quasi-fiscal activities (QFAs) are a major problem in these countries. They divert public resources in an inefficient and non-transparent manner, undermining accountability and economic growth. Although in most countries budget deficits have been brought under control in recent years, on-budget subsidies have often been replaced with quasi-fiscal financing reflecting the unwillingness and/or inability of governments to deny support to perceived structurally or socially important enterprises, regardless of their performance. While it is difficult to determine the size of the QFAs in the CIS7, staff estimates suggest that they are massive, ranging from 5–10 percent of GDP in Moldova, Tajikistan and Kyrgyz Republic, to over 20 percent of GDP in Azerbaijan.

QFAs take two main forms: **explicit**, where governments issue a contract (e.g., a guarantee or insurance policy) to cover defined economic activities, and **implicit**, where economic agents expect (say, based on oral promises or past experience) that the government will compensate ex post for losses through non-enforcement of contract discipline, tolerance of arrears, directed credits, exchange rate guarantees, provision of inputs at less than fair market costs, protection of monopoly positions, and so forth.[1] In the early years of transition, explicit guarantees were a substantive problem, especially in Azerbaijan, Georgia, Moldova, and Kyrgyz Republic, where some government agencies could issue guarantees and comfort letters without guarantee fees and with weak (if any) collateral, even without notifying the Ministry of Finance. As losses on guarantees piled up (in Kyrgyz Republic and Moldova over ¾ of government guarantees were called), governments largely brought these operations to a close, though they remain high in Moldova and Uzbekistan.

The lion's share of QFAs is implicit, especially those flowing through the public utilities to enterprises and households. Three sectors have been the focal points of these activities: energy (by far the largest), water and housing.[2] The **energy** channel has been the most widely used to support loss-making enterprises, even in the net energy exporters (Azerbaijan, Uzbekistan). Underpricing of gas and power and non-enforcement of cash collection of tariff result in over-consumption (thus energy efficiency is very low), under-investment in the utility sector (e.g., the power grid in Kyrgyz Republic and Tajikistan is disintegrating), and very low spending on operations and maintenance. The hidden subsidization in the **water** sector, in particular for irrigation, is particularly acute in Central Asia. Another important subsidy is cheap social **housing**, especially in Armenia, Moldova, and Georgia.

While hidden subsidies are typically rationalized by social concerns (raising the utility tariffs to cost recovery levels would "hurt the poor"), they are untargeted and, as such, waste scarce public resources. Worse, large loss-making enterprises are typically among the largest delinquents on payments to power utilities, effectively discriminating against the new small and medium-sized businesses which have been the engines of growth and labor absorption elsewhere. Hidden subsidies and non-enforcement of collections stimulate overuse or waste of subsidized resources, reduce incentives for enterprise restructuring, and inhibit financial sector development (bank lending to enterprises can be trivial in comparison with financing through arrears). Because they are non-transparent, quasi-fiscal activities fuel corruption, asset stripping and capital flight, and are a prime tool for anti-poor redistribution of income and wealth.

Local governments are an important link in the chain of non-payments, particularly in Moldova and Uzbekistan, but also in Armenia, Georgia, and Kyrgyz Republic. The bulk of budgetary arrears arise at the local level, where local governments typically are less transparent than at the center. Despite the adoption in some cases of legal frameworks supportive of hard budget constraints for local governments, the latter often succeed in negotiating "special regimes" with the central government and continue to run arrears on social expenditures.

Nascent financial sectors of these countries also harbor substantial QFAs, such as the inflexible exchange regime and directed (subsidized) credit, in Uzbekistan. Fiscal risk may arise from commercial banking systems, since in most CIS 7 countries they have shrunk substantially after the Russian default, and remains very shallow. Attempts in revitalize the financial systems should go hand in hand with strengthening their supervision regimes and allowing foreign entry.

Both ownership and political will is necessary in order to reduce QFAs, and transparency and accountability are important ways to build ownership. Thus, while the CIS7 have made progress in modernizing their budget systems, much remains to be done to ensure that budgets are comprehensive, realistic and subject to independent ex post audits. As these long-term reforms take root, the pressure for QFAs can be expected to wane.

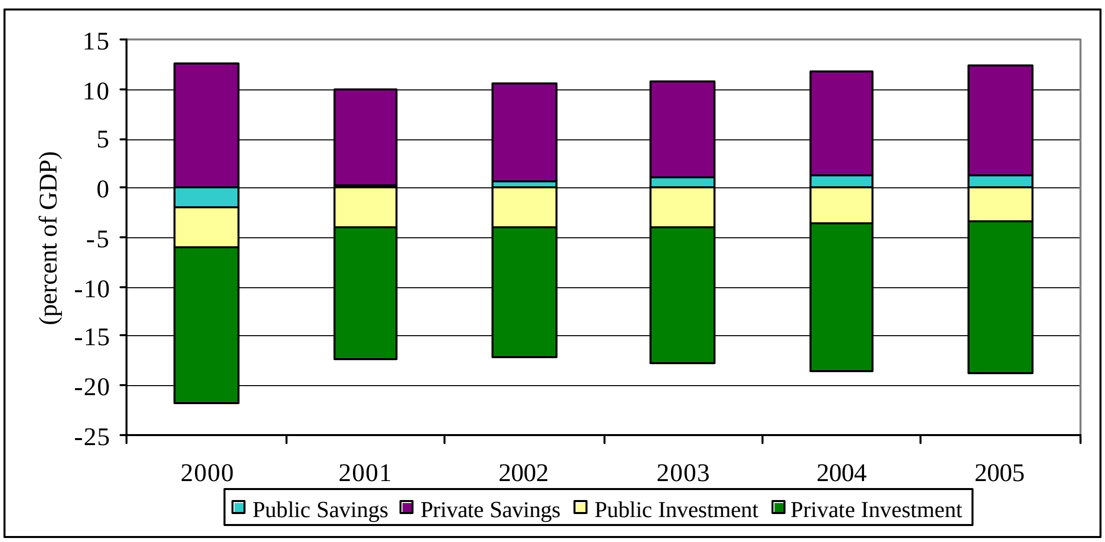
[1] H. Polackova, "Government Contingent Liabilities—a Hidden Risk to Fiscal Stability," World Bank PRP#1989 (1998), and G. MacKenzie and P. Stella, "Quasi-Fiscal Activities of Public Financial Institutions," IMF OP#142 (1996).
[2] M. Petri, G. Taube, A. Tsyvinski, Energy Sector Quasi-Fiscal Activities in the Countries of the Former Soviet Union (draft IMF Working Paper, 2002); and World Bank, Kyrgyz Republic - Fiscal Sustainability Study (2001).

Box 2. Sources of growth over the medium term

Over the coming decade, real GDP growth rates in the CIS 5 are projected to continue at about 4–5 percent per year. Except for Moldova, these rates are close to the levels of recent years. Faster growth is expected to come from gains in factor productivity, particularly from a rebound in capacity utilization.

As the figure below suggests, gross investment ratios are not expected to rise significantly, but the government's share is forecast to fall as public investment programs—notably that in the Kyrgyz Republic—are streamlined. FDI is expected to grow by an average of 4 percent per year over the decade, though the conflict in Afghanistan could raise risk premia, and thus dampen inflows. Continued fiscal consolidation will support lower levels of crowding out, with total savings rising to an average of 12 ½ percent of GDP by 2010.

Savings and Investment under Baseline Projections:
Averages (as percent of GDP) for CIS 5 countries



Source: Appendix tables 10a, 12a, 14a, 16a and 18a.

23. **While revenue performance has generally improved in recent years, the chief burden of adjustment fell on expenditure compression, often achieved in an across-the-board manner.** Under those circumstances, governments faced serious resource and institutional constraints in protecting the poor. At the same time, reforms that could have produced efficiency gains—and made the spending cuts less harmful for the poor—were frequently delayed.[13] Too often, expenditure arrears and netting operations were allowed to distort expenditure priorities away from wages, pensions and social benefits. Furthermore, several countries in this group—particularly Georgia and Tajikistan—were relatively unsuccessful in raising the fiscal revenues needed for normal government operations, including poverty reduction. Arrears in public spending on wages and social benefits became a major source of poverty in some countries.

24. **The efficiency of public expenditures and systems for budget management are important for poverty reduction.** The authorities in six of the CIS 7 are currently undertaking Public Expenditure Reviews (PERs), in collaboration with the World Bank (Table 4). Although the PERs will only be finalized in mid-late 2002, the following early conclusions can be drawn from this work.

25. **First, in all countries concerned, inefficient budget management procedures are a critical constraint on the effectiveness of poverty-fighting policies**. Systemic problems

Table 4. Status of World Bank Public Expenditure Reviews

	Expected Initiation	Expected Completion
Armenia	Q2 2001	Q2 2002
Azerbaijan	Q1 2001	Q2 2002
Georgia	Q4 2001	Q2 2002
Kyrgyz Republic	Q4 2001	Q2 2002
Moldova 1/	Q1 2001	Q1 2002
Tajikistan	Q2 2002	Q1 2003

Sources: World Bank staff.

1/ A PER was done in 1998, and the IMF's Fiscal Affairs Department has also fielded two missions. This report will focus on budget management.

[13] There is evidence that the size of government in these countries remains inappropriately large; see S. Gupta, L. Leruth, L. de Mello and S. Chakravarti, “Transition Economies: How Appropriate is the Size and Scope of Government,” IMF Working Paper WP/01/55.

in budget processes include lack of transparency and accountability, the fragmentation of the budget, unrealistic revenue forecasts, weak ex ante control of expenditure commitments and inadequate ex post audits of budgetary expenditures. The PERs also aim to provide advice on budgetary systems at all levels of government, including the central government, line ministries and local governments.

26. **Second, government spending in all of these countries needs to be rationalized and better focused on priority areas.** Even within the social sectors, government expenditures need to be streamlined and targeted on the poor. At the start of transition, the social sectors in the CIS 7 were not sustainable, and had been maintained via: (i) massive direct and indirect transfers from the central authorities of the Soviet Union, and (ii) the provision of a broad range of services by public enterprises. As central transfers ceased and the financial position of the enterprises deteriorated, the latter often transferred their social infrastructure (housing, clinics, schools) to local governments that were already facing financial difficulties and lacked skills to deliver social services. By 1999, per capita dollar expenditures on health and education in the CIS 7 had fallen well below those of central and Eastern Europe, and in some cases had reached levels comparable to the poorest developing countries (Table 5).

