

Caucasus and Central Asia

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Population, millions (2015)

GDP per capita, U.S. dollars (2015)

■ Oil exporters

■ Oil importers



Sources: IMF Regional Economic Outlook database; and Microsoft Map Land.

Note: The country names and borders on this map do not necessarily reflect the IMF's official positions.

CCA Region Highlights

The CCA region has been hit by large and persistent external shocks since 2014, particularly the slump in commodity prices and slowdown in its key economic partners (mainly Russia and China). Regional growth is projected to average 1.3 percent this year. This represents a sharp weakening of economic activity compared with the rates observed in the 15 years before the shocks, especially for oil exporters. Next year, the region's economies should turn a corner, with average growth picking up to 2.6 percent. However, available policy space has declined, and vulnerabilities have risen. Medium-term prospects are weak, with growth projected to average 4 percent in 2018–21, half that in 2000–14. Under this scenario, the gains that have been made in living standards since independence, vis-à-vis emerging markets, would be partly reversed.

Shocks Mitigated, Vulnerabilities Heightened

Fiscal accommodation, along with currency adjustment, has helped the CCA mitigate the impact of the external shocks. However, amid weakening revenues, increased public spending has widened budget deficits by some 6.3 percentage points of GDP on average since 2014. With financial assets being drawn down and public debt rising, policy space has declined. Going forward, fiscal policy needs to strike a balance between supporting growth in the short term and ensuring debt sustainability, intergenerational equity, and precautionary savings over the longer term. This requires prioritizing pro-growth capital spending and safeguarding social expenditures, while consolidating fiscal positions in the context of credible medium-term plans.

Currency adjustment has supported competitiveness but temporarily raised inflation and, amid weakening growth, contributed to the buildup of vulnerabilities in the highly dollarized financial sectors. With many countries opting for more exchange rate flexibility, the need to strengthen monetary policy frameworks has become a priority. This must be complemented with further steps to contain risks to financial stability and intermediation, including capital injections, restructuring and closing of troubled banks, and revamping of lending practices, as well as strengthening of financial surveillance and macroprudential and crisis management frameworks.

Structural Transformation Needed

Most CCA countries made rapid gains in living standards in the two decades following their independence. However, these gains have lost momentum in recent years amid weak productivity growth and deceleration of investment. Structural transformation to diversify away from reliance on commodities and remittances is imperative to improve medium-term prospects, create jobs, and raise living standards. Many countries have already drawn up diversification and privatization plans. But decisive actions are now needed to implement them. Efforts could focus on improving governance, accountability, property rights and financial intermediation, areas where the CCA lags behind its emerging market peers. Growth will also need to be made more inclusive, to allow the broader population to enjoy the benefits of higher living standards.

CCA Region: Selected Economic Indicators, 2000–17*(Percent of GDP, unless otherwise indicated)*

	Average 2012	2013	2014	2015	Projections	
					2016	2017
CCA						
Real GDP (annual growth)	8.7	6.6	5.3	3.2	1.3	2.6
Current Account Balance	1.5	2.1	2.0	-3.0	-4.1	-2.8
Overall Fiscal Balance	2.7	2.7	1.5	-4.6	-4.9	-3.0
Inflation, p.a. (annual growth)	9.4	6.1	5.9	6.2	9.9	8.3
CCA Oil and Gas Exporters						
Real GDP (annual growth)	9.0	6.7	5.3	3.1	1.0	2.4
Current Account Balance	2.7	2.8	3.3	-2.4	-3.5	-2.0
Overall Fiscal Balance	3.4	3.3	1.9	-4.7	-4.8	-2.8
Inflation, p.a. (annual growth)	9.6	6.4	6.1	6.4	10.8	8.7
CCA Oil and Gas Importers						
Real GDP (annual growth)	6.5	5.7	4.7	3.7	3.7	4.1
Current Account Balance	-7.6	-4.8	-9.4	-7.9	-8.5	-8.8
Overall Fiscal Balance	-3.2	-2.5	-2.0	-3.6	-5.3	-4.4
Inflation, p.a. (annual growth)	7.7	3.6	4.6	4.8	2.4	4.9

Sources: National authorities; and IMF staff calculations and projections.

Note: CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan. CCA oil and gas importers: Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.

Основные положения по региону КЦА

Регион КЦА подвергается сильным и долговременным внешним шокам с 2014 года, особенно в результате падения цен на биржевые товары и замедления роста в странах, являющихся важнейшими экономическими партнерами региона (в основном в России и Китае). Темпы роста в регионе, по прогнозам, составят в среднем в этом году 1,3 процента. Это означает резкое ослабление экономической активности по сравнению с темпами, наблюдавшимися в течение 15 лет до шоков, особенно для стран—экспортеров нефти. На будущий год в экономике стран региона должен наступить поворотный момент, с повышением средних темпов роста до 2,7 процента. При этом имеющиеся возможности экономической политики сокращаются, и факторы уязвимости усиливаются. Темпы роста в среднесрочной перспективе невысоки, они прогнозируются в среднем на уровне 4 процентов в 2018–2021 годах, что составит половину достигнутых в 2000–2014 годы. Соответственно, прогресс в повышении уровня жизни и его приближении к странам с формирующимся рынком, который был достигнут после обретения независимости, частично сойдет на нет.

Смягчение шоков, усиление факторов уязвимости

Адаптивная налогово-бюджетная политика, наряду с корректировкой обменного курса, помогает экономике стран КЦА смягчить последствия внешних шоков. При этом, в условиях сокращения доходов, повышение государственных расходов увеличило бюджетные дефициты в среднем примерно на 6,3 процентного пункта ВВП с 2014 года. С использованием финансовых активов и ростом государственного долга уменьшились возможности выбора экономической политики. В будущем налогово-бюджетная политика должна обеспечивать баланс между поддержкой роста в краткосрочной перспективе и обеспечением устойчивости долговой ситуации, справедливого распределения ресурсов между поколениями и сбережения средств на непредвиденные расходы в более долгосрочной перспективе. Для этого необходимо установить приоритетность капитальных расходов, способствующих росту, и защитить расходы на социальные нужды, проводя бюджетную консолидацию в контексте внушающих доверие среднесрочных планов.

Корректировка обменного курса поддерживает конкурентоспособность, но временно повысила инфляцию и, в условиях ослабления динамики роста, стала одной из причин повышения уязвимости в значительной степени долларизированных финансовых секторов. При растущем числе стран, предпочитающих большую гибкость обменного курса, укрепление основ денежно-кредитной политики становится приоритетной задачей. Это должно дополняться дальнейшими мерами по сдерживанию рисков для финансовой стабильности и посредничества, в том числе вливанием капитала, реструктуризацией и закрытием проблемных банков и пересмотром механизмов кредитования, а также укреплением финансового надзора и макропруденциальных основ, а также основ антикризисного управления.

Необходимы структурные преобразования

Большинство стран КЦА добились быстрого повышения уровня жизни за два десятилетия после обретения независимости. Эти достижения, однако, потеряли набранные обороты в последние

годы в условиях вялого роста производительности и замедления роста инвестиций. Без структурных преобразований в целях диверсификации экономики для уменьшения зависимости от биржевых товаров и денежных переводов невозможно улучшение среднесрочных перспектив, создание рабочих мест и повышение уровня жизни. Многие страны уже разработали планы диверсификации и приватизации. Но для реализации этих планов необходимы решительные действия. Усилия могут быть направлены на совершенствование сфер управления, подотчетности, прав собственности и финансового посредничества, в которых КЦА отстает от сопоставимых стран с формирующимся рынком. Необходимо также добиться более всеобъемлющего характера роста, чтобы позволить более широким слоям населения воспользоваться преимуществами более высокого уровня жизни.

Регион КЦА: отдельные экономические показатели, 2000–2017 годы
(В процентах ВВП, если не указано иное)

	Среднее 2000–12	2013	2014	2015	Прогнозы	
					2016	2017
КЦА						
Реальный ВВП (годовой рост)	8.7	6.6	5.3	3.2	1.3	2.6
Сальдо счета текущих операций	1.5	2.1	2.0	-3.0	-4.1	-2.8
Общее сальдо бюджета	2.7	2.7	1.5	-4.6	-4.9	-3.0
Инфляция, в среднем за период (годовой рост)	9.4	6.1	5.9	6.2	9.9	8.3
Страны-экспортеры нефти и газа КЦА						
Реальный ВВП (годовой рост)	9.0	6.7	5.3	3.1	1.0	2.4
Сальдо счета текущих операций	2.7	2.8	3.3	-2.4	-3.5	-2.0
Общее сальдо бюджета	3.4	3.3	1.9	-4.7	-4.8	-2.8
Инфляция, в среднем за период (годовой рост)	9.6	6.4	6.1	6.4	10.8	8.7
Страны-импортеры нефти и газа КЦА						
Реальный ВВП (годовой рост)	6.5	5.7	4.7	3.7	3.7	4.1
Сальдо счета текущих операций	-7.6	-4.8	-9.4	-7.9	-8.5	-8.8
Общее сальдо бюджета	-3.2	-2.5	-2.0	-3.6	-5.3	-4.4
Инфляция, в среднем за период (годовой рост)	7.7	3.6	4.6	4.8	2.4	4.9

Источники: официальные органы стран; расчеты и прогнозы персонала МВФ.

Страны – экспортеры нефти и газа КЦА: Азербайджан, Казахстан, Туркменистан и Узбекистан.

Страны – импортеры нефти и газа КЦА: Армения, Грузия, Кыргызская Республика и Таджикистан.

3. Caucasus and Central Asia: Is the Worst Over?

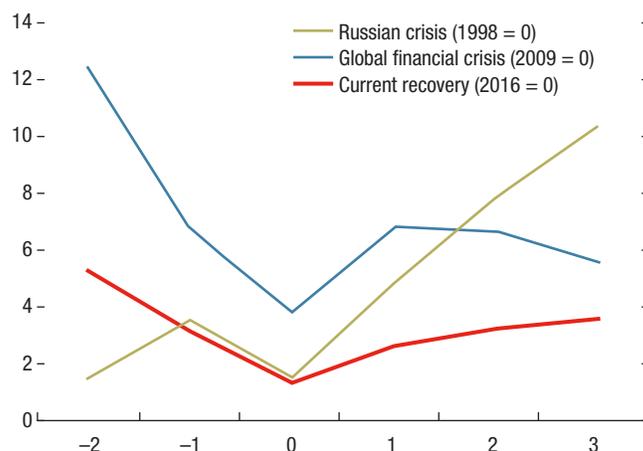
Fiscal accommodation and exchange rate adjustment have helped the Caucasus and Central Asia (CCA) mitigate the immediate impact from large and persistent external shocks, particularly the slump in commodity prices and weaker growth in key trading partners. Growth is starting to recover, but these shocks have left the region with increased fiscal, external, and financial sector vulnerabilities, along with less policy space and weaker medium-term prospects. Policies should continue to support growth in the near term where policy space is available, while aiming to reduce vulnerabilities over time, including through the formulation of credible multiyear fiscal plans, modernization of monetary policy frameworks, and strengthening of financial supervision. Structural transformation to diversify away from commodities and reduce reliance on remittances is needed to improve medium-term growth prospects, boost job creation, and avoid a deterioration in living standards.

Weak and Fragile Recovery

The CCA continues to adjust to large and persistent shocks from abroad, particularly the slump in oil and other commodity prices, depressed economic conditions in Russia, and slowing economic activity in China. GDP growth in the region is projected to be 1.3 percent this year. This represents a sharp weakening of economic activity compared with the historical rates observed before the shocks. Fiscal accommodation and exchange rate adjustment, combined with some improvement in the external environment (a partial recovery in the prices of oil and other key commodities, a milder recession in Russia, and a policy stimulus in China) have provided some relief to the region. However, over the medium term, the oil price recovery is expected to be limited, with futures markets suggesting the price will stay below \$60 by 2021. In addition, the recovery in Russia is likely to

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Figure 3.1. Not a Historical V-Shaped Recovery
(Real GDP, percent change)



Source: IMF staff calculations.

remain modest, and the ongoing prospects for a mild deceleration in China remain. As a result, CCA growth is anticipated to pick up only to 2.6 percent in 2017, a much slower recovery than in previous episodes of economic slowdown (Figure 3.1), reflecting a larger magnitude and greater persistence of the shocks and more limited policy space.

For CCA oil exporters, GDP growth in 2016 is projected to be 1 percent, about 2 percentage points lower than last year and the lowest since 1998—despite fiscal easing in Azerbaijan and Uzbekistan. In Kazakhstan, indicators point to an estimated contraction of $\frac{3}{4}$ percent this year, partly owing to weaker oil-related activities and contractionary fiscal policy. GDP growth for oil exporters is projected to pick up to 2.4 percent next year, supported by the recent recovery in oil prices and an increase in hydrocarbon production in Kazakhstan, as well as by a pickup in non-hydrocarbon activities, especially in Azerbaijan.

Oil-importers' economies are anticipated to expand by 3.7 percent this year, the same rate as in

2015. Armenia is benefiting from stronger-than-expected exports to Russia and rapid growth in services, but domestic demand remains weak. In Georgia, increased public spending is boosting domestic demand. In Tajikistan, growth figures have been revised up significantly on a pickup in investment, which is more than offsetting lower consumption owing to weak remittance flows. With economic activity projected to strengthen, especially in Armenia and Georgia, growth in the CCA oil importers' group is set to firm to 4.1 percent in 2017.

Challenging Yet Critical Exchange Rate Adjustment

Currency weakening and, in some cases, increased exchange rate flexibility, have been an important element of the CCA's adjustment to the new environment of persistently low commodity prices and reduced growth in key trading partners (Figure 3.2).¹ This has helped to both reduce exchange rate misalignments and limit the rundown of foreign currency reserves, support competitiveness (Box 3.1), and, in oil exporters, absorb the fiscal impact of lower oil revenues. With the external shocks receding this year, most CCA exchange rates have stabilized (Figure 3.2). Concerns about adverse economic effects of heightened exchange rate volatility and further depreciations (the so-called “fear of floating”) have also kept some CCA currencies inflexible, limiting the necessary adjustment in real terms.

Policy agendas for moving to greater exchange rate flexibility remain incomplete in many

¹Kazakhstan devalued its currency in early 2014 and officially adopted a floating exchange rate regime in August 2015. Azerbaijan and Turkmenistan undertook step devaluations of their currencies in early 2015, and Azerbaijan devalued again in December. The pace of depreciation in Uzbekistan picked up temporarily toward the end of 2015. Armenia and Georgia experienced large depreciations in late 2014 and early 2015, respectively. Depreciation in the Kyrgyz Republic accelerated from mid-2014 until late 2015, while the crawling pace of devaluation of Tajikistan's currency was accelerated late in 2014 (Figure 3.2). Armenia, Georgia, Kazakhstan, and the Kyrgyz Republic—*de jure* under floating exchange rate regimes—all have a form of inflation-targeting framework in place, with exchange rate interventions remaining an important instrument throughout the region (Horton and others 2016).

countries (Horton and others 2016). A key challenge is the modernization of monetary policy frameworks, including the adoption of credible nominal anchors and the strengthening of central bank independence. Sustained communication efforts are also needed to foster policy credibility and support orderly market conditions. These include providing guidance on factors that influence policy decisions and setting out conditions for intervention in foreign exchange markets. Enhanced financial sector supervision could help preserve the soundness of the highly dollarized financial sectors, which have been weakened by recent depreciations and economic slowdown (Box 3.1).

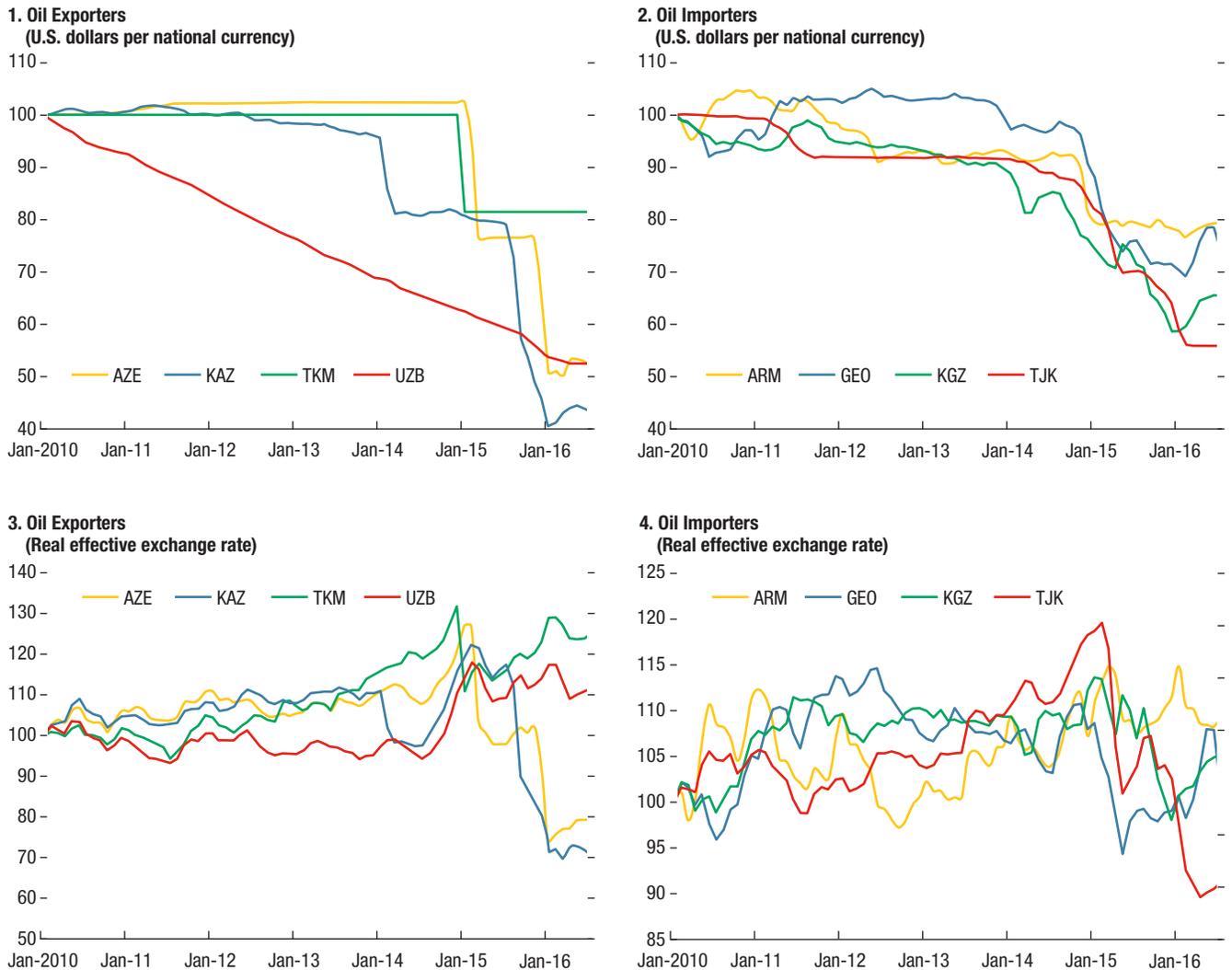
Easing Inflationary Pressures

Inflation is expected to moderate gradually as the effects of currency depreciations unwind. In oil exporters, inflation is set to reach double digits this year for the first time since 2008, reflecting significant depreciations in Azerbaijan and Kazakhstan last year (Figure 3.3). As the effect of currency weakening dissipates, inflation is likely to decline amid weak domestic demand and declining food prices. However, inflation will remain at a rather high 8.7 percent in 2017, partially reflecting high inflation expectations owing to weakness in monetary policy frameworks.

In oil importers, inflationary pressures are expected to remain subdued. Stronger currencies in Armenia, Georgia, and the Kyrgyz Republic, slack in economic activity, together with weak oil and food prices, should help to bring inflation down to 2.4 percent this year. Inflation is expected to pick up to 4.9 percent in 2017 as domestic economic activity starts to recover.

With inflationary pressures easing, some central banks, for example in Armenia, Georgia, and Kazakhstan, have started to gradually shift their tight monetary policy stance to support the recovery by lowering interest rates. In Azerbaijan and Tajikistan, where inflationary pressures remain high, tight monetary policy remains warranted.

Figure 3.2. Exchange Rate Pressures Moderating
(Index, January 2010 = 100)



Sources: Information Notice System database; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

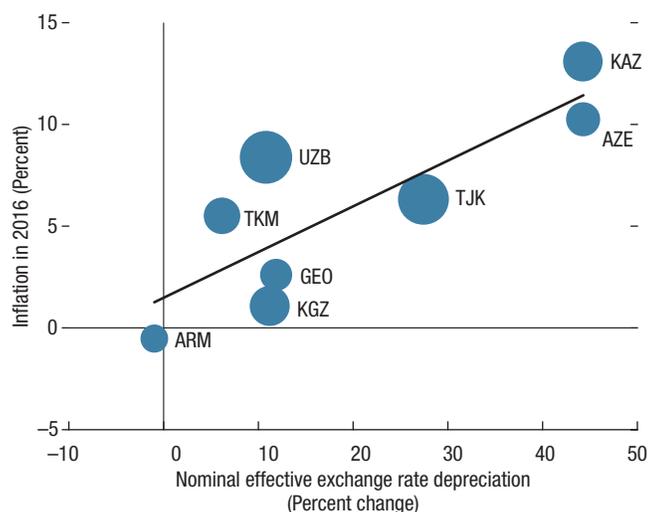
Financial Vulnerabilities Still Rising

Financial vulnerabilities continue to build up across the region. Banking sector risks have increased with currency depreciations, as highly dollarized balance sheets have further weakened (Box 3.1). Some banks continue to report losses and, given their exposure to foreign currency fluctuations, remain vulnerable to further depreciations. The prevalence of unhedged

borrowers is putting downward pressure on asset quality (Figure 3.4).

Country authorities are taking actions to contain risks to financial stability and financial intermediation. These actions include capital injections, restructuring and closing of troubled banks, and revamping lending practices, asset quality review processes, and stress-testing procedures. In Azerbaijan, for example, the licenses of eight banks have been revoked, bank restructuring has gathered momentum, and

Figure 3.3. Pickup in Inflation Driven by Currency Depreciation
(Percent change)



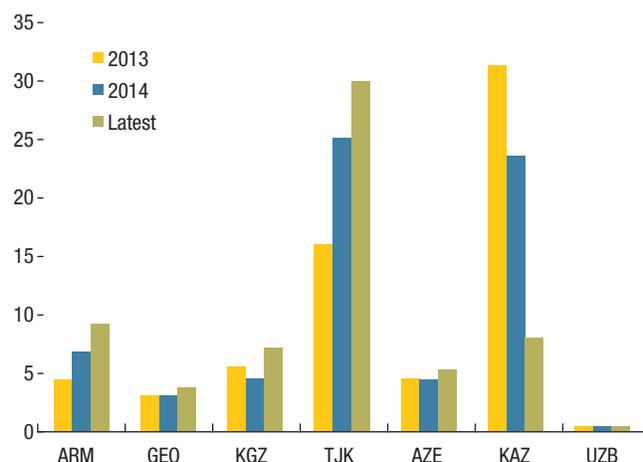
Sources: World Economic Outlook database; IMF, Information Notice System database; and IMF staff calculations.
Note: Country-specific episodes are described in footnote 1. Bubble size indicates average inflation between 2000 and 2013. Country abbreviations are International Organization for Standardization (ISO) country codes.

independent stress testing and asset quality review is underway. In Kazakhstan, liquidity conditions have improved, reflecting a number of policy actions that favored an increase in local currency deposits, and country authorities are expected to review their liquidity and resolution frameworks. In the Kyrgyz Republic, near-term vulnerabilities have been mitigated through the implementation of macroprudential measures, higher capital requirements, and a plan to transition to risk-based supervision. These important efforts need to continue, supported by a further strengthening of financial sector surveillance, such as the monitoring of liquidity risks. Stronger macroprudential and crisis management policies would also help reduce financial sector vulnerabilities.

Declining Space for Further Fiscal Easing

Increased public spending, together with weak revenue, has resulted in wider budget deficits in

Figure 3.4. Nonperforming Loans Continue to Rise
(Percent of total loans)

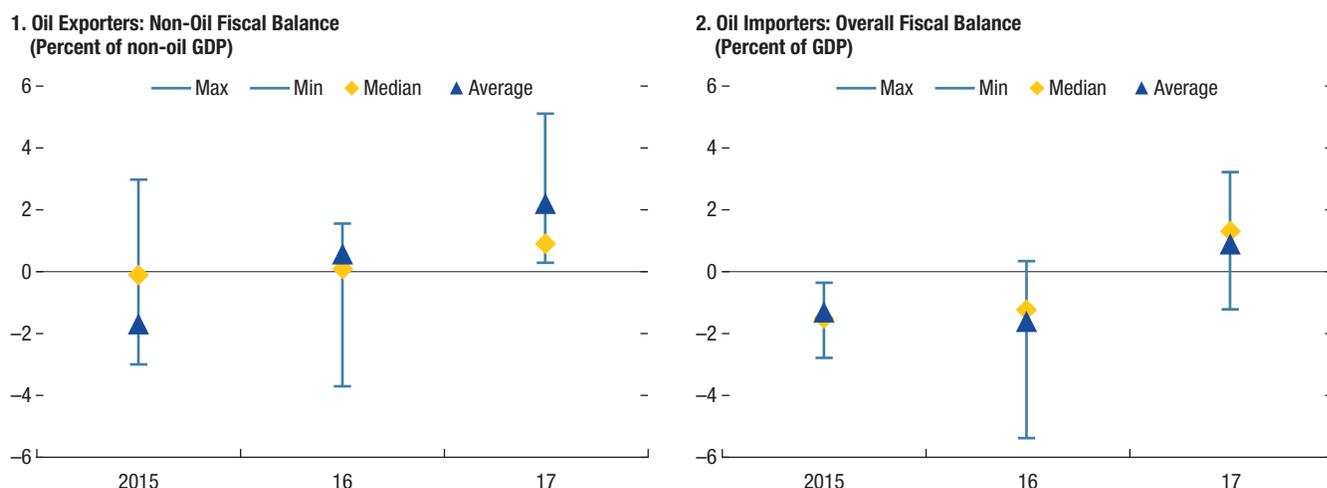


Sources: National authorities; and IMF staff calculations.
Note: Nonperforming loans (NPLs) in Azerbaijan include only the overdue portion of the loans. In Kazakhstan, the reduction reflects the de-licensing of a bank with significant NPLs and legislation changes allowing banks to move NPLs to an external special purpose vehicle. Data are not available for Turkmenistan. Country abbreviations are International Organization for Standardization (ISO) country codes.

oil exporters and importers alike, with overall balances for the region deteriorating some 6.4 percentage points of GDP on average since 2014. However, most countries are projected to consolidate their fiscal positions in 2017 (Figure 3.5).

- The fiscal stance has differed across oil exporters. Average non-oil fiscal deficits are expected to be at 19 percent of non-oil GDP this year, 0.4 percentage points lower than in 2015. With revenues remaining subdued, Kazakhstan and Turkmenistan have tightened their fiscal policies mainly by reducing capital spending, which has helped to improve their non-oil primary balances by about 1.5 percentage points of GDP each, relative to 2015, with further reductions expected in 2017. In Azerbaijan, public investment is projected to decline significantly in 2017, reversing the expansionary fiscal stance following a countercyclical stimulus package this year. Supported by a projected pickup in revenues in line with oil prices, these

Figure 3.5. Fiscal Balance
(Change from previous year)



Sources: National authorities; and IMF staff calculations.
Note: Uzbekistan is excluded from the oil exporters aggregate.