27. **Third, public spending on health should increasingly be focused on basic care.** In six of seven countries, it is less than 2.5 percent of GDP, and stands only slightly higher than 3 percent in Uzbekistan. With total public health expenditures averaging $6 per capita in 1999,[14] these countries are not able to provide a basic package of health services, including vaccination, pre- and post-natal services and HIV/AIDS awareness.[15] Mortality is rising or has ceased to decline, the incidence of serious diseases (e.g. tuberculosis) has increased, and some infectious diseases exterminated decades ago (e.g. malaria) have reappeared. As privately financed (out-of-pocket) and unregulated health care has emerged—even for basic care—access to health care services by the poor has diminished.

28. **Fourth, public spending on education should also be reoriented toward primary and secondary schooling.** Overall government spending in most countries has declined on a per capita basis to very low levels. As a result, primary and secondary education has been inadequately financed, reducing the quality and accessibility of these essential services for the population. As in health, a large portion of education costs has been shifted to households (textbooks, uniforms, and increasing maintenance and heating costs). Facing serious resource constraints, municipalities are increasingly charging fees for preschool education. In turn,

[14] Excluding Uzbekistan, where the official exchange rate distorts the picture.

[15] The 1992 World Development Report estimated that the annual cost of such a minimum essential health package in 1990 varied from $12 per capita in low-income countries to $21.50 in middle-income countries.

Table 5. General Government Social Expenditures in Selected Countries

	Education		Health		Pensions		Other Social Protection	
	1995	1999	1995	1999	1995	1999	1995	1999
					(In U.S. dollars per capita)			
CIS-7								
Armenia	9.7	9.3	6.3	6.7	10.2	18.3	6.2	7.8
Azerbaijan	14.1	21.0	6.6	5.5	5.7	21.1	10.0	13.5
Georgia	6.1 1/	11.2	2.5	4.1	8.2	13.5	n/a	6.8
Kyrgyz Rep.	21.2	12.1	11.9	5.9	24.1	14.2	2.9	5.2
Moldova	34.4	15.0	22.2	8.7	33.8	20.0	8.2	3.2
Tajikistan	4.2	3.8	2.7	1.8	2.9	3.2	1.7	3.2
Uzbekistan 2/	33.0	26.7	15.9	10.2	23.2	35.9	15.2	10.3
Weighted Average	14.8	18.6	11.6	7.3	17.0	23.9	10.3	8.5
Selected developing countries								
Benin	9.5	n.a.	11.2	12.4 3/	4.2	4.9	n.a.	n.a.
Haiti	7.0	11.6	2.6	3.3	2.6	3.3	n.a.	n.a.
Honduras	25.9	36.1	15.4	21.5	3.9 4/	n.a.	12.2 4/	22.1
Lao PDR	8.5	7.2	6.9	3.1 3/	n.a.	n.a.	n.a.	1.9
Vietnam	5.8	7.4	2.8	3.0	1.3	5.6	13.3	13.3
Yemen	17.1	22.4	2.4	8.0	0.4	4.8	1.0	2.0
Weighted Average	8.8	12.4	3.9	5.2	1.6	5.2	11.2	11.5
Selected countries on eastern Europe								
Czech	261.9	190.9	332.4	361.1	507.1	500.4	141.0	201.2
Hungary	199.5	182.8	209.6	336.8	401.7	394.5	125.8	240.5
Poland	97.5	68.2	126.2	180.6	413.0	533.9	183.6	188.7
Slovakia	n.a.	146.1	172.3	255.7	272.3	277.6	237.8	248.4
Slovenia	586.3	434.7	649.9	566.1	1,281.0	1,458.7	370.2	320.5
Weighted Average	158.3	121.9	190.5	249.9	440.6	514.4	178.0	207.3
OECD Average	1,570.6	1,745.8	1,548.8	1,755.3	1,773.6	1,864.4 5/	1,297.2	1,315.3 5/
					(In percent of GDP)			
CIS-7								
Armenia	2.8	1.9	1.8	1.3	3.0	3.8	1.8	1.6
Azerbaijan	4.5	4.2	2.1	1.1	1.8	4.2	3.2	2.7
Georgia	1.2 1/	2.6	0.7	1.1	1.5	2.6	n/a	1.3
Kyrgyz Rep.	6.5	3.9	3.7	2.3	7.4	5.6	0.9	0.7
Moldova	7.5	4.2	4.9	2.4	6.8	5.6	1.8	0.9
Tajikistan	3.3	2.1	2.1	1.0	2.5	1.8	1.1	0.1
Uzbekistan 2/	7.4	7.8	3.6	3.0	5.2	10.5	3.4	3.0
Weighted Average	5.8	5.9	3.1	2.3	4.7	7.7	2.6	2.4
Selected developing countries								
Benin	2.6	n.a.	1.6	1.6 3/	0.4	1.3	n.a.	n.a.
Haiti	1.9	2.1	0.7	0.6	0.7	0.6	n.a.	n.a.
Honduras	3.5	4.2	2.2	2.5	0.6 4/	n.a.	1.7 4/	2.6
Lao PDR	2.7	2.8	1.8	1.2 3/	n.a.	n.a.	n.a.	0.3
Vietnam	2.1	2.0	1.0	0.8	0.5	1.5	4.8	3.6
Yemen	6.5	n.a.	0.9	2.0	0.2	1.2	0.4	0.5
Weighted Average	2.8	2.7	2.7	1.2	0.5	1.4	3.7	2.9
Selected countries on eastern Europe								
Czech	5.2	3.7	6.6	7.0	9.03	9.7	2.8	3.9
Hungary	4.6	3.8	4.8	2.6	9.2	8.2	2.9	5.0
Poland	3.4	1.7	4.4	4.5	14.4	13.3	6.4	4.7
Slovakia	n.a.	4.0	5.0	7.0	7.9	7.6	6.9	6.8
Slovenia	5.8	4.3	6.9	5.6	13.6	14.4	3.9	3.2
Weighted Average	4.2	2.7	5.2	4.9	11.8	11.5	4.8	4.6
OECD Average	5.8	5.9	6.1	6.2	9.6	9.7 5/	6.2	6.2 5/

Source: WDI and IMF country reports

1/ 1996.
2/ Estimation based on indicative exchange rate for 1995.
3/ 1998.
4/ 1994.
5/ 1997.

this development, combined with the absence of targeted safety nets for the truly needy, has made access to education more difficult for the poor (particularly for women).

29. **Fifth, the pension systems of most countries in the CIS 7 will need to be reformed in order to become sustainable.** Most of these countries sought to maintain pension spending as a share of GDP. However, pensions have declined in real terms, and households headed by pensioners are among the poorest in these countries. The aging of the population has particularly affected Armenia, Georgia, and Moldova, where the ratio of dependents to contributors is quite high, and rising. While collections can be improved, payroll tax rates (the main revenue source of the pension funds) cannot be increased because they are already very high, serving to promote corruption, stifle investment, and hamper absorption of unemployed labor. As with other social expenditures, pension benefits will have to be rationalized. Some countries have begun reforming their pension systems by tightening the link between contributions and benefits, shifting to notionally defined contribution schemes, raising retirement ages, reducing replacement rates and changing pension indexation formulae. However, these countries have not been able to move to multipillar pension schemes because the transition is costly and capital markets in the CIS 7 are not developed.

30. **Finally, serious spending distortions will need to be addressed within each social sector** in order to increase the efficiency of scarce social protection funds and to achieve the desired poverty reduction. Due to the oversupply of hospitals, clinics, and schools, the bulk of the limited social expenditure is absorbed by wages, energy and supply costs. In education, the oversupply of teachers and the reluctance of the governments to lay them off have resulted in an unsustainable wage bill. In health, the share of wage bill has been growing, while budget spending on maintenance, equipment and medications has been declining. Excessive wage bills are common throughout the public sectors of these countries. The low average salaries that result from excessive employment undermine the performance and motivation of public servants.

31. **To reduce poverty significantly, these countries also need to implement credible debt reduction strategies,** coupled in some cases with debt relief by major creditors and in all cases with a reallocation of public spending toward social safety nets. The ability of these countries to address their social needs is constrained by their limited domestic resources, inefficient expenditure management systems, and high public debt burden. Indeed, external debt service consumed an average of one-third of central government revenue in 2000 in the five relatively indebted countries.

C. Domestic Policy Priorities to Promote Growth

32. **The domestic reform agenda has been hampered by an inability to make sufficient progress on several priority issues that are critical to improving the prospects for economic growth.** Despite some initial progress, the CIS 7 have generally not developed the consensus or ownership required for taking difficult political decisions, partly due to the emergence of powerful groups that benefit from the status quo. All of these countries need to

undertake key policy reforms in order to promote sustainable economic growth and reduce poverty. The recommendations of the IFIs are summarized in Table 6 and outlined below.

33. **Enterprise restructuring or liquidation should be encouraged and—in the case of insolvent firms—required** (Figure 5).[16] Indeed, the price liberalization steps that have been introduced will have limited benefits if enterprises do not transact on the basis of these prices. To varying degrees, the CIS 7 have tried to protect unprofitable enterprises and activities through soft-budget constraints, including on-budget subsidies, favorable tax and regulatory arrangements, tolerance of enterprise arrears and nonpayment (including of taxes and for energy consumption), lack of imposition of bankruptcy, and, in the case of Uzbekistan, via directed credits. This budget and quasi-fiscal assistance has been a significant drain on the resources available for other uses, discouraging development of new employment-generating activities, and hence worsening poverty.

34. **It is essential to harden the budget constraints of outmoded public enterprises inherited from the Soviet period**. Inconsistent financial discipline has meant that the old loss-making enterprises were slow to release capital and labor for the use of more dynamic new entrants. Financial discipline may be achieved by allowing competition in product markets, strengthening bankruptcy mechanisms and monitoring managerial behavior to create incentives for profitability and innovation.

35. **Similarly, faster economic growth** requires an attractive and competitive investment climate. The business environment can be improved by reducing excessively high marginal tax rates, simplifying registration procedures, protecting property rights, and providing basic infrastructure, while maintaining a level playing field among the restructured and new enterprises. Where institutions of public and corporate governance are not strong enough, asset stripping becomes widespread and new entry is discouraged. Complex licensing and registration procedures lend themselves to abuse, especially where the legal and judicial system is weak. Strong anti-corruption measures are needed to improve the business climate in these countries.