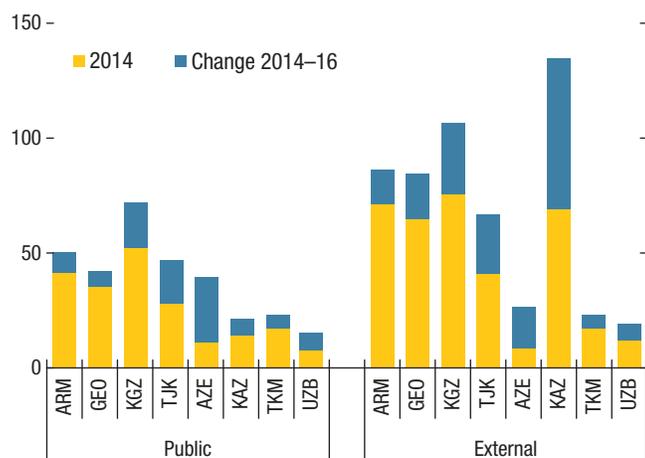
actions are expected to improve non-oil fiscal balances in oil exporters by some 2.2 percentage points of non-oil GDP in 2017.

- In oil importers, budget deficits are projected to widen to 5.3 percent of GDP in 2016 from 3.6 percent last year. This reflects weaker revenues, as well as increased spending in support of economic activity, particularly in Georgia, the Kyrgyz Republic, and Tajikistan. Increases in expenditure were driven by increases in the wage bill in the Kyrgyz Republic, and by strong public investment both there and in Tajikistan. With the recovery projected to strengthen next year, all countries except Georgia are expected to improve their fiscal positions in 2017, modestly narrowing the deficit of the group to 4.4 percent of GDP. Georgia is set to provide additional incentives to boost investment and growth by replacing the corporate income tax with a tax on dividends which is expected to reduce tax revenue and widen the deficit, unless offsetting measures are implemented.

Although fiscal easing has helped support domestic demand in a number of countries, policy space is declining in many of them, as fiscal buffers are run down and debt increases rapidly. Since 2014, oil exporters have used some \$20 billion of their savings (equivalent to almost 6 percent of their 2015 GDP) to finance budget deficits, and public debt, although remaining at moderate levels in most cases, has increased by double digits in many oil exporters and importers (Figure 3.6, left panel). In addition to widening deficits, currency depreciations and the decline in nominal GDP in oil exporters from lower oil prices have all contributed to an increase in the debt-to-GDP ratio. With public debt levels and debt service rising, and, given large contingent liabilities, fiscal space for any further stimulus has shrunk in the Kyrgyz Republic and Tajikistan. In Armenia and Georgia, public debt has reached or surpassed 40 percent of GDP and, while short-term obligations are not a concern, a weak growth outlook and rising financing costs suggest that these countries may find it difficult to maintain public debt at or below current levels.

Fiscal policy will need to strike a balance between supporting economic activity in the short term

Figure 3.6. Debt Has Increased Rapidly
(Percent of GDP)

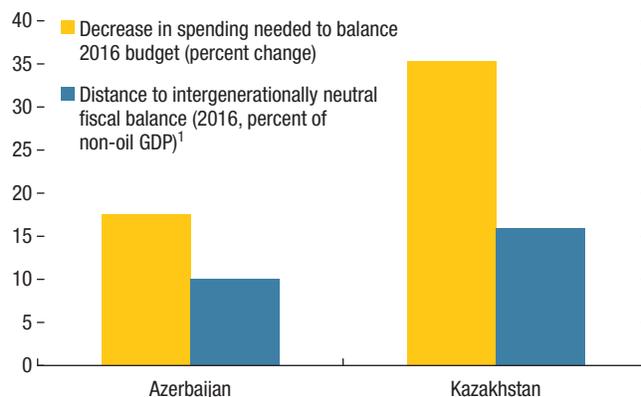


Sources: National authorities; and IMF staff calculations.

Note: The cumulative height of the two bars reflect the debt levels projected for 2016. Public debt includes both domestic and external public debt. External debt includes both private and public debt with the exception of Azerbaijan. External debt in Azerbaijan only includes public external debt. The external debt figure for Georgia excludes inter-company loans. Country abbreviations are International Organization for Standardization (ISO) country codes.

and ensuring long-term sustainability, as countries adjust to the persistent declines in the price of oil and other commodities, and in trading partners' growth prospects. With growth at an 18-year low, oil exporters with strong buffers should support economic activity in the near term through fiscal easing, while putting in place plans to consolidate their fiscal positions over the medium term as soon as conditions allow. These adjustments are needed to ensure fiscal sustainability and intergenerational equity, and rebuild fiscal buffers against any future shocks (Figure 3.7). Oil importers also need to consolidate their fiscal positions in the coming years to both ensure debt sustainability, and create fiscal space for countercyclical policy. Raising non-oil revenues in a growth-friendly way and developing credible medium-term fiscal frameworks that guide the pace of fiscal adjustment are particularly important. As regards the composition of adjustment, countries should aim to prioritize and safeguard capital spending that supports growth and social spending that supports the poor and vulnerable.

Figure 3.7. Illustrative Fiscal Adjustment Needs in Oil Exporters
(Percent)



Source: IMF staff estimates.

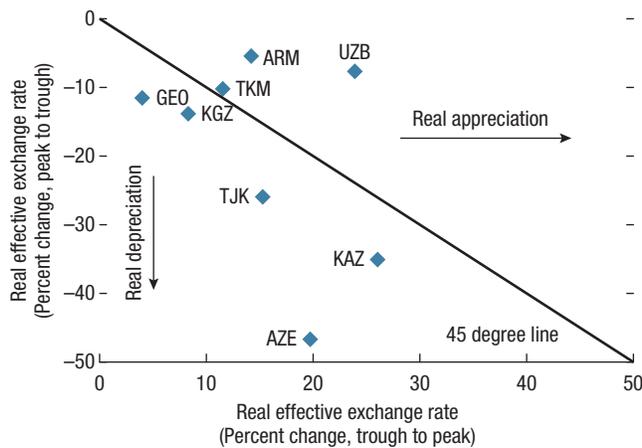
¹This is the gap between the projected nonhydrocarbon primary balance and the desirable fiscal balance based on a permanent income hypothesis.

Exports Supporting External Positions

At 4.1 percent of GDP, the CCA's current account deficit for 2016 is projected to deteriorate by 1.1 percentage points compared with last year. Export volumes are projected to rise this year in most countries (with the exceptions of Kazakhstan and Uzbekistan), likely supported by improvements in competitiveness from exchange rate depreciation (Figure 3.2 lower panels, Figure 3.8, and Box 3.1) and the recent pickup in commodity prices (Figure 3.9), as well as some strengthening in external demand from Russia—which has also helped remittances to stabilize—and from China, where a policy stimulus is helping boost economic activity.² In CCA oil exporters, the combined deficit is projected to be 3.5 percent of GDP this year, reflecting a deficit of 18.5 percent of GDP in Turkmenistan, which more than offsets a move into surplus in Azerbaijan and a lower deficit in Kazakhstan relative to last year. Having received a boost from currency depreciation, the value of non-oil exports is projected to increase and offset some of the losses from oil exports.

²Horton and others (2016) discuss the extent to which currency adjustment has helped correct earlier real exchange rate misalignments in the CCA region.

Figure 3.8. Earlier Appreciations Unwinding
(Percent change)



Sources: IMF, Information Notice System database; and IMF staff calculations. Note: Pre-shock real appreciation is depicted on the horizontal axis (peak-trough dates are country-specific). Post-shock real depreciation on the vertical axis (peak-trough dates are country-specific). Country abbreviations are International Organization for Standardization (ISO) country codes.

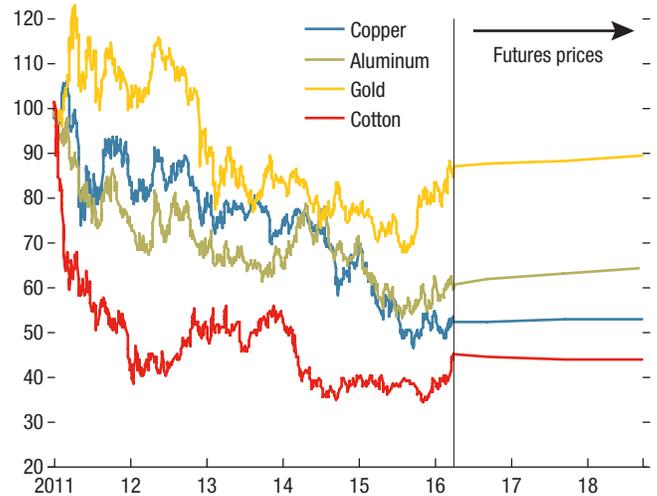
In CCA oil importers, current account deficits are projected to be 8.5 percent of GDP in 2016, 0.6 percentage point wider than last year, mainly reflecting developments in the Kyrgyz Republic and Georgia. The deficit is set to reach 15 percent in the Kyrgyz Republic, due to large investment projects, and edge up to 12.1 percent in Georgia.

External debt has continued to rise in a number of countries (Figure 3.6, right panel). This reflects currency depreciations and increased borrowing by governments and oil companies in some oil-exporting countries. External imbalances throughout the region are anticipated to gradually unwind as exports pick up further—in line with a recovery in commodity prices—and economic conditions improve in key trading partners, particularly Russia.

Downside Risks Are Multifarious

Although fiscal easing and currency adjustment have helped mitigate the immediate impact of the recent shocks on the CCA economies, adjustment to the persistent component of these shocks—the fact that, over the medium term, oil prices

Figure 3.9. Recent Pickup in Key Commodity Prices
(Index, June 2011 = 100)



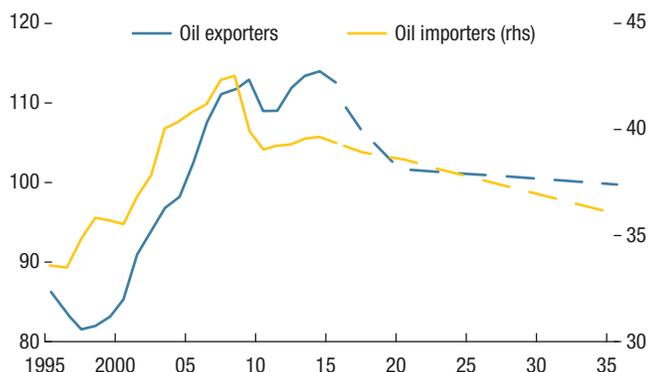
Source: Bloomberg, L.P.; Haver Analytics.

and growth in Russia are expected to be much lower than their recent historical levels—is not yet complete. Moreover, increased vulnerabilities suggest that the region is now more exposed to future adverse shocks. In this context, a further drop in oil prices, and/or slower-than-anticipated growth in key trading partners—China, Russia, and Europe (for example, from Brexit; see Box 1.3)—could delay the recovery. With weaker-than-anticipated economic conditions under baseline assumptions, governments could find it difficult to implement multiyear fiscal consolidation plans, which, in turn, could undermine fiscal sustainability and confidence. In the absence of further actions, amplification of financial vulnerabilities could slow credit growth and weaken economic activity further.

Structural Transformation Needed

The region has grown strongly since independence to close the gap in living standards with emerging markets (Figure 3.10). However, growth in GDP per capita has steadily lost momentum since the global financial crisis of 2008–09, especially in

Figure 3.10. Risk of Living Standards Falling Behind Peers?
(GDP per capita, percent of emerging market average)



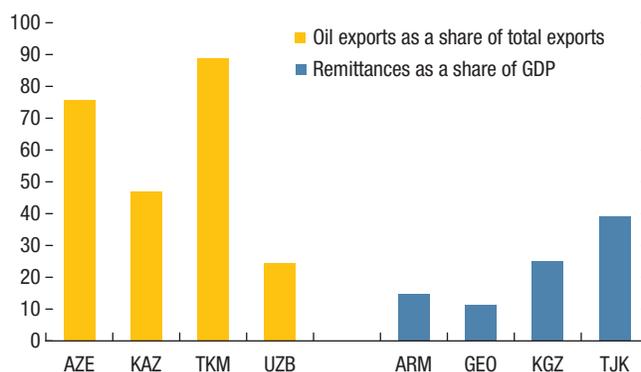
Source: IMF staff calculations.

Note: GDP per capita is assumed to grow at the same rate as 2021 for the years 2022–35. rhs = right-hand side.

oil importers. This loss of momentum is, in part, due to weak growth in productivity relative to emerging market and developing countries, and deceleration in investment growth in oil importers (Mitra and others 2016). The recent slump in commodity prices and remittances has exacerbated this trend. While regional GDP growth is expected to average 4 percent in 2018–21 based on a modest pickup in commodity prices and economic activity in key trading partners, it is about half of the 8.3 percent average of 2000–14. With weaker medium-term growth prospects, the gains made in living standards vis-à-vis emerging markets during the two decades since independence are expected to be partly reversed.

A structural transformation from the growth models based on commodity exports and remittance inflows is needed, to diversify sources of growth and boost job creation (Figure 3.11). Many countries have already announced privatization and diversification plans. However, decisive actions are now needed for their implementation. As macroeconomic conditions start to improve, it is important that the urgency of reforms does not wane. Transparency in the privatization process is essential, with clear timetables and implementation strategies communicated to all stakeholders. To be successful, diversification plans need to be market-

Figure 3.11. High Reliance on Commodities and Remittances
(Percent, 2015)



Sources: National authorities; World Bank.

Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

driven, accompanied by structural reforms to further improve the business climate, strengthen corporate governance, and foster competition. Efforts could focus on improving governance, accountability, property rights, and financial markets—some of the areas where many of the countries lag behind emerging markets.

While growth in the past decades has increased average living standards, it has yet to trickle down to benefit all, as about 16 percent of the population in the region still lives below the poverty line, with poverty rates exceeding 30 percent in Armenia, the Kyrgyz Republic, and Tajikistan.² At this juncture, labor market pressures continue to intensify with the return of some migrant workers to their home countries. These challenges underscore the importance not only of raising growth, but doing so in a way that provides benefit to all segments of the population.

Further investment in education and strengthening labor market policies (Box 2.2), in particular, could help to improve the productivity of the labor force and make growth more inclusive. The rebalancing in China provides a unique opportunity for the region to fill the rising demand for consumption goods in that country,

²Calculation is based on 2013 World Development Indicators data for population living below the national poverty line and excludes Turkmenistan and Uzbekistan, for which data are missing.

and attract some of its manufacturing activities (Chapter 4). Accelerating the pace of structural reforms will not only help the countries in the region overcome the current macroeconomic

challenges, but will also help them capitalize on such opportunities, unlock the region's significant potential, boost long-term growth, and lift people out of poverty.

Box 3.1. Exploring the Effects of Currency Adjustment in CCA Countries

Currency adjustment and, in some cases, increased exchange rate flexibility, have been an important part of the Caucasus and Central Asia (CCA) countries' policy response to the recent external shocks. This box quantifies how changes in exchange rates affect key economic and financial sector variables in the region.

Inflation. Pass-through for the region is estimated at 52 percent and 61 percent after four and eight quarters, respectively.¹ This is higher than the 20 to 30 percent average for emerging Asia and Latin America after 1 to 2 years, but close to the 50 percent estimated for emerging Europe. There is substantial heterogeneity across CCA countries (Figure 3.1.1), with oil importers exhibiting higher pass-through than oil exporters. This may reflect the timing of the policy change since oil exporters maintained pegs to the U.S. dollar during most of the sample period (1997–2015), and a higher share of administered prices in their consumption basket, especially in Turkmenistan and Uzbekistan. There is also evidence of asymmetry, as depreciations are generally associated with a higher pass-through than appreciations (80 percent versus 46 percent).

Foreign currency-denominated loans and deposits. A vector autoregression analysis finds that a devaluation/

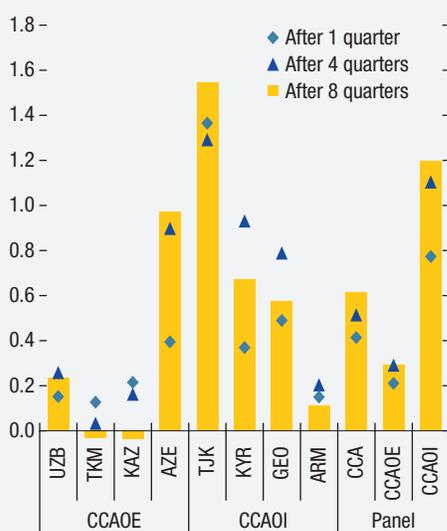
depreciation shock tends to increase the currency mismatch in CCA banking systems (Figure 3.1.2).

Deposits in dollars tend to rise by 0.1 percentage point in response to a 1 percentage point increase in the nominal effective exchange rate (NEER) on impact, while dollar-denominated loans increase by some 0.07 percentage point (a somewhat puzzling result which requires further analysis). The countries with the highest elasticities are Armenia for the case of loans, and Kazakhstan for deposits.

Non-oil exports. Depreciation in the real effective exchange rate (REER) is associated with improvements in non-oil exports in the CCA region (Figure 3.1.3). Overall, a 10 percent REER depreciation is associated with an improvement in non-oil exports of 1.6 percent of GDP. The relationship between changes in the REER and improvements in non-oil exports is stronger in oil importers than in oil exporters. This reflects, in part, greater export diversification in the former, as well as greater exchange rate pass-through to domestic prices. In oil importers, most of the impact appears to be in the first year of the depreciation; whereas, oil exporters have a modest but significant impact in the following year.

The analysis suggests that currency adjustment is indeed an important channel through which external imbalances can be lowered in the CCA. Adopting greater flexibility has allowed the exchange rate to play its shock-absorbing role by adjusting relative prices and supporting export

Figure 3.1.1. Exchange Rate Pass-Through to Inflation (Percent)



Source: IMF staff estimations.

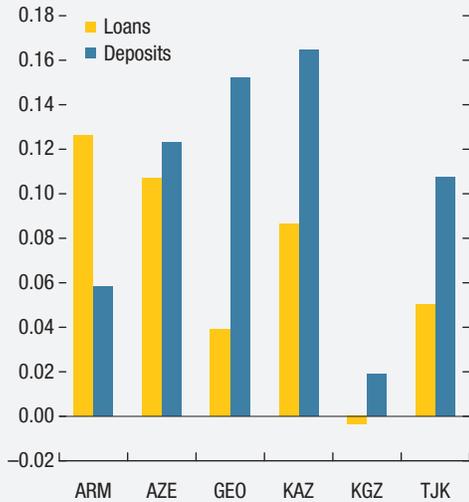
Note: Impulse response to 1 percentage point temporary shock to the nominal effective exchange rate. Country abbreviations are International Organization for Standardization (ISO) country codes. CCA = Caucasus and Central Asia; OE = oil exporters; OI = oil importers.

Prepared by Matteo Ghilardi, Tarak Jardak, Keyra Primus, Saad Quayyum, Juan Treviño, and Hong Yang.

¹The effects of changes in the exchange rate on inflation are estimated using the local projections method developed by Jordà (2005), which allows estimation of the impact over time of a shock by using impulse-response functions obtained by ordinary least squares regressions.

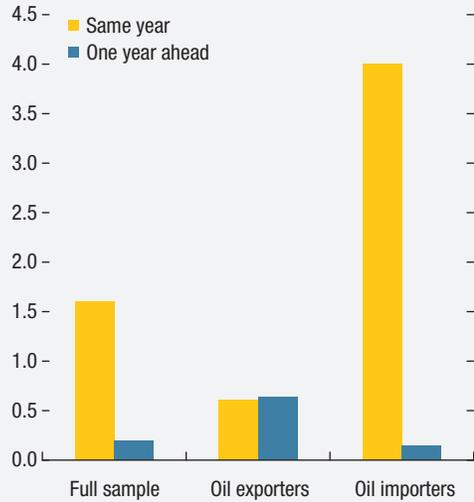
Box 3.1. (continued)

Figure 3.1.2. Response to a Depreciation Shock¹
(Percentage points, one period ahead)



Source: IMF staff estimations.
¹1 percentage point shock to the log difference of nominal effective exchange rate.
 Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 3.1.3. Change in Non-Oil Exports¹
(Percent of GDP)



Source: IMF staff estimations.
¹Response to a 10 percent real effective exchange rate depreciation.
 Note: The results are robust to the use of non-oil exports in percent of non-oil GDP.

competitiveness. To mitigate the adverse effects of currency adjustment on inflation, countries need to develop stronger monetary policy frameworks as they move toward increased exchange rate flexibility. They also need to strengthen efforts toward building confidence in local currency-denominated assets, and improving financial sector oversight. Structural reforms can help the CCA economies diversify and develop more vibrant private sectors, which can, in turn, help them adjust more quickly to exchange rate changes.

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CCA: Selected Economic Indicators

	Average 2011–12	2013	2014	2015	Projections	
					2016	2017
Real GDP Growth	8.7	6.6	5.3	3.2	1.3	2.6
<i>(Annual change; percent)</i>						
Armenia	7.9	3.3	3.6	3.0	3.2	3.4
Azerbaijan	11.9	5.8	2.8	1.1	-2.4	1.4
Georgia	6.1	3.4	4.6	2.8	3.4	5.2
Kazakhstan	8.1	6.0	4.3	1.2	-0.8	0.6
Kyrgyz Republic	3.9	10.9	4.0	3.5	2.2	2.3
Tajikistan	7.9	7.4	6.7	6.0	6.0	4.5
Turkmenistan	13.6	10.2	10.3	6.5	5.4	5.4
Uzbekistan	6.9	8.0	8.1	8.0	6.0	6.0
Consumer Price Inflation	9.4	6.1	5.9	6.2	9.9	8.3
<i>(Year average; percent)</i>						
Armenia	4.1	5.8	3.0	3.7	-0.5	2.5
Azerbaijan	6.7	2.4	1.4	4.0	10.2	8.5
Georgia	6.0	-0.5	3.1	4.0	2.6	3.6
Kazakhstan	8.7	5.8	6.7	6.5	13.1	9.3
Kyrgyz Republic	8.7	6.6	7.5	6.5	1.1	7.4
Tajikistan	14.6	5.0	6.1	5.8	6.3	7.3
Turkmenistan	7.1	6.8	6.0	6.4	5.5	5.0
Uzbekistan	15.1	11.7	9.1	8.5	8.4	9.6
General Gov. Overall Fiscal Balance	2.7	2.7	1.5	-4.6	-4.9	-3.0
<i>(Percent of GDP)</i>						
Armenia ¹	-3.3	-1.6	-1.9	-4.8	-4.5	-3.0
Azerbaijan ¹	4.7	1.0	3.2	-6.8	-9.9	-3.9
Georgia	-3.3	-2.6	-2.9	-3.8	-4.7	-6.0
Kazakhstan	2.9	4.7	1.7	-6.9	-5.7	-4.2
Kyrgyz Republic	-3.2	-5.1	-2.8	-3.2	-8.8	-5.5
Tajikistan	-2.8	-0.8	0.0	-2.3	-4.0	-2.7
Turkmenistan ²	3.4	1.2	0.8	-0.7	-0.8	-0.4
Uzbekistan	3.2	2.9	1.9	0.7	-0.5	-0.3
Current Account Balance	1.5	2.1	2.0	-3.0	-4.1	-2.8
<i>(Percent of GDP)</i>						
Armenia	-9.1	-7.3	-7.6	-2.7	-2.5	-3.0
Azerbaijan	8.1	16.4	13.9	-0.4	0.7	3.1
Georgia	-11.4	-5.8	-10.6	-11.7	-12.1	-12.0
Kazakhstan	-1.0	0.4	2.6	-2.4	-2.2	0.0
Kyrgyz Republic	-0.4	-1.1	-17.8	-10.4	-15.0	-14.9
Tajikistan	-3.8	-2.9	-2.8	-6.0	-5.0	-5.0
Turkmenistan	3.8	-7.2	-7.5	-10.3	-18.5	-18.0
Uzbekistan	4.9	2.9	0.7	0.1	0.1	0.2

Sources: National authorities; and IMF staff estimates and projections.

¹Central government.²State government.

4. How Will China's Rebalancing Affect the Middle East and Central Asia?

Weaker commodity prices, slower global growth, and higher global risk aversion are the channels through which the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and the Caucasus and Central Asia (CCA) economies could be most affected by China's rebalancing, especially if the rebalancing leads to a hard landing. Overall, the impact on the MENAP and CCA regions is likely to be small—between 0.01 percent and 0.1 percent for each 1 percentage point slowdown in China's growth—given the limited bilateral trade and financial linkages with China. Within the regions, commodity exporters would be impacted the most. On the positive side, China's One Belt One Road (OBOR) investments, mainly in infrastructure, could help increase growth in the CCA and Pakistan—even if this investment is less than originally planned. China's rebalancing also presents an opportunity for the region to increase consumption-oriented exports, for example, tourism, agricultural products, and clothing, while creating jobs. To reap these benefits, however, countries need to step up structural reforms to improve their business environment and boost productivity and competitiveness.

Global Spillovers from China's Rebalancing

The Chinese economy is undergoing a substantial structural change. It is moving toward a model in which consumption and services increasingly drive growth rather than public investment and exports (also known as rebalancing). In the long term, the rebalancing should be beneficial for the global economy, as it reduces the risk of a collapse in unsustainable investment and a hard landing in China. In the near term, however, the transition (which began in 2012) entails China's growth gradually slowing to a more sustainable pace. Since China is the world's second-largest economy (at

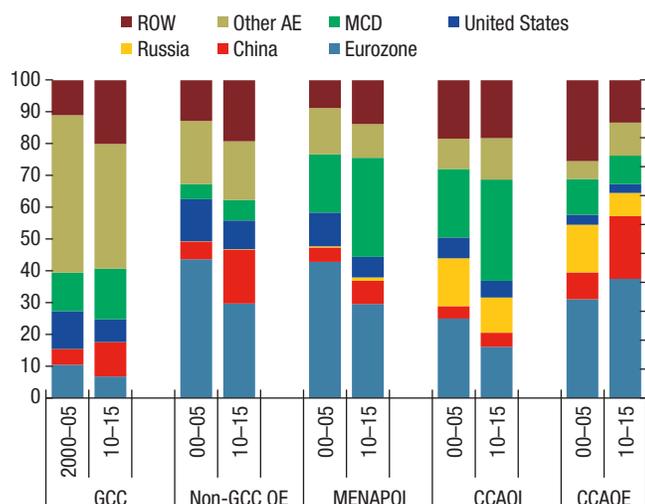
market exchange rates), its slowdown is expected to lower global growth (IMF 2016).

Given China's size, high investment rate, and high import content of its investment and exports, an economic slowdown in China is likely to spill over to the rest of the world through trade, commodity prices, and confidence. Growing financial linkages with the rest of the world, especially with ongoing internationalization of the renminbi and China's gradual capital account liberalization, may also impact currency valuations and increase global financial market volatility—as exemplified by market turbulence triggered by concerns about China's growth in 2015. China's rebalancing away from investment is also contributing to a slowing in demand for many commodities—especially metals, for which it accounted for about 40 percent of total global demand—and their prices, which have fallen by about 60 percent since 2011 (April 2016 *Regional Economic Outlook: Asia and Pacific* [APD REO]).