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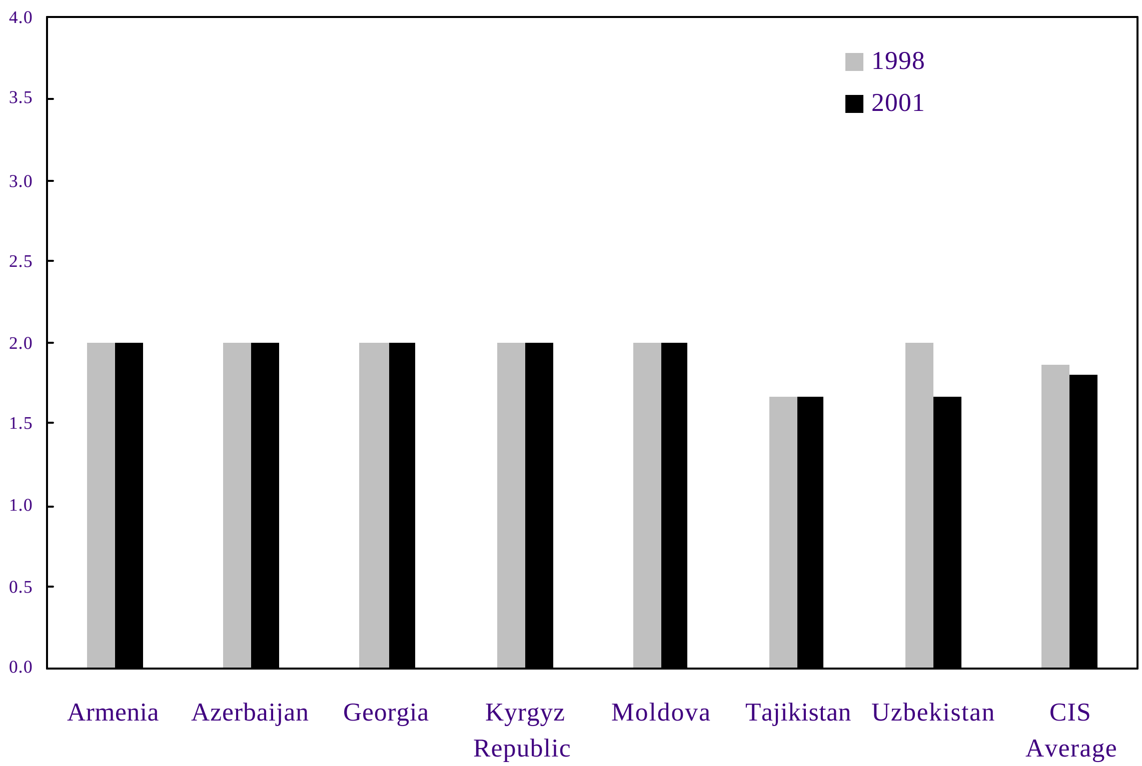
[16] A score of 4 would be appropriate for an economy well-advanced in transition

Figure 5. Progress with Governance and Enterprise Restructuring
EBRD Transition Indicator



Source: EBRD, Transition Report, various years.

Table 6. Key Domestic Policy Reform Priorities

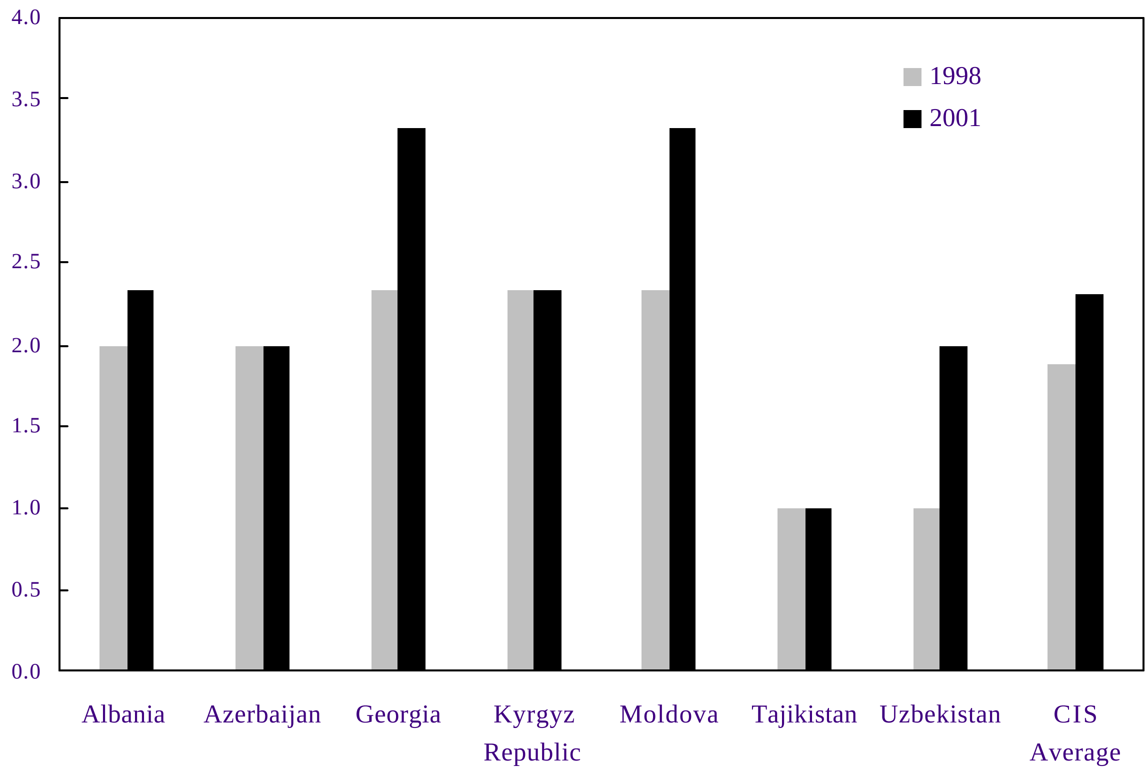
	Armenia	Azerbaijan	Georgia	Kyrgyz Rep.	Moldova	Tajikistan	Uzbekistan
MACRO/FISCAL STABILITY							
Foreign exchange regime liberalization							x
Increase in fiscal revenues	x		x	x		x	
Rationalization of spending, including social safety net, subsidy, and investment programs	x	x	x	x	x	x	
Better target social spending to the truly needy	x	x	x	x	x	x	x
SECTOR POLICIES							
Reform energy sector pricing, targeting of energy subsidies, payment discipline	x	x	x	x	x	x	x
Reform agricultural sector			x	x		x	x
Strengthen financial sector policies and practices, including directed lending		x		x		x	x
GOVERNANCE, INSTITUTION-BUILDING AND ENTERPRISE REFORM							
Improve business environment to encourage SMEs and FDI through regulatory reform, contract enforcement, bankruptcy, etc	x	x	x	x	x	x	x
Privatization under transparent procedures	x			x	x	x	x
Better public governance (anti-corruption)	x	x	x	x	x	x	x

Sources: Country authorities and IFI staff.

36. **Energy sector reform is especially critical.** Collection discipline needs to be enforced at the same time as tariffs are increased to cover costs and to promote efficient energy consumption by households, enterprises, and especially budget units. Metering of energy use will help, and introduction of lifeline and block tariffs could help to protect the poor. There is also a need to shift from barter and other non-cash forms to cash payments for energy use, and to ensure that subsidies—including protection from being cut off—are targeted to the poor and fully reflected in the government's budget. Transparent privatization

of the energy sector, while not a panacea, could strengthen the decaying capital stock of the energy sector and shore up cash collections in several of these countries. In recent years, Armenia, Georgia, and Moldova have strengthened their regulatory environment in the energy sector, by adopting laws on sectoral restructuring, setting up independent regulators, and unbundling the generation, transmission, and distribution networks (Figure 6). Uzbekistan has corporatized the national power company, and private sector management of energy assets has been undertaken in several of these countries.

Figure 6. Progress with Electric Power Reform
EBRD Transition Indicator



Source: EBRD, Transition Report, various years.

37. **Growth potential of many of these countries is likely to depend on agriculture and agro-processing,** the development of which is important for reducing rural poverty. In virtually all CIS 7 countries, the agricultural sector is substantially larger relative to GDP than the average for the CIS as a whole (Table 7). Important policies needed in this regard relate to clarification of land ownership (Georgia, Moldova, and especially in Tajikistan), encouraging private sector provision of agricultural inputs such as fertilizers and pesticides, reducing trade barriers, implying regional cooperation, elimination of export taxes, reduction in import tariffs on farm equipment, and for some countries further privatization of agro-processing plants (Moldova). Provision of financial and of government extension services would also be important (e.g., in Georgia). Agricultural policies are especially weak in Uzbekistan, where growers are paid well below market prices.

Table 7. Production Shares in GDP, 2000
(In percent)

	Agriculture	Industry			Services
		Total	Manufacturing	Other	
Armenia	29	33	23	10	39
Azerbaijan	23	35	6	30	41
Georgia	36	13	8	5	51
Kyrgyz Republic	38	27	13	14	36
Moldova	25	22	15	7	53
Tajikistan	19	25	21	3	57
Uzbekistan	33	25	…	…	43
Average CIS7 (unweighted)	29	25	14	12	46
Russia	7	38	…	…	56
Others not shown	19	39	…	…	45
CIS (unweighted)	24	31	21	10	46

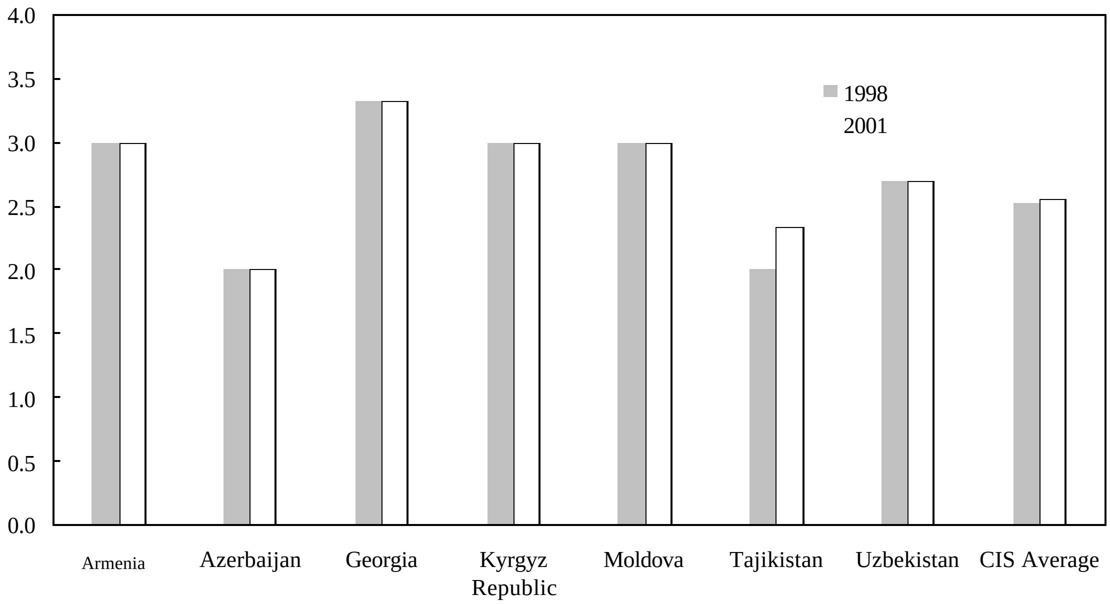
Source: World Development Report, 2002.