Global macroeconomic modeling suggests that a 1 percentage point (investment-driven) drop in China's output growth would reduce Group of Twenty (G20) growth by $\frac{1}{4}$ percentage point (April 2016 *World Economic Outlook*). How other countries would be affected by China's rebalancing depends on the extent and nature of their bilateral exposures to China and their exposure to countries with heavy bilateral exposures to China (April 2016 APD REO). Countries exporting investment-related goods to China, such as those in Southeast Asia, would be hit hardest: a 1 percentage point slowdown in China's growth rate is expected to lead to a 0.15–0.30 percentage point slowdown in that region's growth (Duval and others 2014; Cashin, Mohaddes, and Raissi 2016). Financial spillovers, especially in equity and foreign exchange markets, are likely to be higher for economies with stronger trade linkages to China—for example, Korea, Singapore, and Taiwan Province of China—and countries that

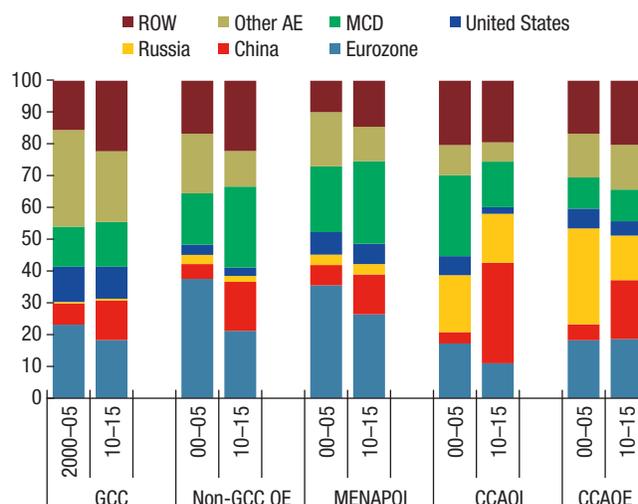
Prepared by Alexei Kireyev, Pritha Mitra (lead author), Nour Tawk, and Hong Yang with input from Ritu Basu, Eddy Gemayel, Keiko Honjo, and Jonah Rosenthal.

Figure 4.1. Share of Exports by Destination
(Percent, period averages)



Sources: IMF, Direction of Trade database; and IMF staff calculations.
Note: AE = advanced economy; CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers; ROW = rest of the world.

Figure 4.2. Share of Imports by Destination
(Percent, period averages)



Sources: IMF, Direction of Trade database; and IMF staff calculations.
Note: AE = advanced economy; CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers; ROW = rest of the world.

are sensitive to changes in global risk aversion (April 2016 APD REO). Slowing trade and financial inflows would reduce investment and consumption, hurting both near- and long-term global growth prospects. Lower inflows would increase exchange rate pressures, though the effect would be partly offset by import contraction.

Moderate Linkages Between MENAP and CCA Regions and China

MENAP and CCA countries' links to China, primarily through trade, have grown substantially yet remain moderate (Figures 4.1 and 4.2). Trade links are strongest with Europe and Russia, and within the regions.¹ However, since 2000, China has gained importance as an export destination: exports to China have grown tenfold for MENAP oil exporters (\$100 billion in 2015) and CCA oil exporters (\$15 billion in 2015) and nearly

¹Transit trade within MENAP and CCA countries may understate export shares to other destinations in Figure 4.1.

quadrupled for the rest of the region (\$6 billion for MENAP oil importers; \$400 million for CCA oil importers). The pattern is similar for imports. In the early 2000s, the region had virtually no imports from China. Over the next 15 years, imports picked up pace rapidly and grew almost 10 times—except MENAP oil importers, for which imports grew by about half as much.

The regions' exports to China are varied, ranging from natural resources to electronic components, with commodities accounting for the bulk of exports. MENAP and CCA oil exporters sell hydrocarbons to China (Figure 4.3)—now a top-five export market destination for the CCA. China is a large export market for iron ore from Mauritania (more than 40 percent of total exports) and Tajikistan (about 10 percent of total exports), as well as copper from Armenia (about 5 percent of total exports). The rest of the regions' exports to China are mainly consumption-oriented goods (or inputs for them; well below 10 percent of total exports), including cotton from Pakistan and electronic components from Morocco. The presence of Chinese tourists has been growing

across the region but remains well below 5 percent of the overall total.

Imports from China have driven a large trade deficit with China. Mostly textiles, electronics, and machinery (Figure 4.4), these imports have continued growing—and at a faster pace than exports—despite the various economic shocks recently faced by the region. Consequently, they have contributed to a rising trade deficit with China for MENAP oil importers and a consistently large deficit for CCA oil exporters, as well as shrinking surpluses for MENAP oil exporters (along with lower oil export revenues) and CCA oil importers (along with lower metal export revenues).

Financial linkages among the CCA, Pakistan, and China are substantial, and they are strengthening owing to the One Belt One Road Initiative (OBOR). China's official lending to CCA countries has risen from \$300 million (0.1 percent of GDP) in 2007 to \$4.4 billion (1 percent of GDP) in 2014. Over the next five years, as part of OBOR (Box 4.1), China is expected to invest an additional cumulative \$35 billion (2 percent of GDP) in the CCA, mainly in infrastructure and mining. As a part of this initiative, China is also investing \$28 billion (2 percent of GDP) in Pakistan (mainly energy and infrastructure) over the same period and another \$16.5 billion over the longer term. In the rest of MENAP, China contributes less than 5 percent of total foreign direct investment, mainly for energy and transport infrastructure. In Egypt, China's direct investment would rise if it moves forward with financing energy projects worth \$15 billion (totaling 0.9 percent of GDP over the next five years). Otherwise, financial links between China and the MENAP region are modest. Foreign direct investment, banking flows, remittances, and portfolio flows are mainly from Europe and the Gulf Cooperation Council (GCC) (Figure 4.5).

What Does China's Economic Transition Mean for MENAP and CCA?

On the upside, exposure to China's rising consumption growth could boost its consumption-related imports. As part of the rebalancing process, China's exports are also moving up the value chain and exiting some sectors. This creates opportunities for developing economies to enter those sectors to both satisfy China's rising consumption demand and replace some of China's exports to the rest of the world (April 2016 APD REO).²

The impact of China's rebalancing could be large for MENAP and CCA oil exporters due to reduced oil exports. So far, China's demand for oil has only marginally declined and is expected to rise with increased consumption. However, China's lower import demand and its adverse effects on global growth are weighing on global oil demand—accounting for about one-third of the past two years' oil price decline (April 2016 APD REO). This price decline, combined with lower oil demand from MENAP and CCA oil exporters' main trading partners, weakens their export revenues and economic growth.

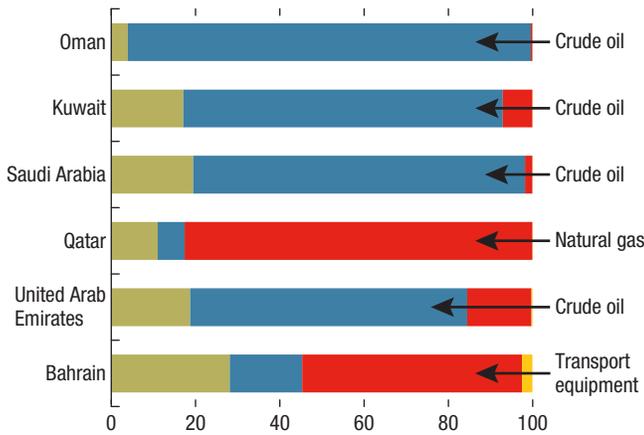
Spillovers from China's rebalancing to the MENAP and CCA regions are estimated using a global vector autoregression (GVAR) model. The model analyzes interactions in the global economy, applying a long time series on more than 30 countries taking into account trade and financial linkages.³ A 1 percentage point decline in China's growth is estimated to reduce GCC growth by 0.1 percentage point in the near term (Figure 4.6)—about one-half of the impact on the region expected to be hit hardest, Southeast Asia—and would mainly occur through the decline in global oil demand and prices. The impact on non-GCC oil exporters is smaller due to sanctions on Iran

²China's move up the value chain has increased competition for some advanced economies (Germany, Japan, Korea, and the United States).

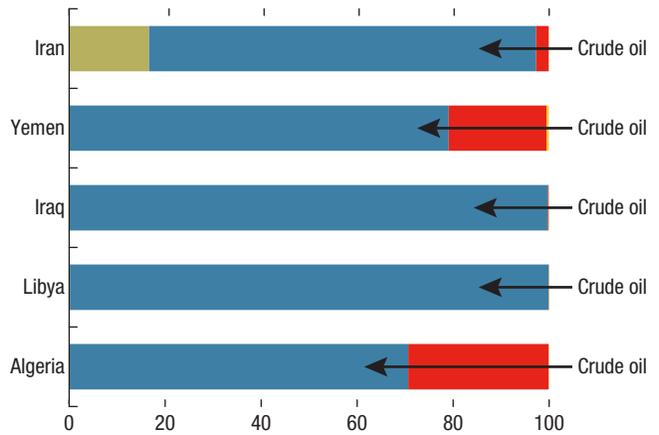
³For simplicity, the rebalancing in China is modeled as a negative growth shock in China.

Figure 4.3. Exports to China
(Percent of total exports to China)

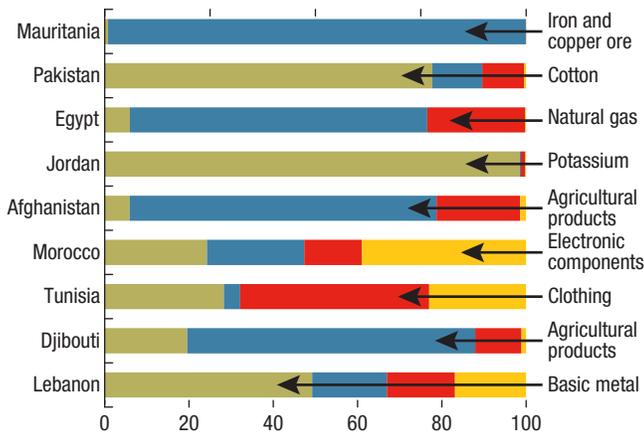
1. GCC, 2012–14 Average



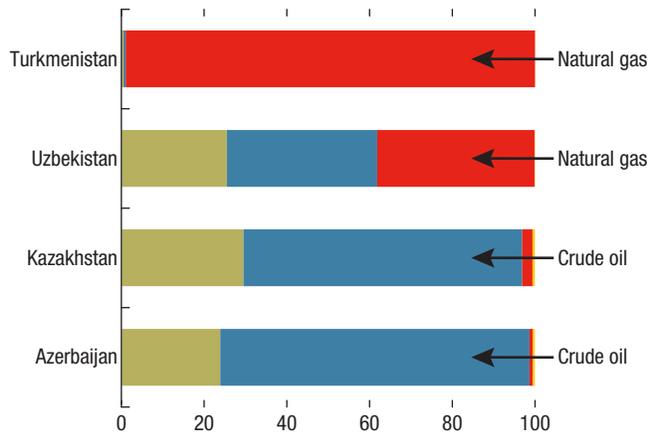
2. Non-GCC OE, 2012–14 Average



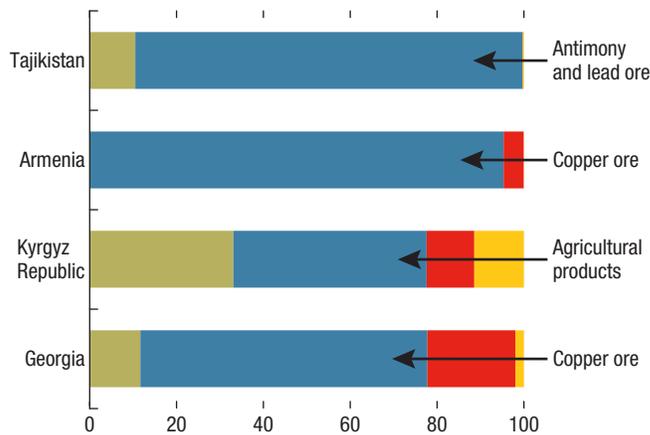
3. MENAPOI, 2012–14 Average



4. CCAOE, 2012–14 Average



5. CCAOI, 2012–14 Average



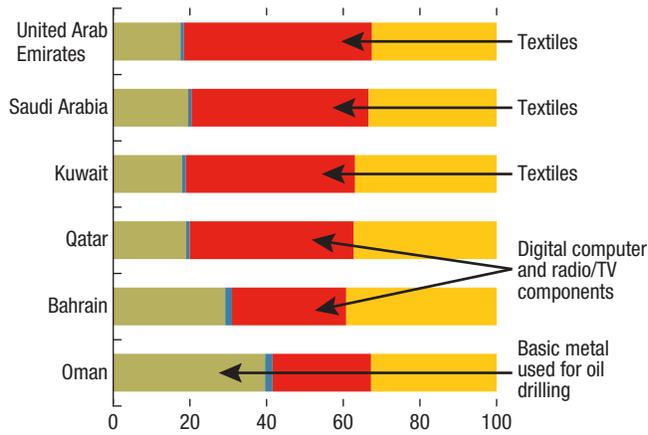
■ Raw materials ■ Capital goods (incl. consumer durable goods) ■ Final consumption goods ■ Intermediate goods

Sources: Centre d'Etudes Prospectives et d'Informations Internationales BACI International Trade database; and IMF staff calculations.
Note: Classifications based on UN Stage of Processing in which natural gas is classified as a final consumption good although it may also be used as an intermediate good. CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

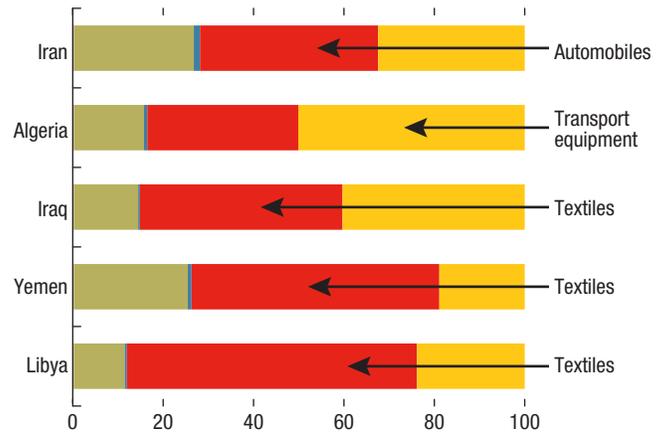
4. HOW WILL CHINA'S REBALANCING AFFECT THE MIDDLE EAST AND CENTRAL ASIA?