38. **Divestiture of large state enterprises should be accelerated through transparent and competitive procedures.** In general, these countries have transferred substantial productive assets to the private sector via the divestiture of small- and medium-sized firms. The privatization of large strategic enterprises has been slower than hoped in all countries, but is more advanced in Armenia, Georgia, the Kyrgyz Republic, and Moldova than in the other CIS 7 countries (Figure 7).

39. **There is also an urgent need to strengthen the business environment in all these countries** (Figure 8). FDI and domestic investment—especially in SMEs—depend heavily on perceptions of corruption and transparency. In general, these countries offer significantly worse investment climates than Central and Eastern Europe, as reflected in a recent EBRD survey.[17] Good governance is thus essential for promotion of private activity in the CIS 7,

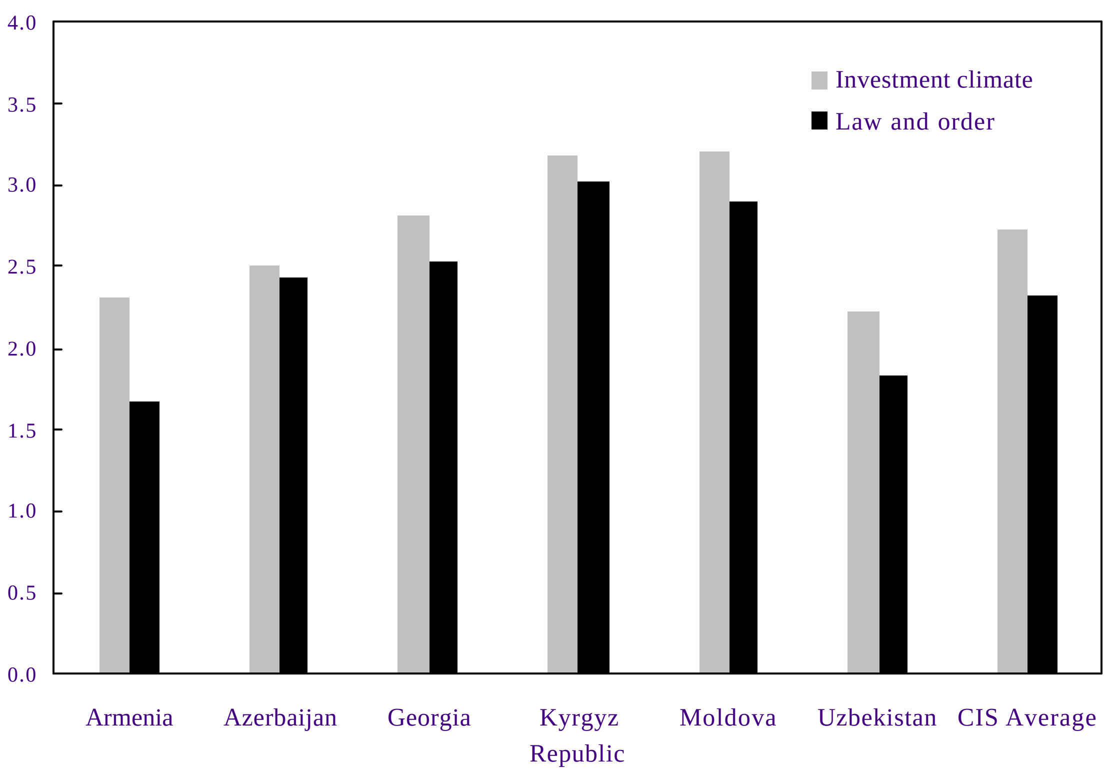
[17] The questions focused on macroeconomic conditions (inflation, exchange rate and policy stability), microeconomic constraints (due to business regulation and taxation and access to finance and infrastructure) and law and order (including the functioning of the judiciary, corruption, street and organized crime). Surprisingly, enterprises generally regard law and order to be a less serious problem than the other constraints. However, this could reflect the heightened macroeconomic uncertainty in these countries in 1999, just a few months after the Russian crisis.

Figure 7. Progress with Large-Scale Privatization
EBRD Transition Indicator



Source: EBRD, Transition Reports, various years.

Figure 8. Investment Climate and Law and Order, 2001
EBRD Transition Indicators



Source: EBRD, Transition Report 2001.

and there is an urgent need to prevent the state from interfering with day-to-day business decisions in order to improve the investment climate and encourage significant increases in FDI. The key policy reforms in this regard include:

- Establishment of a regulatory and judicial environment that ensures a level playing field for private activities in terms of the rule of law (including reducing harassment), and subsequent stability in business laws and procedures;
- uniform and more transparent tax regime with a low burden (including reform of tax and customs administrations);
- protection of creditor rights and contract enforcement, under sanction of bankruptcy provision where appropriate;
- use of audits based on international standards, especially for government activities, along with serious efforts to reduce corruption, and
- more transparent privatization.

40. **To promote economic growth, there is a need to strengthen public infrastructure in the context of carefully designed public investment programs**. This is especially important for countries that have had major conflicts, but also for those with significant tourism and agricultural potential. Given the scarce fiscal resources, more careful screening of the public investment programs is needed in several cases, particularly the Kyrgyz Republic, in order to ensure that the budget is able to allocate resources for the operations and maintenance of public investments over time.

41. **Finally, banking sector reform is needed to promote savings and productive investment**. This is especially important for the development of SMEs and the agricultural sector, which as noted is a central priority in most of these countries. Government borrowing also needs to be contained so that high interest rates on government bonds do not crowd out borrowing by the private sector. A level playing field and enforcement of banking system prudential requirements—especially in state-owned banks—is necessary to instill confidence in the banking system. Elimination of directed credits, guaranteed lending, and liberalization of interest rates are also needed in Uzbekistan.

D. Regional Policies and Challenges

42. **Several distinct regional issues affect growth prospect in the CIS 7**. These countries inherited their economic structures from the central planning period, when all major decisions were dictated by the needs of a much larger and highly integrated Soviet economic space. Further, in Central Asia and the Caucasus, the Soviet planning system had fostered the development of regional economic complexes, which in some cases could be maintained only by the highly distorted input and output prices characteristic of central planning. At independence, the collapse of the common economic space and price

liberalization, meant that the economic rationale of many of these projects disappeared. But there remain key regional issues affecting the CIS 7 in trade, transport, energy, water, and natural resources management.[18]

43. **With independence, the CIS 7 have become increasingly insular.**[19] Conflicts, closing of borders, high transport costs, numerous customs points, tariff and non-tariff barriers have undermined regional trade. Efforts to diversify or promote trade, for example, access to OECD markets or WTO membership, have brought mixed results. After 10 years of transition, trade and transport patterns remain largely unchanged from the Soviet period. Corruption, security problems, drugs and weapons trafficking have markedly restricted regional cooperation.

44. **To foster regional trade and economic cooperation, there have been several attempts at re-integration by the CIS countries**, including the CIS Economic and Customs Union; the Central Asian Economic Community; the Economic Cooperation Organization (ECO); the Shanghai Forum; and GUUAM (Georgia, Ukraine, Uzbekistan, Azerbaijan, and Moldova). Unfortunately, these agreements have had modest success, at best, while some, such as the CIS customs union, could have been counterproductive for the low-income CIS countries.[20]

45. **For example, the need for tax harmonization has grown as national tax systems have developed.** Although all CIS countries began transition with more or less the same tax system, over time countries have taken decisions that—although perhaps rational from a domestic standpoint—are sub-optimal on a regional scale. For example, countries have moved to the destination basis for VAT in an ad hoc and relatively uncoordinated manner. Similarly, excise tax rates and VAT bases differ in important ways, leading to irrational round-tripping to avoid taxation. It will be important to create a regional forum where these technical issues can be sorted out constructively.[21]

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[18] Drug smuggling and security are also important concerns, but they lie outside the remit of this paper.

[19] See Appendix Tables 3–8.

[20] For the smaller CIS countries that already have quite liberal trade regimes, membership in a customs union could be disadvantageous, as tariff-free trade between the members of the customs union could result in trade diversion, rather than trade creation. See for example C. Michalopoulos and D.Tarr, *The Economics of Customs Unions in the Commonwealth of Independent States*, 1997.

[21] In April 2002, the IMF's Fiscal Affairs Department is planning a CIS-wide seminar in Almaty to discuss regional indirect tax issues.

Central Asia[22]

46. **In Central Asia, trade disruption as well as complex regional infrastructure problems—water, energy and environment—impair the economic development of these landlocked countries**. Agriculture in this region is impossible without irrigation, and during the Soviet period, the irrigation and energy networks of these countries were developed as one system, with massive investments from the Soviet central budget. Since independence and the disappearance of these investments from Moscow, regional cooperation has been insufficient to maintain the normal functioning of these systems.

47. **For example, the irrigation needs of Uzbekistan, Kazakhstan, and to a lesser extent Tajikistan are primarily met by the Naryn/Syr Darya river system**. In winter, traditionally water had been accumulated in a cascade of five hydro power stations in the Kyrgyz Republic, and in summer it was released to meet the downstream irrigation needs of three neighboring states. Since independence, and due to its financial difficulties, the Kyrgyz Republic has increasingly used this flow for its own power generation needs, leading to irrigation water shortages for its neighbors. This trade-off has been resolved through annual bilateral agreements, under which Kyrgyz water and electricity are swapped for Uzbek gas and Kazakh coal. However, there have been conflicts over prices, late payments, and supply cut-offs, resulting in sub-optimal use of water resources. A more medium-to-long term agreement is needed in order to settle the water-sharing and payment issues and to enhance the reliability of water supply in the region. This would foster agricultural growth, and improve the prospects for trade and economic development in Central Asia.

48. **In addition, the push of some Central Asian countries for greater economic autonomy, and energy self-sufficiency, has resulted in inefficient production and consumption patterns**. The energy complex in Central Asia was built to capitalize on the comparative strengths of each country: Turkmenistan and Uzbekistan have considerable gas reserves; Kyrgyz Republic and Tajikistan have vast hydropower assets; and Kazakhstan possesses large oil and coal reserves. After the Soviet collapse, these countries pursued mostly autonomous energy strategies that neglected comparative advantages. Improved cooperation could help to find long-term solutions to the energy and water sharing problems that are crucial for economic growth in this region.

49. **Prospects for trade in the landlocked Central Asian countries also depend on improving regional transit arrangements and transportation systems**. Transport patterns still display features characteristic of the former Soviet Union, with relatively few connections to non-CIS neighboring countries. The longstanding hostilities in and around Afghanistan have exacerbated this problem and weakened transportation safety. The Kyrgyz

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[22] This section draws heavily from Asian Development Bank, *Regional Economic Cooperation in Central Asia*, TA No. 5707-REG (April 1998), and World Bank, *Central Asia Regional Issues* (2001).

Republic and Tajikistan are highly dependent on China, Kazakhstan, Uzbekistan, and Russia for transit. High transit fees and other barriers in Kazakhstan and Uzbekistan are very serious problems for their smaller neighbors. Longer-term regional agreements on transit trade could bring greater stability to and decrease transportation costs in this region.

50. **The conflict in Afghanistan now appears to have had only limited direct economic consequences for Central Asia**. Higher security-related spending may have put additional pressure on the fragile budgets of the Kyrgyz Republic, Tajikistan, and Uzbekistan, and increased investor uncertainty. A resolution of this conflict could lead to lower defense spending and give rise to new trade flows in the region.

Caucasus

51. **As in Central Asia, high transportation costs and the lack of security for trade flows are serious impediments to economic growth in the Caucasus**. Economic activity in this region remains severely affected by civil and ethnic conflicts that have lingered since independence. A ceasefire has been in force since 1994 between Azerbaijan and Armenia, but their border remains closed, as does Armenia's border with Turkey, leaving Armenia only two trade corridors—through Iran and Georgia. In the latter case, the conflict between the central government and its constituent republics of Abkhazia and South Ossetia has led to disruptions in domestic and international trade flows. Finally, the war in Chechnya has made regional trade more difficult and expensive for all parties. These conflicts are politically sensitive and involve a number of countries in the region, but they have severely undermined prospects for trade and private investment in the CIS 7 countries.

52. **These unresolved security issues impose a heavy cost on the Caucasus in terms of forgone or diverted trade.** For example, Armenia has ample power generation capacity, and could export electricity to Turkey if trade relations were normalized. Significant differences in agricultural prices between the three Caucasian countries suggest considerable potential for regional trade. A recent World Bank study estimated that Armenia could double its exports and halve its trade deficit, and Azerbaijan could increase its exports by about 11 percent, if the economic blockade were to be lifted.[23] Georgia could face some reduction in transit fees in the short-term, but would eventually gain from increased cooperation and stability in the region.

Moldova

53. **Moldova's trade is impaired by transportation problems, security issues associated with Transnistria and market access problems in the EU.** Moldova has had less success in diversifying its trade away from its traditional markets than other CIS

[23] E. Polyakov, "Changing Trade Patterns after Conflict Resolution in South Caucasus," World Bank Policy Research Working Paper No. 2593 (April 2001).

countries.[24] This dependency had dramatic results during the 1998 Russia crisis, when Moldova's exports fell by one half.

54. **The unsettled status of the breakaway Transnistria region poses serious threats to growth and stability in Moldova.** Progress in achieving a solution that would preserve Moldova's territorial integrity has been slow, hampered by political developments in the region, as well as by corruption and vested interests on both sides of the internal border that capitalize on the existing impasse. In this environment, Transnistria has reportedly become a conduit for smuggling and drug and arms trafficking. Transnistria has also repeatedly blocked railroads and gas pipelines, seriously disrupting trade flows and energy supplies to the rest of Moldova. Although the Transnistria problem is politically sensitive, the economic viability of Moldova may continue to be undermined unless it is resolved.

55. **Moldova's trade problems could be reduced by WTO accession and membership in the Stability Pact for South Eastern Europe (SP)**, both of which took place in 2001.[25] Moldova has a very liberal trade regime, retaining price controls and export licenses for only a limited range of agricultural exports. WTO accession should ensure that the remaining barriers to exports are removed promptly; but still to have a significant impact, the full cooperation and support of Moldova's immediate neighbors and the European Union will be needed. The Stability Pact opens further opportunities with the creation of a free trade zone of more than 50 million consumers, helping Moldova to diversify its trade and reduce its external vulnerability. At the same, the structure of the economies of the SP member countries may limit the potential for regional trade expansion. Increased access to EU markets for agricultural products and wine is essential for growth and poverty reduction in Moldova.

IV. EXTERNAL FINANCING AND DEBT SUSTAINABILITY

56. **Apart from the debt burden accumulated during transition, these countries can—with help from the international community—achieve external sustainability and reduce poverty.** The unprecedented scale of their economic and political challenges over the past decade has left them with considerable debt burdens, but in each case a sustainable long run path can be achieved through a combination of further fiscal adjustment, continued engagement by the IFIs, and generous debt relief and new ODA by bilateral partners. There are risks to this approach, but under current baseline macroeconomic forecasts, there is a way

[24] In 1998, almost 70 percent of Moldova's predominantly agricultural exports were destined for other CIS countries (Appendix Table 3).

[25] See World Bank, *The Road to Stability and Prosperity in South Eastern Europe: A Regional Strategy Paper* (2000), and IMF and World Bank, *Building Peace in South East Europe: Macroeconomic Policies and Structural Reforms since the Kosovo Conflict*, SM/01/317 (October 18, 2001).

forward that is consistent with poverty reduction efforts and a resumption of investment inflows to support growth.

A. Debt and Debt Service Indicators

57. **The nominal stock of government and government-guaranteed external debt of Armenia, Georgia, Kyrgyz Republic, Moldova and Tajikistan grew from near zero in 1992 to about $5.9 billion by end-2000** (Table 8 and Figure 9).[26] This debt averages 73.5 percent of GDP for these five countries, while in per capita terms it averages $252. **Azerbaijan**'s external debt is significantly smaller as a ratio of exports or GDP. The underlying burden of government and government-guaranteed external debt in **Uzbekistan** may be masked by administered exchange rates, but it has stabilized after a sharp build up over 1997–2000.

58. **Much of the debt is on concessional terms, typically from multilateral agencies, and thus the net present value (NPV) of the debt is significantly lower than the nominal value.** For the five countries noted above, the NPV of government and government-guaranteed debt at end-2000 is $4.0 billion, suggesting an average grant element of 32 percent.[27] The World Bank and the IMF are the largest creditors—and the multilateral institutions as a group hold more than half of the debt in nominal terms.[28]

59. **Official bilateral debt is owed primarily to Russia and to several other CIS countries.** Although Russia is a member of the Paris Club, Turkmenistan—the other large bilateral creditor for some of these countries—is not. Uzbekistan is a significant creditor to Tajikistan, as a result of usage fees owed by Tajikrail. **Commercial debt** owed by governments is generally quite limited, except in the case of Moldova, where a $75 million Eurobond falls due in 2002.

B. Current Strategy: A Case-by-Case approach

60. **Under this approach, the authorities—aided by the IFIs—aim first at achieving the maximum adjustment and structural reform consistent with each individual country's poverty reduction strategy**.[29] Although every case is unique, a typical debt strategy aims for a strong fiscal adjustment and focused structural reforms, as well as

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[26] All seven countries eventually ratified bilateral "zero option" agreements with Russia, under which the latter assumed all of the external liabilities and assets of the USSR.

[27] Debt indicators in NPV terms are not available for Azerbaijan and Uzbekistan.

[28] However, in some countries, particularly Georgia and Tajikistan, the bilateral debt built up in the aftermath of the breakup of the USSR is comparable in size to multilateral debt.

[29] The debt strategies of these countries are discussed in companion country notes.

Table 8. Structure of External Debt, End-2000
(In millions of U.S. dollars)

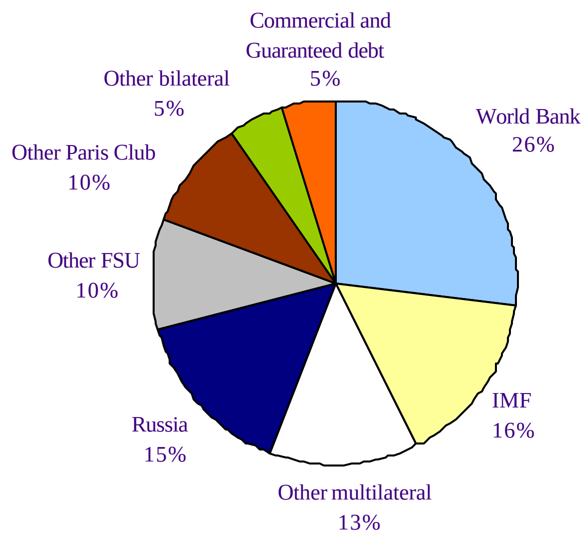
	Armenia	Georgia 2/	Kyrgyz Rep.	Moldova	Tajikistan	Total
Nominal Figures						
Total External Liabilities	862	1,610	1,724	1,234	1,228	6,657
Total government and government guaranteed	862	1,592	1,465	1,024	921	5,864
Total multilateral debt	647	793	919	569	367	3,296
World Bank	397	377	379	289	151	1,593
IMF	175	289	191	154	113	922
Other multilateral	75	127	350	126	103	780
Total bilateral debt	193	796	507	252	533	2,281
Russia	115	157	186	123	313	894
Other FSU	13	402	15	0	150	580
o.w. Turkmenistan	13	337	…	0	…	350
Other Paris Club	52	169	233	102	22	577
Other bilateral	63	68	73	27	48	280
Commercial and Guaranteed debt	22	3	39	202	22	287
Non-Guaranteed Debt	...	18	258	210	307	793
of which: State-owned enterprises	...	...	258	...	307	565
Private non-guaranteed	...	...	…	...		0
Memorandum item:						
Cross-border arrears 1/	...	182	…	345	…	527
Present Value Terms						
Total External Liabilities	534	1,123	1,119	1,100	919	4,795
Total government and government guaranteed	534	1,110	863	890	612	4,009
Total multilateral debt	357	443	469	476	208	1,953
World Bank	168	130	141	215	61	715
IMF	140	223	146	138	81	728
Other multilateral	49	90	182	123	66	510
Total bilateral debt	155	665	356	226	382	1,784
Russia	108	138	154	119	214	733
Other FSU	13	357	13	0	114	497
o.w. Turkmenistan	13	298	…	0	…	311
Other Paris Club	28	134	143	82	15	401
Other bilateral	6	36	47	25	39	153
Commercial and Guaranteed debt	22	2	37	188	22	272
Non-Guaranteed Debt	...	13	257	210	307	786
of which: State-owned enterprises	...	...	257	...	307	564
Private non-guaranteed	...	...	…	...	…	0
Memorandum item:						
Cross-border arrears 1/	...	150	…	345	…	496

Sources: National authorities and staff estimates.