Figure 4.4. Imports from China
(Percent of total imports from China)

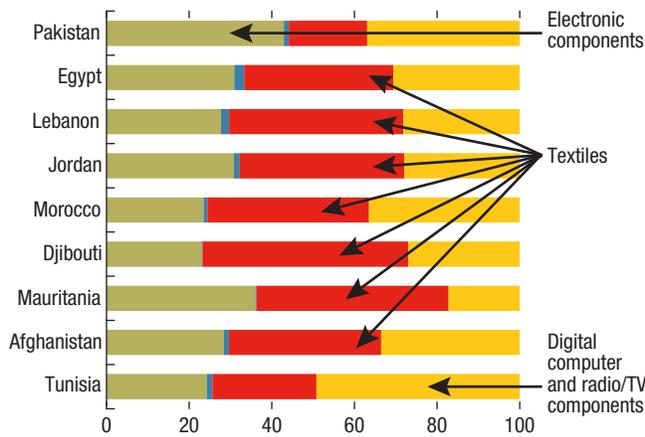
1. GCC, 2012–14 Average



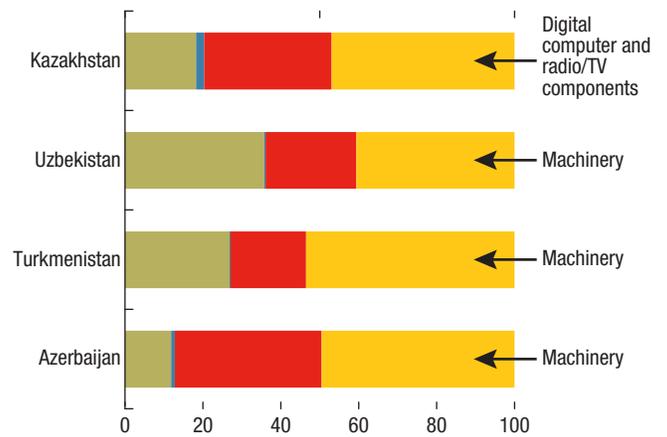
2. Non-GCC OE, 2012–14 Average



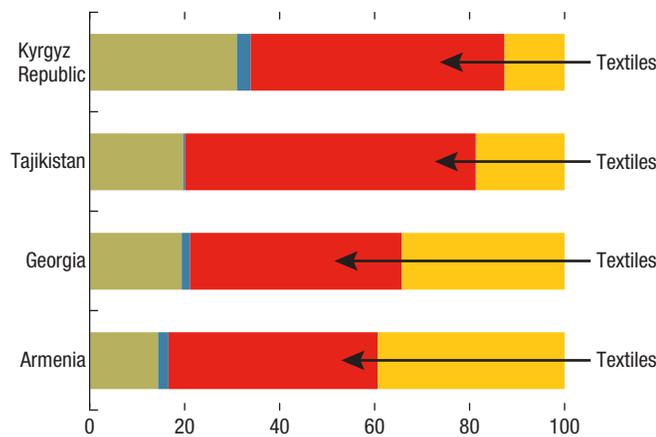
3. MENAPOI, 2012–14 Average



4. CCAOE, 2012–14 Average



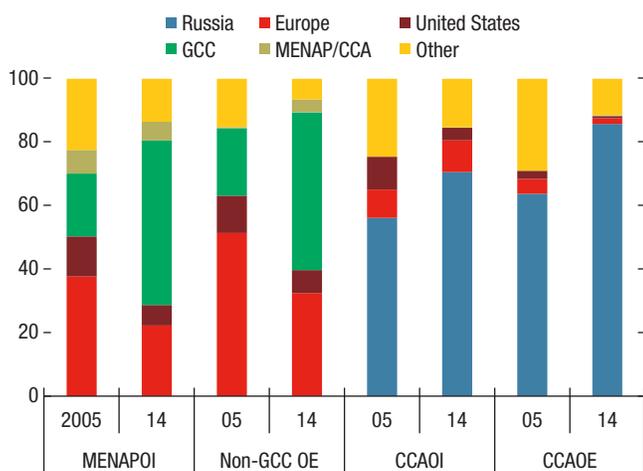
5. CCAOI, 2012–14 Average



■ Raw materials ■ Capital goods (incl. consumer durable goods) ■ Final consumption goods ■ Intermediate goods

Sources: Centre d'Etudes Prospectives et d'Informations Internationales BACI International Trade database; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

Figure 4.5. Remittance Inflows by Region, 2014 vs. 2005 (Percent)



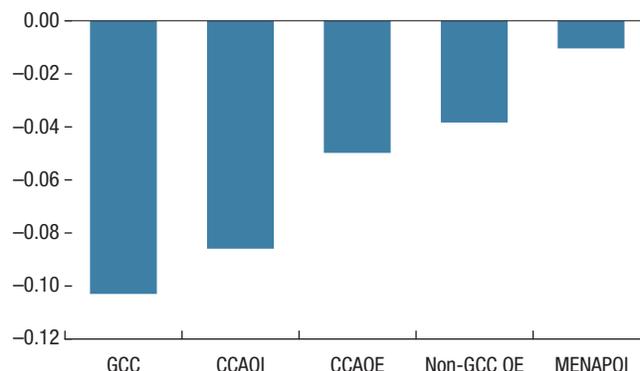
Sources: World Bank; and IMF staff calculations.
 Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

having lowered the sensitivity of its total exports to changes in oil prices. (With the recent removal of the sanctions, the impact might increase.) CCA oil exporters are also expected to have a lower impact because they export a significant amount of natural gas directly to China and we assume China’s gas demand will continue to be relatively stable (Figure 4.7 highlights the large direct trade links of the CCA oil exporters with China).

Other commodity exporters in the MENAP and CCA regions are also likely to be affected. Globally, about 40 percent of the recent decline in metal prices is attributable to China. In 2015, Mauritania’s growth fell to one-third of what it was the previous year, largely due to iron exports losses to China—which have declined by \$180 million. Similarly, Armenia’s copper exports fell by \$16 million over the past year. Further declines in metal prices could force the closure of some of the region’s mines.

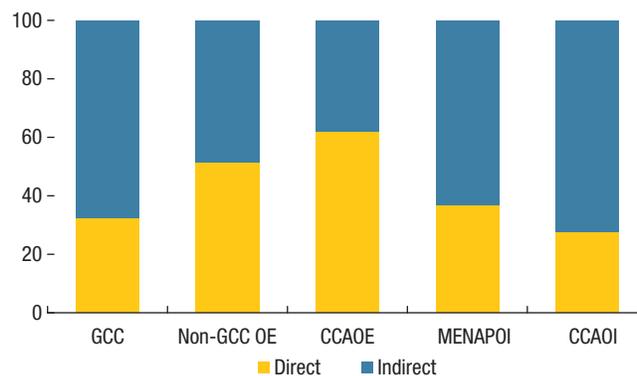
MENAP and CCA oil importers’ exposures to China reflect their strong links to China’s trading partners: Europe, the GCC, and Russia. Lower Chinese demand for imports reduces economic growth in its trading partners. Lower oil prices

Figure 4.6. Near-Term Growth Impact of 1 Percentage Point Slowdown in China’s Growth (Percentage points)



Source: IMF staff estimates based on global vector autoregression model.
 Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

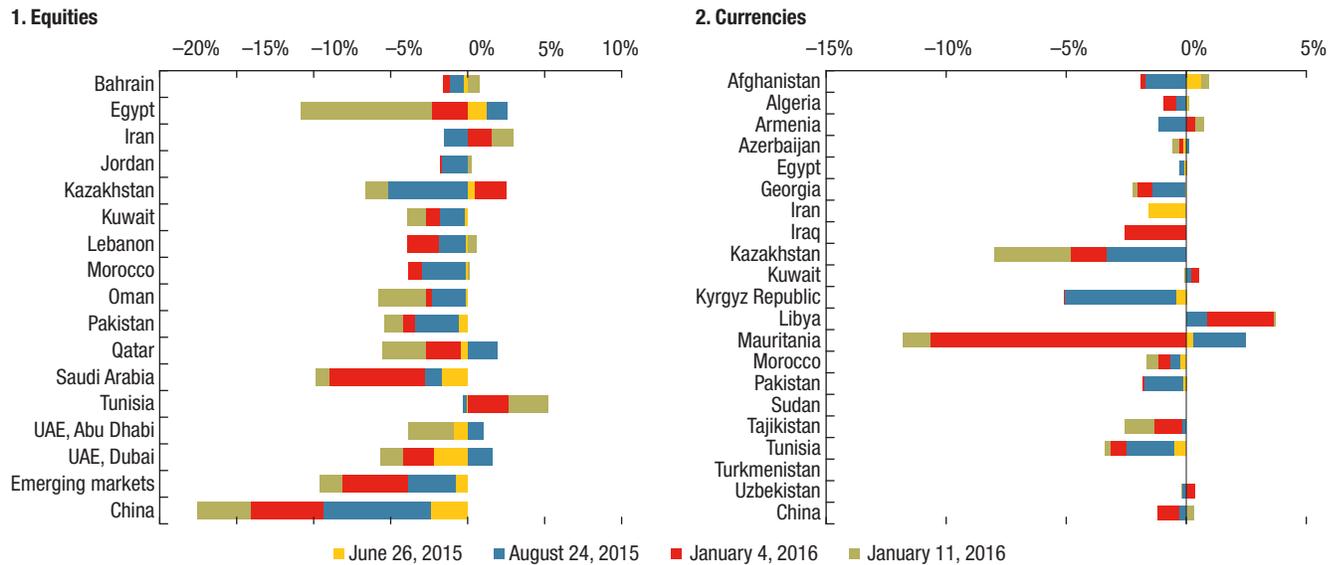
Figure 4.7. Direct and Indirect Trade Spillovers from China’s Slowdown (Percent)



Sources: Kireyev and Leonidov (2015); and IMF staff estimates.
 Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

partly mitigate the impact by improving their (and Europe’s) terms of trade, disposable incomes, and input costs. The latter effect dominates for the MENAP oil importers (directly and indirectly by softening the impact of China’s rebalancing on Europe) where a 1 percentage point decline in China’s growth has almost no impact on growth in the near term (Figure 4.6). In contrast, the CCA oil importers are almost as affected as the GCC, reflecting spillovers from lower Russian growth in

Figure 4.8. Financial Market Response to Sharp Drops in Chinese Equities
(Percent change, during three days after event)



Sources: Bloomberg L.P.; and IMF staff calculations.

Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; UAE = United Arab Emirates. Country abbreviations are International Organization for Standardization (ISO) country codes.

response to China's rebalancing, including lower remittances and foreign direct investment.

In addition to spillovers through commodity prices and trade, the MENAP and CCA regions have been sensitive to increases in global risk aversion—as evidenced by financial market reactions during recent risk-off episodes related to China. However, the financial market impact has been short-lived and smaller than in other regions that are more integrated in global financial markets (Figure 4.8).

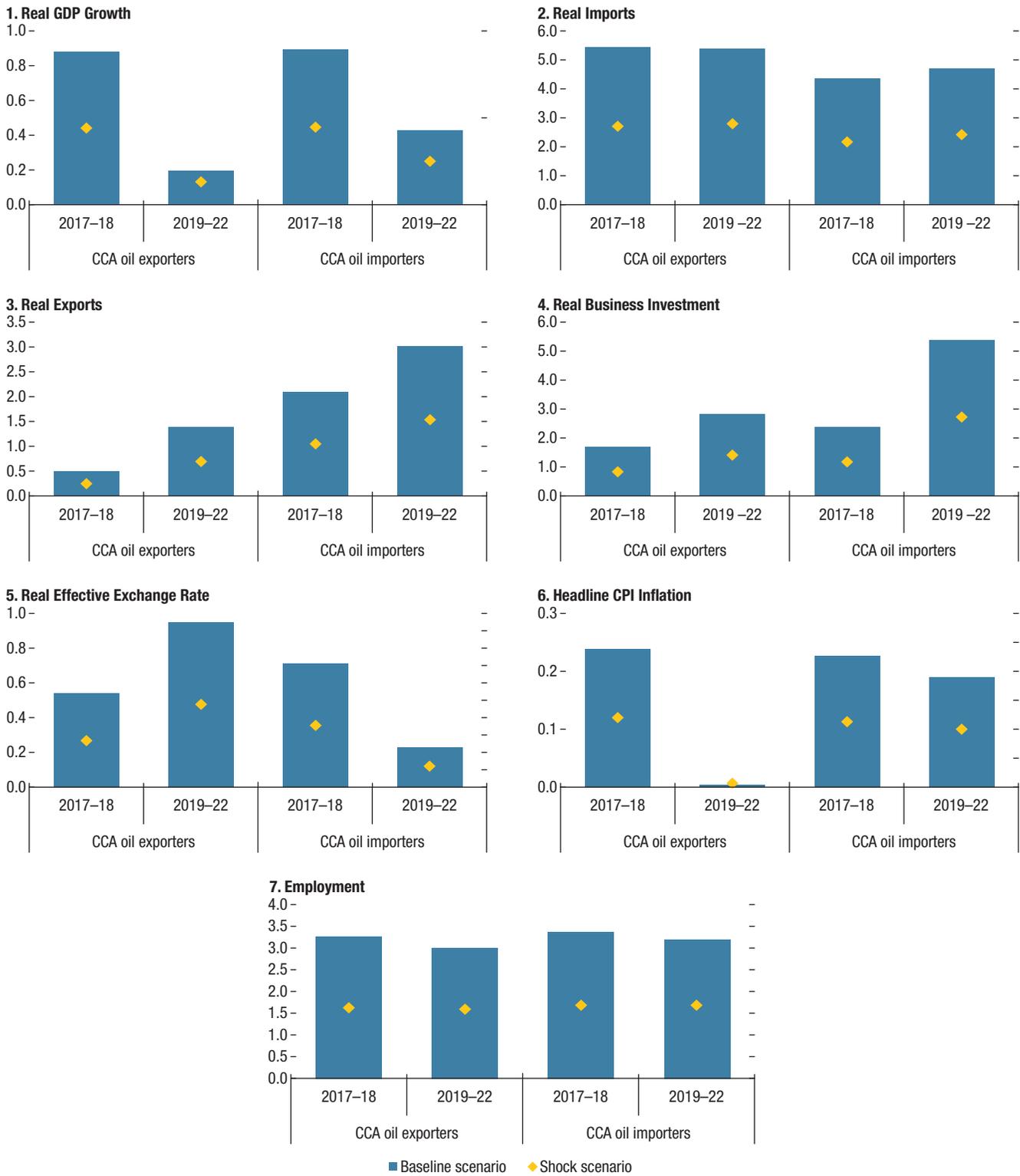
Looking ahead, the CCA could benefit the most from China's OBOR investments. According to the authorities from countries involved in OBOR, it could potentially raise CCA investment (mostly infrastructure) by nearly 2 percent of GDP annually for the next five years. Under these assumptions, simulations using a global dynamic stochastic general equilibrium model—notwithstanding significant uncertainty surrounding such estimates—suggest that the anticipated increase in productivity growth would boost exports and employment (net of any

increase in investment-related imports of goods, services, or labor) with annual economic growth rising by 1½ percentage points in the near term and by 0.3 in the long term (Figure 4.9). However, initially, increased investment demand would raise price pressures (possibly hurting competitiveness) and imports, eroding some of the benefits to growth. Half as much OBOR investment would dampen the net positive impact on growth, exports, and employment by about one-half in the near term and by about one-third in the long term (shock scenario, Figure 4.9).

Policies To Help MENAP and CCA Respond to China's Rebalancing

How can the regions mitigate against adverse economic spillovers from China's rebalancing? If policy space and/or buffers are available, fiscal policy could be used to help smooth adjustment to the growth and commodity price shocks that may accompany China's transition. Where financing constraints are tight, raising

Figure 4.9. Model-Based Estimates of One Belt One Road Impact
(Percentage points)



Source: IMF staff estimates.

Note: Estimates are based on simulations from a dynamic stochastic general equilibrium model. CCA = Caucasus and Central Asia; CPI = consumer price index.

the efficiency of public spending and revenue collection may help create savings that can be channeled toward growth-enhancing spending, supporting demand over the near term and raising potential growth. Greater exchange rate flexibility would also facilitate adjustment to shocks in some cases. If global risk aversion starts to weigh on the regions' financial systems, prudential policies could be applied to safeguard financial stability by increasing liquidity and mitigating risks to asset quality.

If MENAP and CCA countries implement appropriate supporting policies, China's rebalancing can offer them an opportunity to expand exports and create jobs. The shift toward a consumption- and services-driven economy in China is likely to boost China's demand for tourism and consumption goods, as well as demand for services along the OBOR corridor.

- This shift creates an opportunity for the region (especially commodity importers) to expand exports to China—notwithstanding competition from Southeast Asia—since most of the MENAP and CCA non-commodity exports to China are already consumption-oriented or inputs to consumption goods (including, for example, agricultural products, cotton, and clothing). Although so far there is no evidence that China's rebalancing has had any significant impact on the growth of consumption-oriented exports, structural reforms targeted at boosting productivity and competitiveness of consumption-oriented industries could help raise the regions' market shares in China over time. Greater exchange rate flexibility could also help improve competitiveness in some cases. In addition to raising economic diversification, the regions'

commodity exporters that export directly to China could seek out new export markets.

- Tourism is another potential growth area. Kazakhstan, Morocco, and Tunisia, are already starting to target Chinese tourists by increasing marketing efforts and facilitating transportation. Other countries may follow suit.
- As China's exports move up the value chains, MENAP and CCA countries could seek to pick up the slack. Success will hinge not only on improving the business environment but also increasing labor market efficiency and boosting worker talent across the region.
- Increased transit across the OBOR corridor provides an opportunity for countries to increase sales of transit-related services (for instance, restaurants, fuel stations, and hotels). To this end, structural reforms—including infrastructure and access to financing—should aim to facilitate the growth of these businesses.

OBOR offers a unique opportunity to improve infrastructure and raise potential growth in CCA and other countries in the region, and macroeconomic policies need to mitigate against OBOR's risks to debt sustainability and inflation. In the initial years of its implementation, some fiscal tightening (through taxes or cuts in noninvestment spending) and monetary tightening may be needed to avoid overheating. Capacity building will be important to ensure that the countries involved with OBOR can implement the planned increase in investment. Careful debt management is needed to minimize risks to debt sustainability.⁴

⁴ Djibouti's recent experience offers a cautionary example in this context. This country's debt increased by 50 percent over the past three years, owing to Chinese debt-financed public infrastructure projects.

Box 4.1. The One Belt One Road Initiative

To raise connectivity and cooperation across Eurasia, China is spearheading the One Belt One Road (OBOR) initiative. The aim is to create the Silk Road Economic Belt connecting the Caucasus and Central Asia (CCA), South Asia, Southeast Asia, the Middle East, and Europe in a transport-linked corridor via land roads, in tandem with the 21st Century Maritime Silk Route, which will connect China to Europe via sea routes through Asia (Figure 4.1.1). These initiatives are supported by the \$40 billion Silk Road Development Fund and the \$100 billion Asian Infrastructure Investment Bank. China’s involvement is expected to expand the economic prospects of the Middle East, North Africa, Afghanistan, and Pakistan and CCA regions by enhancing the scope for addressing infrastructure gaps and economic diversification.

Figure 4.1.1. One Belt One Road Map



Sources: *The Economist* (2016); national authorities of Pakistan.

Prepared by Pritha Mitra.

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5. Financing Fiscal Deficits in Selected MENAP and CCA Oil Exporters

Despite efforts to consolidate, fiscal deficits will remain large in the Gulf Cooperation Council (GCC), the Caucasus and Central Asia (CCA) oil exporters, and Algeria over the medium term. Countries will need robust strategies to finance these deficits, striking a balance between drawing down assets and issuing debt. These financing choices should be underpinned by strong institutional arrangements and clear medium-term fiscal frameworks. In the short term, constraints on domestic financing sources will lead countries to rely heavily on external financing. But the scale of ongoing financing needs provides opportunities and incentives to develop domestic debt markets, which could generate broader economic benefits.

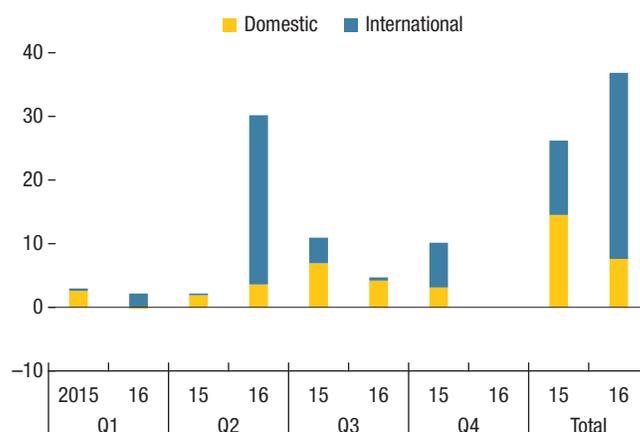
How Fiscal Deficits Have Grown

In 2015, the GCC, CCA oil exporters, and Algeria had an aggregate general government fiscal deficit of about \$153 billion, six times that of 2014 (of about \$25 billion), with most (\$108 billion) concentrated in the countries of the GCC.¹ About 80 percent of these deficits were covered by drawing down financial assets, including deposits at commercial banks, limiting the recourse to debt. However, in 2016, GCC countries are expected to switch their relative use of assets and debt, with asset drawdowns expected to provide only about 20 percent of total financing needs. In some cases, this reflects concerns regarding the impact of a sustained withdrawal of government deposits from the commercial banking sector on domestic liquidity conditions, while, for others, it reflects a desire to maintain high-return investments or keep precautionary buffers. Overall, with the GCC, CCA oil exporters, and Algeria facing an aggregate fiscal deficit of \$143 billion in 2016, new borrowings are set to reach about \$100 billion.

Prepared by Gomez Agou, Allison Holland (lead author), Zhe Liu, Andre Santos, and Aminata Toure.

¹This chapter focuses on the GCC, Algeria, and CCA oil exporters. Other MENAP oil exporters are excluded from this analysis as developments there are primarily driven by conflicts (Iraq, Libya, Yemen) or by the removal of sanctions (Iran).

Figure 5.1. Marketable Debt Issuance in 2016 Has Outstripped 2015, with International Issuance Dominating¹
(Billions of U.S. dollars)



Sources: Bloomberg, L.P.; and IMF staff calculations.
¹Data for 2016 are as of August 31.

This greater reliance on debt is reflected in a surge in issuance of marketable debt. While in 2015 about three-quarters of the debt raised, or \$26 billion, was in the form of marketable debt (including a record \$4 billion Eurobond by Kazakhstan and a \$5.5 billion syndicated loan by Qatar), \$37 billion had already been issued by August 2016 (Figure 5.1). International debt issuance has dominated in 2016—comprising close to 80 percent of the total issuance compared with slightly less than half in 2015. This includes a jumbo \$9 billion deal from Qatar, a \$5 billion deal from the United Arab Emirates (Abu Dhabi), Oman’s return to the Eurobond markets after a 19-year absence (with a \$2.5 billion deal), and a \$10 billion syndicated loan from Saudi Arabia. Meanwhile, a large debut international bond is expected from Saudi Arabia in the fourth quarter.

Looking ahead, the cumulative fiscal deficit for the GCC, CCA oil exporters, and Algeria for 2017-21 is projected to be about \$336 billion. The scale and sustained nature of these deficits will

require robust financing strategies that strike an appropriate balance between drawing down assets and issuing debt domestically or abroad. Such strategies should provide a systematic evaluation of the costs and risks of different options, facilitate risk measurement and management, enhance policy coordination, and support domestic debt market development (IMF and World Bank 2014).

Choice of Financing Strategies: Key Considerations

Asset-Liability Management

The GCC and CCA oil exporters have substantial financial savings that could be used to cover some or, in a few cases, all of their medium-term financing needs. In addition, there may be scope to privatize other assets (including in Algeria) to reduce the overall financing need. To help determine the most appropriate financing mix of assets and debt, countries will need to develop a comprehensive sovereign asset-liability management (SALM) framework. Such a framework should analyze each country's sovereign balance sheet to determine the relative use of assets (sovereign wealth funds, or SWFs, bank deposits, privatization) versus borrowing, and to integrate various macroeconomic and financial trade-offs with the objective of maximizing the net return, or minimizing the net cost, while containing overall balance sheet financial risks (Das and others 2012).

The rates of return on assets relative to the cost of debt will be a key consideration in this decision. However, other considerations also come into play. For instance, given the spread between deposit rates and bond yields, a purely quantitative analysis of the relative cost-return trade-off would indicate that countries should first draw down their deposits in the commercial banking system. This approach would have the added benefit of providing access to readily available funds, thereby providing certainty regarding the timing

and availability of financing. However, it could also lead to a tightening of liquidity conditions in the banking system and less credit to the private sector. These deposits also provide insurance against unanticipated budget or financing shocks, so maintaining a minimum cash balance may be desirable despite the cost. This practice has been employed in some emerging markets, such as Turkey and Uruguay, to insure against the risk of a “sudden stop” in international markets. So, seeking alternative sources of financing even while deposits remain available may be an appropriate policy choice (for example, IMF 2016).

Similarly, in determining the relative use of SWF assets and debt accumulation, countries need to consider the relative cost-return trade-off. The relatively low level of financing costs in international markets suggests this trade-off might currently favor issuing more debt, especially for higher-rated countries (see Figure 5.3).² Note that this comparison should be made on the basis of risk-adjusted returns. Alongside the cost-return considerations, countries also need to consider the institutional issues related to the intended purpose of these savings. These considerations may be more straightforward for budget stabilization SWFs. However, drawing down assets set aside for future generations would require a clear assessment—and communication—that the decision is consistent with delivering intergenerational equity. Alternatively, some countries may value the implicit insurance benefits provided by savings. For instance, those countries with fewer financial assets may want to rely first on borrowing, with their residual savings again providing some insurance in the event of any unanticipated budget or financing shocks. Or some countries may choose to issue some debt, even if the relative cost-return trade-off is not clearly met, to secure greater financing diversification and preserve savings. This approach

²This is difficult to assess as many SWFs do not publish their rates of return. However, as an illustration, Oman's State General Reserve Fund reports an average annual rate of return of 7.5 percent from its inception to 2013 (see State General Reserve Fund 2014). If that were indicative of current and projected returns (on a risk-adjusted basis), that would compare favorably with the 4.75 percent yield on its recent 10-year Eurobond issue.

would also be consistent with a country's objective to develop the domestic debt market to expand the private sector's financing sources or investment choices.

Privatization of corporate assets could also provide substantial deficit financing. For instance, the plan to privatize a small share (5 percent) of Saudi Aramco, the world's biggest oil and gas company with assets estimated at over \$2 trillion, is likely to yield significant financing. Privatization would bring other benefits by encouraging private sector investment (including attracting foreign direct investment) and improving efficiency in operations. However, realizing these assets will likely take considerable time and require interim debt financing to bridge the delay, and some assets may need restructuring in order to maximize value. In addition, countries need to weigh other factors, such as the strategic importance of these assets, while any losses owing to a perceived "forced sale" may prove negative for investor confidence.