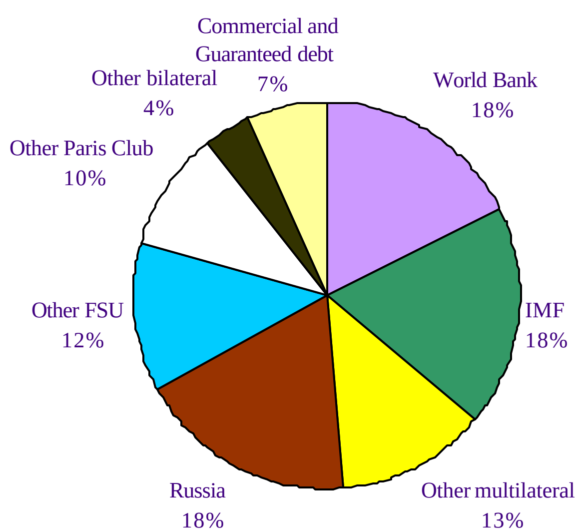
1/ Cross-border arrears are mostly energy-related.
2/ The net present value is based on debt service obligation prior to the Paris Club agreement in March 2001 and the assumption of 10 year repayment with respect to the arrears to Turkmenistan.

Figure 9. Structure of External Public Debt, End-2000
(Armenia, Georgia, Kyrgyz Republic, Moldova, Tajikistan)

Face value terms: $5.9 billion total



Present value terms: $4.0 billion total



Sources: National authorities; and staff estimates.

creation of a more favorable environment for FDI. While prospects for privatization proceeds remain uncertain, these are generally earmarked to debt repayment. Box 3 highlights a number of important issues in this area in the case of the Kyrgyz Republic.

61. **Second, restructuring of bilateral debt would be necessary if adjustment efforts are not sufficient to restore external debt sustainability.** Generally, it is expected that countries would request relief through the Paris Club, though other mechanisms have not been ruled out; in some cases it may be appropriate to seek bilateral agreements. In March 2001, the Paris Club granted Georgia a flow rescheduling—on nonconcessional terms—of debt maturing during 2001–2. The Paris Club has recently agreed to consider debt rescheduling for the Kyrgyz Republic, and Tajikistan and Moldova are likely to seek relief in the near future. Armenia, Azerbaijan and Uzbekistan are not expected to approach the Paris Club for assistance.

62. **Third, multilateral debt relief including under the enhanced HIPC Initiative could only be considered if and when it became clear that traditional debt rescheduling approaches were insufficient**. However, based on current projections, the amount of multilateral debt reduction that could be achieved under the HIPC Initiative would be relatively small. Indeed, in our simulations of the full use of traditional debt relief mechanisms (Naples terms), only two countries (the Kyrgyz Republic and Moldova) have debt at end-2000 that exceeds the sustainability thresholds under the enhanced HIPC Initiative, and that by modest amounts (Box 4).

C. Limits to Fiscal Adjustment

63. **Although the first stage of the case-by-case approach emphasizes the need for aggressive fiscal adjustment, it is likely to be difficult to achieve a substantial fiscal adjustment beyond that assumed under existing programs**. Existing IFI programs already target major fiscal adjustment efforts, which in several countries follow significant fiscal retrenchment in the recent past (Table 9). In addition, these fiscal adjustment measures specifically target the reductions in quasi-fiscal activities (Box 1).

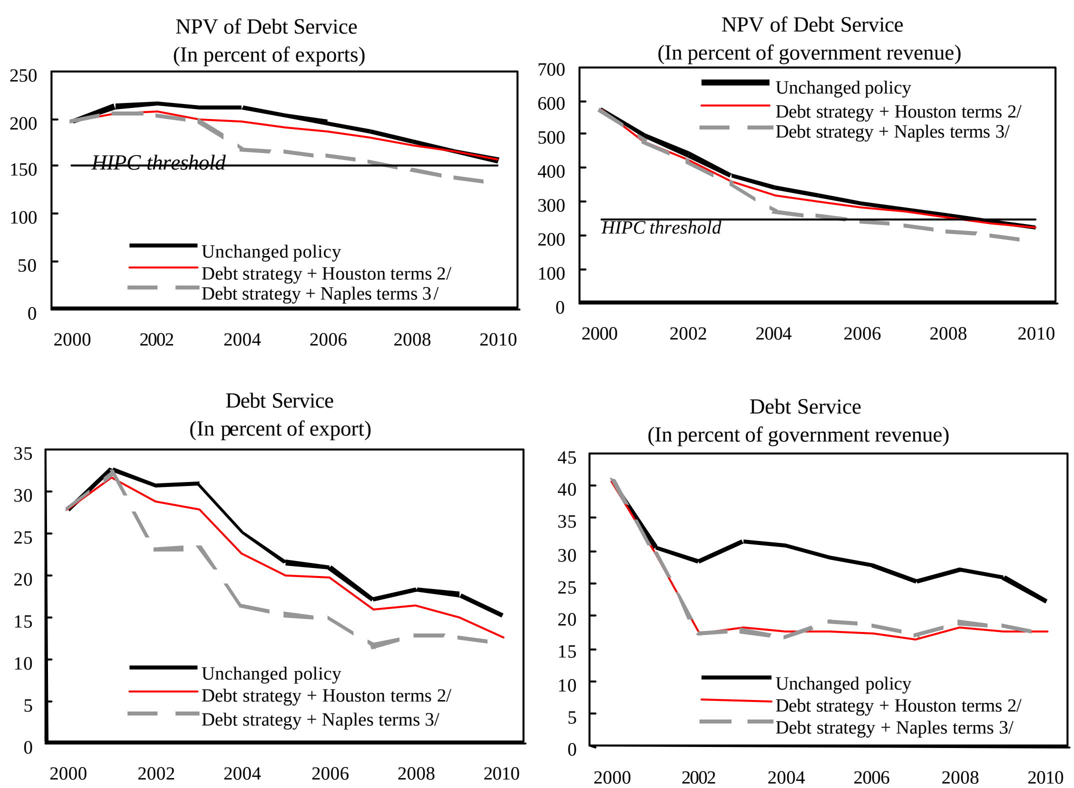
64. **It is far from assured that these countries will achieve the projected fiscal consolidation** (Figure 3). Indeed, these adjustments are comparable to those achieved by a number of other highly indebted countries, including some in Latin America in the 1980s, as well as several African HIPC countries more recently (Table 10). Deeper or faster fiscal adjustment in these countries—beyond what is already envisaged under the Fund-supported programs—would probably not be desirable. On the contrary, regaining at least some of the ground lost in the past decade requires supplementing modest domestic savings with substantial foreign inflows for a number of years to come. These flows will have to be provided on highly concessional or grant terms

Box 3. Debt reduction strategies: the Kyrgyz case

The Kyrgyz authorities have introduced a comprehensive debt strategy to alleviate the debt burden and to restore debt ratios to sustainable levels over time. This strategy involves: (i) strong fiscal adjustment; (ii) a gradual reduction of the PIP from 6 percent of GDP in 2001 to 3 percent in 2005; (iii) increasing the required minimum grant element on all new financing to 45 percent; (iv) repaying $100 million of nonconcessional debt ahead of schedule – under a comparability of treatment clause – in 2002–05; and (v) requesting debt rescheduling from the Paris Club on Naples terms. Discussion with the authorities—who have made no early repayment agreements thus far—continue on how to repay all creditors (including private and official) in a proportional and equitable manner, were funds to become available for early debt repayments.

The results of this strategy are shown below. Debt to export and debt to revenue ratios are brought to sustainable levels in the second half of the decade, unlike in the unchanged policy scenario or the scenario with nonconcessional (Houston) terms. Debt service also becomes manageable in this case. The Paris Club has indicated its willingness to consider the Kyrgyz request positively, although the terms of the rescheduling have yet to be determined.

Kyrgyz Republic: Debt Sustainability Under Debt Strategy 1/



Sources: national authorities; and staff estimates/projections.

1/ Baseline macroeconomic assumptions. Not identical to Appendix Figure 3, which includes two scenarios based on low case macroeconomic assumptions.

2/ Flow rescheduling 12/2001 - 12/2010.

3/ Flow rescheduling 12/2001 - 12/2004; stock of debt operation in 12/2004.

Box 4. CIS 5: HIPC Eligibility at End-2000

The Kyrgyz Republic appears to be eligible for treatment under the HIPC initiative on the basis of actual data for 2000 (applied to bilateral as well as commercial debt). As the table below suggests, a hypothetical stock of debt operation on Naples terms in 2000 would leave the ratio of debt (NPV) to exports slightly above the critical threshold of 150 percent. Using the fiscal criterion, the Kyrgyz Republic would be eligible for more significant debt relief from multilateral creditors, but eligibility under the fiscal criterion requires that exports exceed 30 percent of GDP and that central government revenues exceed 15 percent of GDP. The latter condition fails in the Kyrgyz Republic.

On the other hand, Moldova could be eligible for HIPC relief under the fiscal window—albeit modest—on the basis of end-2000 data. Recent revisions to revenue sharing outcomes suggest that central government revenue may be as low as 16 ½ percent of GDP, with the result that the ratio of NPV to central government revenue exceeds 250 percent by a mo dest amount.