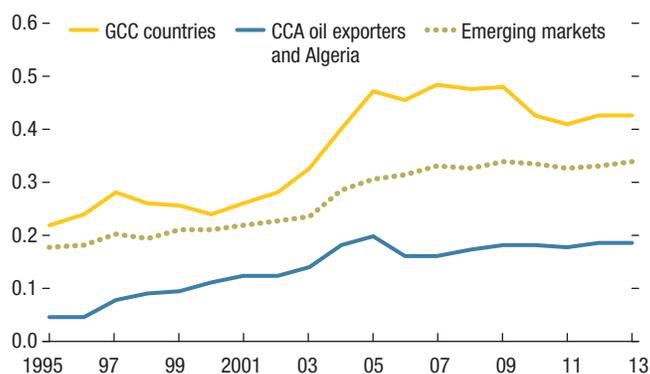
Domestic Versus External Debt

Once the targeted quantity of debt is identified, policymakers need to decide whether to borrow domestically or externally. While domestic debt has many benefits, including a generally more stable investor base and an absence of any currency risk, the scope to rely on domestic debt will be constrained by the extent of financial development.

As with other emerging markets, financial development has been on the rise in these countries (Figure 5.2). However, this has been underpinned by developments in the banking sector rather than broader financial market development. While financial market depth and efficiency increased strongly in the GCC during 2000–08, translating into a rapid increase in financial market development, that trend reversed with the global financial crisis.³ Consequently, in

³Financial market depth is measured by a variety of stock and debt market indicators, while financial market efficiency is measured with reference to the stock market. Note that the stock market will

Figure 5.2. Financial Development Index



Sources: Sahay and others (2015); and IMF staff calculations.

Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council.

the near term, the scope to rely on domestic debt will be largely determined by the capacity of the banking sector to absorb it.

The development of the banking sector has seen a doubling of credit to the private sector since 2000, to 80 percent of GDP in the GCC, while it increased eightfold in the CCA oil exporters and Algeria—although it is still only half that of the GCC. To limit any “crowding out” and to maintain the benefits of this increased availability of credit to the private sector, any decision to intermediate more government borrowing via the banking system requires caution (Box 5.1).⁴

Analysis suggests the domestic banking system could readily absorb net financing of only about 17 percent, on average, of countries' individual cumulative deficits without a change in banks' asset composition (Box 5.1, scenario 1). That would generate about \$76 billion in total of the aggregate \$500 billion needed by deficit countries in our sample. With asset substitution (for example, from foreign assets or a run down of excess reserves), this could increase to about \$250

be the most representative proxy for financial market development in these countries given their limited need to access debt markets in the past. See Sahay and others (2015), Annex I, for a fuller discussion on measurement of financial development.

⁴For the purposes of this chapter, “crowding out” is taken to mean a reduction in the share of credit to the private sector in banks' assets as a consequence of an increase in the share of claims on the government.

billion.^{5,6} Undertaking this borrowing through issuance of debt securities rather than by loans would support banks' continued liquidity by providing collateral to be used in central bank facilities or interbank markets if necessary. The capacity of the domestic banking system to absorb new government borrowing could be increased through continued efforts to increase financial inclusion. These efforts could bring more savings into the formal financial sector, thereby increasing the size of bank balance sheets.

This analysis indicates that countries will need to use alternative financing sources to cover the residual \$250 billion cumulative deficit to avoid any crowding out. Although current conditions in international markets are very favorable (see October 2016 *Global Financial Stability Report*), and the GCC and CCA oil exporters have enjoyed good market access so far—accounting for about 30 percent of the total emerging market sovereign issuance of \$100 billion in the first half of 2016.⁷ However, sustaining this into the medium term could prove challenging. In particular, while there was an estimated \$3.6 trillion of emerging market issuance in international markets over the past six years, suggesting the market capacity exists, emerging market sovereign issuers only accounted for \$600 billion of this, suggesting some substitution from non-sovereign issuers could be needed to support sustained access at current levels by these sovereign issues.

Cost considerations also support a reliance on international markets. While, on a relative basis, international cost conditions have deteriorated for GCC oil exporters through 2016 (reflecting the decline in the economic outlook coupled with a

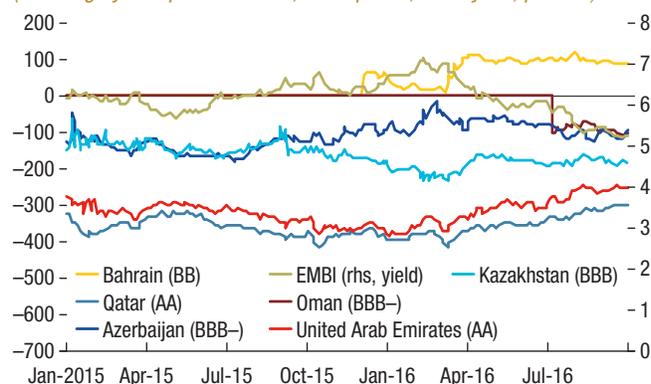
⁵This shift could be supported by reducing reserve requirements or changes in macroprudential limits, if appropriate. For example, Oman recently changed the measurement of the reserve requirement to allow government securities to meet up to 2 percent of the required 5 percent, while in parallel it increased the maximum holding limit to 45 percent of net worth. It also reduced the maximum permitted exposure to foreign assets by half. Note that any such changes would need to consider the subsequent impact on other risk exposures to determine whether they are appropriate or not.

⁶Individual country projections will involve more tailored assumptions regarding the evolution of bank balance sheets.

⁷Source: Dealogic. Note that Algeria has not borrowed externally since 1999.

Figure 5.3. International Financing Conditions Remain Benign, although Relative Costs Are Increasing for GCC Issuers

(Sovereign yield spread to EMBI, basis points; EMBI yield, percent)



Sources: Bloomberg, L.P.; and IMF staff calculations.

Note: Credit ratings refer to Standard & Poor's rating. EMBI = Emerging Market Bond Index; rhs = right-hand side.

number of sovereign downgrades) (Figure 5.3),⁸ the continued appetite for emerging markets means they have fallen on an absolute basis. In contrast, less favorable domestic liquidity conditions (see Chapter 1) mean domestic financing costs have increased absolutely and are generally higher than equivalent international yields. For example, Qatar issued a five-year domestic bond in August at a yield 60 basis points higher than the yield on its five-year Eurobond, while the 10-year domestic bond was issued at a yield 85 basis points higher than the yield on the 10-year Eurobond.

Nevertheless, despite the benefits of having access to a broader investor base and relatively low cost, accessing international markets entails some important risks that will need managing. In particular, international issuance is more exposed to sudden shifts in investor sentiment that affects both the risk of a “sudden stop,” which can be mitigated by short-term contingent credit arrangements or maintaining access to alternative financing sources, and the risk that international financing conditions deteriorate suddenly, which can be partly mitigated by countries maintaining their deficit-reduction efforts and placing their

⁸Spreads relative to U.S. Treasury bonds have also deteriorated.

medium-term fiscal trajectories on a sounder footing (Chapter 1). In addition, the associated foreign currency risks, which also apply to other forms of external debt, will need to be carefully managed. For example, the exchange rate pressures experienced by CCA oil exporters (Chapter 3) will have translated into a significant increase in their debt burden given the dominance of foreign currency borrowing in their debt stock. Again, countries can mitigate these risks by implementing sound policy frameworks that support broader confidence in the economy.

Instrument Design and Market Infrastructure

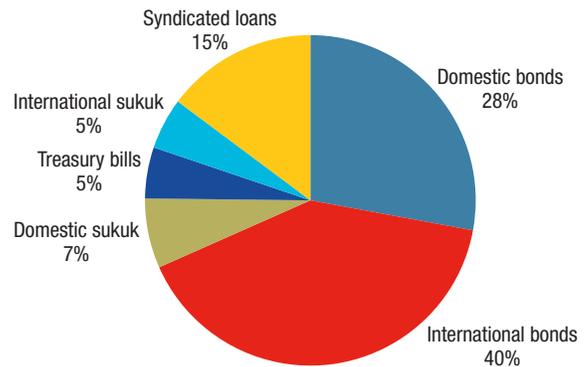
Operationalizing decisions on the scale of domestic or international issuance also requires technical decisions on instrument design. These decisions should reflect considerations on costs, risks, and potential benefits,⁹ as well as the preferences of investors (to reduce the risk of financing shortfalls). Overall, the goal is to find an appropriate mix of instruments that delivers an acceptable level of portfolio risk at an acceptable cost (IMF and World Bank 2014). In particular, instruments with fixed interest rates offer more predictable repayment structures, while long-term debt helps reduce the rollover risk, with both helping to limit interest rate risks. However, short-term debt might be more attractive for specific investors, such as banks, given their own balance sheet considerations, and may be generally more attractive to investors when the macroeconomic environment is uncertain (with the greater price sensitivity of long-term debt more challenging to manage).¹⁰ Consequently, the relative cost premium generally associated with long-term debt needs to be considered against the risk mitigation properties.

As of August 31, 2016, 60 percent of marketable debt outstanding of the GCC, CCA oil exporters, and Algeria comprised international securities

⁹Sommer and others (2016).

¹⁰Long-term debt has greater duration which increases the price sensitivity to small changes in yield.

Figure 5.4. Outstanding Marketable Debt by Instrument Type
(Percent of total outstanding debt)



Sources: Bloomberg, L.P.; country authorities; and IMF staff calculations. Note: Data for Algeria are as of end-December 2015.

(Figure 5.4).¹¹ This is also reflected in the currency composition, with only 40 percent denominated in local currency, indicating some exposure to exchange rate risk. However, interest rate and rollover risks appear limited given the dominance of debt with fixed coupons (73 percent of total marketable debt) and only 13 percent due to be repaid within 12 months.¹²

Conventional debt instruments dominate, with Islamic instruments representing only about 12 percent of outstanding marketable debt. These have been issued by Bahrain, Oman, Qatar, and the United Arab Emirates. An exclusive reliance on conventional borrowing might exclude sizable sources of Islamic finance that would provide an important opportunity to expand and diversify the investor base. Despite a number of obstacles—specifically the need for a suitable legal framework—the potential gains, including by providing Islamic investors with access to a relatively low credit-risk instrument, could justify the effort to develop these instruments.

Given the current level of financial development, countries aiming to expand the set of financing instruments also need to weigh the likely growth

¹¹Marketable debt comprises Treasury bills, bonds, Islamic instruments (such as Sukuk), and syndicated loans; bilateral loans are not captured.

¹²Based on the residual maturity of the debt.

and sophistication of institutional investors (insurance, pension, hedge, and mutual funds) and households. The development of the domestic debt market should be gradual and underpinned by a robust issuance framework that addresses the modalities of sale (including the role of primary dealers, use of a retail network, and auction design), provision of auction calendar, and size of instrument. Where feasible, countries should promote large benchmark issuances to support the development of a secondary market, while at the same time balancing the associated rollover risk. Regular issuance of securities at key maturities would also support the development of a reliable yield curve. This approach would not only support the development of the broader corporate debt market, but also provide a useful tool with which to measure the market's expectations about macroeconomic conditions and prospects. Coordination across regional issuers on key elements of a debt market development strategy could facilitate the participation of foreign investors and more rapidly expand the capacity of the domestic debt market relative to independent efforts (Box 5.2).

To underpin the development of a large and diverse investor base (providing the maximum scope for portfolio risk mitigation), emerging market experience suggests a robust investor relations program is essential. An effective investor relations program would establish a two-way continuous communication channel between the government and investors that (1) provides key economic and financial information quickly, including medium-term fiscal plans and debt strategy; (2) allows a continual assessment of market sentiment on key policies; and (3) ensures that issuers can communicate clear and controlled messages to investors.

Conclusions and Policy Recommendations

The GCC, CCA oil exporters, and Algeria face significant financing needs into the medium term—about \$680 billion over 2016–21. The scale

of these financing needs, coupled with the likely capacity of markets to absorb new debt, suggests that countries will need to continue combining asset drawdowns with debt issuance to meet these needs. Choosing the balance between asset drawdown or debt issuance is not straightforward. While the relative return on assets versus the cost of debt is relevant in all cases, other policy considerations are also important.

Countries will need to develop robust financing strategies, reflecting a comprehensive view of each country's sovereign balance sheet, to minimize the potential burden of these financing choices on the economy. Countries will need to invest in their capacity and institutional frameworks to develop such strategies:

- To complement existing asset management operations, countries need to establish debt management structures that (1) are adequately staffed; (2) have clear governance frameworks that clarify objectives, establish well-defined mandates, roles and responsibilities, and a robust legal framework; and (3) feature robust portfolio management frameworks to monitor and report on evolving costs and risks.
- To support effective decision making, countries will also need to develop coordination mechanisms across key stakeholders, especially between asset and debt management operations, but also those that bring together monetary, fiscal, and financial sector considerations. Although the design of such mechanisms vary, they should provide clear decision-making authority and accountability.
- Other technical impediments may also need attention. For example, effective coordination between cash and debt management can be impeded by the absence of a single treasury account, as in the GCC.

Countries should continue to focus on international borrowing in the short term, but associated risks will need managing. These markets have the capacity to absorb large volumes of

financing, while bringing in external financing will enhance domestic liquidity, address any external financing gaps, and minimize any crowding out. To date, the GCC and CCA oil exporters have enjoyed good market access on favorable terms. However, to maintain this level of access, countries will need to continue strengthening their fiscal sustainability, along with their broader economic policy framework, to support their credit ratings. Countries also need to develop systematic investor relation programs—targeted at enhancing the transparency and predictability of fiscal policy, ensuring timely and quality data on financial assets and liabilities, and developing continuous two-way communication with investors—to support this market access.

Over the medium to long term, all countries should seek to develop their domestic debt markets. That would provide a meaningful alternative to international borrowing, allowing the risks associated with international market access to be managed more effectively. Because these efforts take time, countries need to begin now to expand the reach of the financial sector. In developing domestic markets, countries should seek to also broaden financing options for the private sector, including by establishing a yield curve. Where relevant, countries should consider the scope for coordination with others to enhance the impact of their market development efforts and maximize appeal to a broad investor base.