	Armenia	Georgia	Kyrgyz Republic	Moldova	Tajikistan
Before debt relief					
NPV of debt (NPV) / exports	135	128	201[3]	139	133
NPV / central government revenue (CGR)	177	356[2]	586[3, 4]	380	432[4]
Total debt service / exports, 2000	11	10	23	15	10
Total debt service / CGR, 2000	16	36	26[4,5]	42	35[4]
After hypothetical Naples terms stock treatment at end- 2000					
NPV of debt (NPV) / exports	…	89	169[6]	104	64
NPV / CGR	…	246	493[4, 6]	284	211
Memorandum items:					
GDP / capita	549	567	263	360	158
Exports / GDP	16.2	37.7	39.2	33.3	82.6
General government revenue[1]/ GDP	18.9	15.1	18.6	26.9	13.5
CGR / GDP	15.7	10.3[2]	12.8	16.4	8.7
Extrabudgetary fund rev. (EBFR) / GDP	3.0	2.4	5.4	5.6	1.7
NPV (after Naples stock) / (CGR+EBFR)	…	246	457[4]	211	188[4]
NPV / GDP	28	37	88[3]	62	28

Source: National authorities and IMF staff calculations.

[1]Includes central government, local governments and extrabudgetary funds (EBFs); excludes grants. [2]CGR includes EBFR. [3]Be fore rescheduling agreements with Russia and Turkey. [4]Denominator includes local government revenue. [5]Excluding Kumtor debt service. [6]Does not include Kumtor debt in the reschedulings.

Table 9. Fiscal Adjustment Under Baseline Scenario
(In percent of GDP)

	Revenue	Expenditure	Primary Balance	Adjustment in Primary Balance
Armenia 1/				
1997-99 average	17.4	23.2	-3.6	...
2000	16.5	22.8	-4.7	-1.1
2001-05 average	17.2	20.2	-1.7	3.0
Georgia 2/				
1995-99 average	14.0	20.9	-4.8	...
2000	15.3	19.4	-1.1	3.8
2001-05 average	18.1	18.2	2.0	3.1
Kyrgyz Republic 3/				
1995-99 average	16.9	28.6	-10.0	...
2000	15.9	26.1	-7.3	2.7
2001-05 average	18.4	22.2	-1.8	5.5
Moldova 2/				
1995-99 average	32.0	39.0	-2.9	...
2000	27.6	29.6	3.7	6.6
2001-05 average	25.9	27.9	1.8	-1.9
Tajikistan 2/				
1995-99 average	13.0	17.9	-4.9	...
2000	13.6	14.2	-0.3	4.6
2001-05 average	15.1	15.3	1.1	1.4

Source: Appendix Table 1.

1/ Central government.
2/ General government.
3/ State government (excludes extrabudgetary funds).

Table 10. Primary Fiscal Balance
(In percent of GDP; period average)

	1995-99	2000-05 (For.)
CIS 5		
Armenia 1/	-3.6	-2.2
Georgia 2/	-4.8	1.5
Kyrgyz Republic 3/	-10.0	-2.7
Moldova 2/	-2.9	2.1
Tajikistan 2/	-4.9	0.9
Average (unweighted)	-5.3	-0.1
	1977-85	1986-95
Latin America		
Argentina 4/	-7.9	-1.9
Bolivia	-8.8	-0.4
Brazil	0.7	5.3
Chile	-1.0	-0.2
Mexico	-1.5	4.1
Peru	-0.2	-0.9
Average (unweighted)	-3.1	1.0
	1995-99	2000-05 (For.)
African HIPC		
Gambia	-0.5	3.0
Malawi	-0.5	2.2
Tanzania	2.3	0.2
Uganda	-0.6	-2.2
Zambia	-1.9	-0.6
Average (unweighted)	-0.2	0.5

Sources: Staff estimates/projections (CIS 5 and Uganda); WEO (Gambia, Malawi, Tanzania, and Zambia); GFS (Argentina and Chile); and Interamerican Development Bank (Bolivia, Brazil, Mexico, and Peru).
1/ Central government; average for 1997-99.
2/ General government.
3/ State government (excludes extrabudgetary funds).
4/ Data available beginning 1981.

D. Results of debt projections

65. **Debt sustainability analysis (DSA) projections on two sets of macroeconomic assumptions are included in the companion country notes**. The baseline scenarios are consistent with recent IMF– and World Bank–supported program estimates,[30] and are conservative in relation to the recent past (Table 11 and Figure 10). Growth forecasts, for instance, are generally not above actual outcomes in the past year or two. By contrast, the low case scenarios assume that average real GDP and export growth rates are about two percentage points lower than in the base case (Table 12). FDI and privatization proceeds are also generally more modest under the low case scenario. Real exchange rates are generally assumed to appreciate less in the low case scenario, and in Tajikistan they are assumed to depreciate modestly.

66. **The DSA results are very sensitive to real exchange rate assumptions**. That exchange rate depreciations could worsen the fiscal picture sharply is evidenced by the significant deterioration of the debt situation in four of the five CIS countries following the depreciations after the Russian financial crisis. Even a mild depreciation could significantly undermine fiscal sustainability in all countries. For example, modest simulated depreciation in 2001 would have caused a sharp deterioration of the ratio of NPV of external debt to revenues in the subsequent four years.[31]

67. **The DSA projections suggest that the Kyrgyz Republic is the most likely candidate for HIPC treatment.** Technically, on the basis of end-2000 data, the Kyrgyz Republic and Moldova may be eligible for relief—albeit minimal—under the HIPC initiative.[32] Moldova and Tajikistan could become eligible for HIPC under the fiscal criterion as well. Georgia will probably avoid HIPC eligibility, although further rescheduling by the Paris Club is likely to be needed in 2003–4. Armenia is unlikely to qualify for, or need, HIPC treatment, and it may not even need restructuring of bilateral debt (Box 4). Debt-service ratios peak over the next three or four years for several of these countries (Table 13).

68. **Looking ahead, apart from the Kyrgyz Republic, HIPC eligibility is relatively unlikely over the coming decade in these countries**. This outcome depends on good policy performance, avoidance of a further build-up in debt, and increased provision of grant

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[30] See recent IMF Staff Reports for Armenia (EBS/01/61), Georgia (EBS/01/173), the Kyrgyz Republic (EBS/01/187), Moldova (EBS/00/249), and Tajikistan (EBS/01/85).

[31] IMF and World Bank, *Republic of Armenia, Georgia, Kyrgyz Republic, Republic of Moldova, and Republic of Tajikistan—External Debt and Fiscal Sustainability*, February 6, 2001, Box 3.

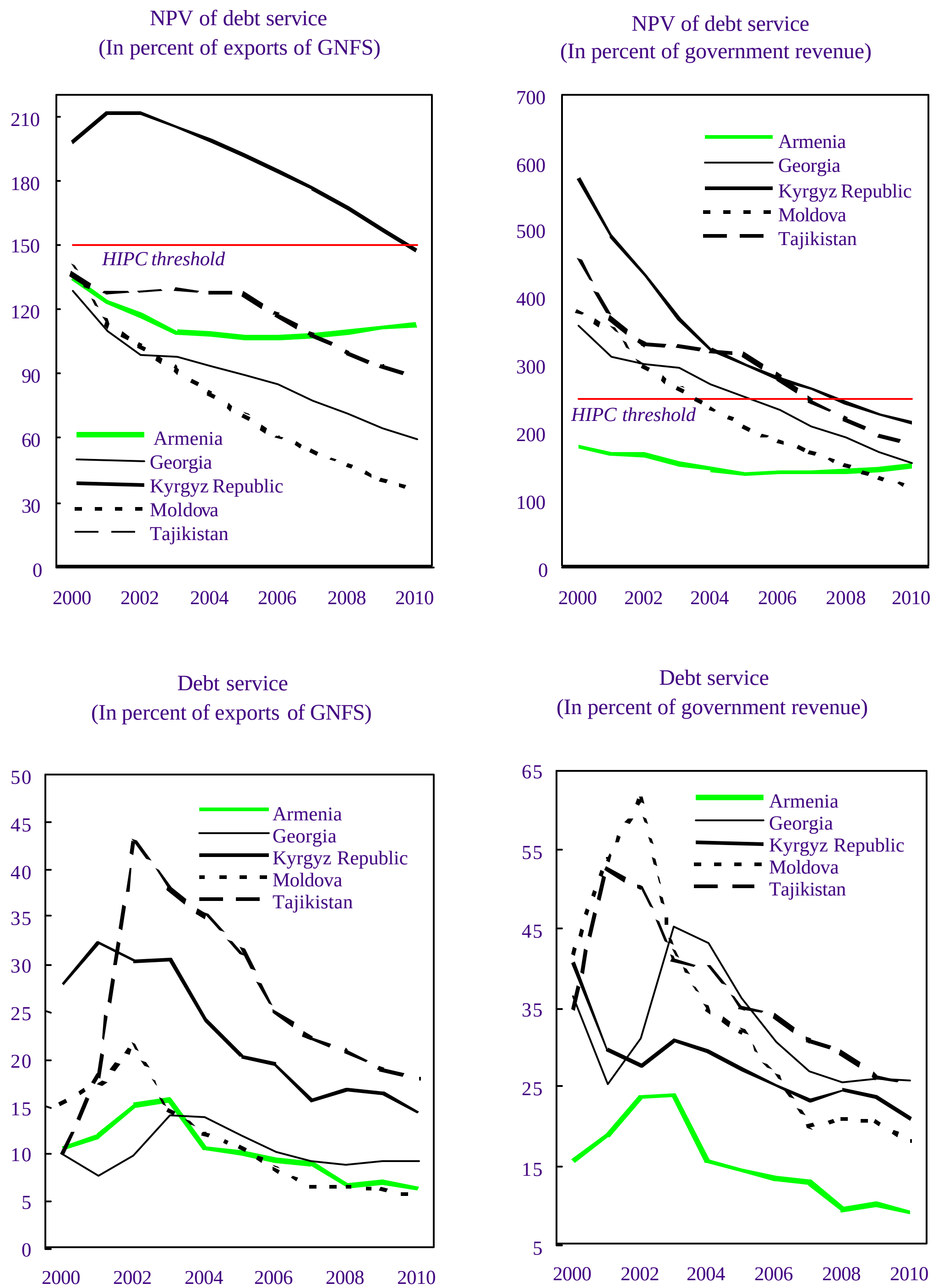
[32] However, under the authorities' debt strategy, the country could achieve durable debt sustainability without HIPC relief, if bilateral creditors provide highly concessional (Naples terms) debt relief.

Table 11. Debt and Debt-Service Ratios 1/
(In percent)

	2000	Average for 2001-05 Baseline assumptions	Average for 2001-05 Low-case assumptions
Armenia			
Ratio of NPV of external debt to:			
Exports of goods and services	134.9	113.0	118.6
Central government revenue	176.6	154.7	163.5
Ratio of debt service to:			
Exports of goods and services	10.5	12.7	13.1
Central government revenue	15.5	19.2	19.8
Georgia			
Ratio of NPV of external debt to:			
Exports of goods and services	128.3	97.9	102.5
Central government revenue	356.4	286.6	323.5
Ratio of debt service to:			
Exports of goods and services	10.0	11.4	12.0
Central government revenue	36.4	36.1	40.7
Kyrgyz Republic			
Ratio of NPV of external debt to:			
Exports of goods and services	197.8	203.6	209.5
State government revenue	575.9	382.8	403.1
Ratio of debt service to:			
Exports of goods and services	27.9	27.6	28.2
State government revenue 2/	40.7	29.0	30.7
Moldova			
Ratio of NPV of external debt to:			
Exports of goods and services	139.0	92.2	99.6
Central government revenue	379.5	271.3	305.7
Ratio of debt service to:			
Exports of goods and services	15.3	15.2	15.9
Central government revenue	41.9	44.7	48.7
Tajikistan			
Ratio of NPV of external debt to:			
Exports of goods and services	137.0	128.1	151.8
Central government revenue	449.5	332.8	411.9
Ratio of debt service to:			
Exports of goods and services	10.0	33.2	18.8
Central government revenue	35.0	43.8	50.9

Sources: Ministries of Finance and Central Banks of respective countries; staff estimates.
1/ Public and publicly guaranteed debt; ratios shown are before debt strategies or new debt relief.
2/ Excluding Kumtor (public enterprise).

Figure 10. CIS5: Debt Sustainability Under Baseline Scenario, 2000 -



Source: Staff projections

Table 12. Macroeconomic Assumptions for Debt Sustainability Analysis

	Armenia	Georgia	Kyrgyz Republic	Moldova	Tajikistan
	(In percent; averages for 2001-10)				
Baseline Scenario					
Real GDP growth	5.5	3.8	4.4	4.5	4.6
Growth in external trade 1/:					
Exports of GNFS	9.3	7.3	6.2	11.9	5.9
Imports of GNFS	5.5	6.0	5.8	9.4	5.7
RER change (against US dollar) 2/	0.3	-0.1	2.0	2.0	2.5
FDI (in percent of GDP)	5.0	3.3	2.8	6.6	1.9
Central government revenue (in percent of GDP) 3/	17.4	12.8	17.4	16.3	15.9
Low-Case Scenario					
Real GDP growth	3.9	2.4	2.6	2.3	2.2
Growth in external trade 1/:					
Exports of GNFS	7.4	5.8	3.8	8.0	2.0
Imports of GNFS	4.3	5.4	4.9	6.2	2.1
RER change (against US dollar) 2/	0.3	-0.4	1.2	0.4	-1.5
FDI (in percent of GDP)	4.2	2.6	1.9	4.7	1.3
Central government revenue (in percent of GDP) 3/	17.4	12.0	17.5	15.9	14.6
Memorandum items:					
	(In percent; averages for 1995 - 2000)				
Real GDP growth	5.5	5.2	3.7	-2.3	0.3
Export growth	8.1	8.3	-0.5	9.8	6.4
FDI (in percent of GDP)	5.2	3.8	4.4	3.9	1.8

Source: Staff projections.

1/ Volume growth for Tajikistan.
2/ A positive sign means appreciation.
3/ Excluding grants.

Table 13. Summary of DSA results

	Baseline scenario	Low-case scenario
Armenia	**Armenia should not need restructuring of bilateral or commercial debt.** The net present value of debt as a ratio of exports is expected to decline from 135 percent in 2000 to around 110 percent in 2010. As a share of fiscal revenue, the NPV of debt falls to around 150 percent in 2010.	**With lower growth and exports, the ratio of NPV of debt to exports would increase rapidly and could exceed 150 percent of exports from 2009 onwards.** Sustainability can be restored through a permanent ¼– ½ percent of GDP fiscal adjustment beyond that assumed in the program, which the staff feels would be achievable, or by a flow rescheduling of official bilateral debt. HIPC eligibility is unlikely.
Georgia	**Georgia can avoid HIPC treatment.** However, even with strong performance, it will require continued concessional lending and grants from abroad, as well as concessional rescheduling of bilateral debts. Debt in Georgia is particularly problematic in terms of fiscal revenues.	**Flow rescheduling in 2003–04 even on concessional terms, would probably not be sufficient to address liquidity problems.** The ratio of debt service to central government revenues would peak in 2003/04 at about 50 percent, but it would remain over 30 percent thereafter. HIPC eligibility is unlikely.
Kyrgyz Republic	**Without debt relief, the Kyrgyz Republic would not achieve external sustainability by the end of the decade**. The NPV of debt to exports ratio would not fall below 150 percent, while the ratio of NPV of debt revenues would fall below 250 percent only in 2009. A flow rescheduling on Naples terms in 2002 would improve these variables only modestly, but the ratios of NPV of debt to exports and central government revenue remain above the HIPC threshold level even after a hypothetical stock operation on Naples terms in 2004.	**The Kyrgyz Republic would have difficulty meeting its external debt obligations, unless multilateral debt relief was considered**. In this case, even a Naples stock of debt reduction would be insufficient to achieve external sustainability, as the ratios of NPV of debt service to exports and central government revenue remain well above 150 and 250 percent respectively throughout the decade. HIPC eligibility is likely to persist, but the amount of relief afforded is relatively modest.
Moldova	**Moldova is likely to need short term debt relief**, with debt service exceeding 60 percent of central government revenue in 2002 (because of maturing Eurobond debt). Debt service remains above 30 percent of central government revenues until 2006.	**Under low case assumptions, Moldova would have persistent debt sustainability problems.** With slower growth and weaker exports, NPV as a share of central government revenues remains above 250 percent until 2008. However, with a stock of debt operation on Naples terms, this ratio falls below 250 percent in 2001. In light of the short-term nature of the debt problem, HIPC eligibility should not be persistent, however.
Tajikistan	**Tajikistan faces a particular liquidity problem until late in the decade, and in fiscal terms, the burden is very high (partly owing to low revenue levels).** A flow rescheduling on Naples terms provides modest relief, but a stock of debt operation in 2004 would help significantly.	**Tajikistan will face severe difficulties meeting its debt service obligations**. In this case, the ratio of NPV of debt to revenues remains well above the HIPC threshold of 250 percent throughout the projection period, despite concessional rescheduling of bilateral debt. However, eligibility under the fiscal window is not certain

Source: Appendix I.

support from bilateral partners. Thus, on the basis of current projections, Armenia would not be eligible, while Moldova's debt-to-revenue ratio falls below 250 percent with hypothetical Naples terms relief by next year. After a stock of debt restructuring on Naples terms, Georgia and Tajikistan have debt to export ratios well below 150 percent, and although debt to revenue ratios are high in both cases, neither would be eligible under the fiscal window owing to low central government revenue to GDP ratios.

E. Risks to these programs

69. **The chief risk to the programs is an external shock,** such as a sharp slowdown in the world economy or a spillover from the conflict in Afghanistan. In either case, a significant deterioration in the balance of payments would undermine monetary and exchange rate policies, and could lead to loss of reserves and a sharp depreciation of the exchange rate in some countries, resulting in payments difficulties.[33] In Georgia, for instance, debt service per annum is projected to remain above 50 percent of gross reserves over the medium term. Moldova—which was especially hard hit by the Russian turmoil of 1998—is also very exposed to external shocks, as are the Kyrgyz Republic and Tajikistan. As noted earlier, sharp exchange rate depreciation could leave a number of these countries with debt levels over the HIPC eligibility thresholds.

70. **Other significant risks** include renewed military conflicts (in the Caucasus, but also—in light of the Afghan conflict—in Central Asia) and weak program implementation due either to institutional weakness or inadequate ownership (all countries). A failure to boost fiscal revenues would undermine the adjustment program in all countries, though the problem is particularly severe at the central government level in Georgia. Poor program implementation in Moldova would cause multilateral creditors to hold up disbursements, and this factor—like a delay in privatization of Moldtelecom—would cause the program to be under-financed. Any delay in streamlining the Kyrgyz public investment program would be detrimental, whereas, in addition to reforms, Tajikistan has a particular need to strengthen debt management capacity.

V. CONCLUSION

71. **The end of a decade of transition is a good opportunity to take stock of achievements and remaining challenges in the low-income CIS countries.** While much has indeed been accomplished (macro stability, fiscal consolidation, institutional development, resumption of growth), poverty has increased and public debt is approaching or exceeding unsustainable levels. Much of the debt is owed to the IFIs that were asked to help these new countries enter into the global economic system.

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[33] The program for Georgia assumes a modest real depreciation in the short term (and no significant change over the longer run), while those for the other four assume no change or modest real appreciation.

72. Given the unprecedented challenges faced by these countries, **their achievements outweigh their failures**. From the beginning, the task of transition was recognized as being daunting, though the extent of the decline in output and the increase in poverty was not foreseen (in part because of the various shocks—such as military conflicts, drought, the Russia crisis—that these countries have suffered since then). Studies have generally shown that the policy reform agenda identified early in transition was correct, but that it was not implemented as systematically and forcefully as it could have been. The record of transition strongly indicates that the countries that moved more rapidly and with greater determination to introduce market oriented institutions (such as Poland or the Baltics) have been rewarded with a faster and more robust rebound in economic growth.[34] In our view, most of the CIS 7 countries have managed to introduce far reaching reforms and to adjust—albeit slowly—to the massive financial and institutional constraints that they faced at the beginning of the transition.

73. While significant problems remain, **these countries have a chance to grow out of their present difficulties with forceful policy implementation and ownership**. This requires a sustained commitment the reform strategy already adopted in principle, especially fiscal prudence, structural reforms and control of corruption. Most of these countries are also likely to need enhanced international assistance to make timely progress with the implementation of their poverty reduction strategies.

74. **How best can the international community help these countries to escape poverty and achieve sustainable economic growth?** In many ways, only the countries themselves can do what is needed, and the authorities are encouraged to move rapidly ahead with the structural reforms that have been identified, including in the PRSP process. But the international community – including their neighbors in each region – has a responsibility to support these young countries. The IFIs have well-identified roles in terms of financial and technical assistance. Bilateral donors and creditors can also do much to secure the future stability of these countries, including through grants and other concessional aid, generous debt relief where needed, and the promotion of better regional cooperation.

[34] J. Linn, "Ten Years of Transition in Central Europe and the Former Soviet Union: the Good News and the Not-So-Good News," in M. Blejer and M. Škreb, eds., *Transition: The First Decade*, Kluwer Academic (forthcoming), and O. Havrylyshyn, et al., *Growth Experience in Transition Countries, 1990–98*, IMF Occasional Paper No. 184 (1999).