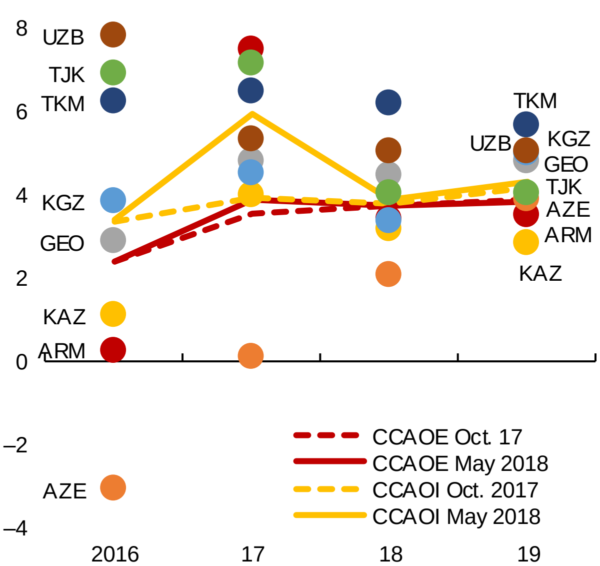
# Caucasus and Central Asia: A Need to Capitalize on the Current Growth Momentum

*Economic growth in the Caucasus and Central Asia (CCA) region exceeded expectations in 2017, in part due to stronger oil prices, remittances, and external demand, which are not expected to be sufficient, however, to maintain this growth momentum in 2018–19. Growth is projected to stabilize in the medium term around levels that are below the average reached in the first decade of this century. To avoid a new reality of subdued growth, a more deliberate push toward a private-sector-led growth model is needed now. That would enable countries to effectively leverage the opportunities created by the current rebound in global activity and the prospect of closer regional and global integration. In addition to preserving macroeconomic stability, including by addressing fiscal and financial sector challenges, countries therefore need to make further progress on structural reforms.*

## A Growth Momentum That Will Not Last ...

Supported by favorable external conditions and, in some countries, a revival of domestic demand, ***growth in the CCA*** is now estimated at 4.1 percent in 2017, up from 2.5 percent in 2016 (Figure 1).

Figure 1
**Medium-Term Growth Prospects in CCA**
*(Real GDP growth, percent; weighted averages for regions)*




Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. CCAOE = Caucasus and Central Asia oil exporters; CCAOI = Caucasus and Central Asia oil importers.

In CCA ***oil-exporting countries***, growth accelerated to almost 4 percent (from 2.4 percent in 2016), driven by Azerbaijan and Kazakhstan, the largest economies in the region, which benefited from the sharp increase in oil prices in the second half of 2017 (see *Global Developments* section). In Azerbaijan, high public investment also contributed to the growth momentum, offsetting weaknesses in other sectors, while, in Kazakhstan, stronger demand for metals and agricultural products also boosted growth.

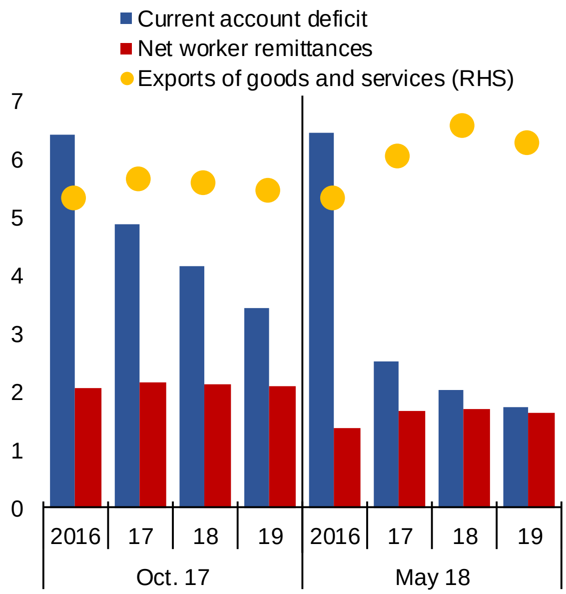
In CCA ***oil importers***, growth jumped to 5.9 percent in 2017 from 3.4 percent in 2016. Rising remittances across the board, stronger external demand (Georgia, Tajikistan), and more robust industrial production (Kyrgyz Republic) all contributed to higher growth in oil importers. In Armenia, monetary easing also helped increase domestic demand, and there was a sharp rebound in agriculture in the fourth quarter. Tajikistan also benefited from a delayed impact of the fiscal expansion in 2016, despite continued financial sector vulnerabilities.

The growth outcome in the CCA region exceeded expectations in 2017—an upward revision of 0.5 percentage points from the forecast in the

October 2017 *Regional Economic Outlook*—with Armenia, Azerbaijan, the Kyrgyz Republic, and Tajikistan posting much larger upward revisions.

Despite the expected continuation of positive external conditions, the ***growth momentum is projected to falter in 2018.*** GDP growth is projected to slow to 3.7 percent, as many factors driving the stronger-than-expected growth outturn in 2017 are likely to prove temporary. Real GDP growth in ***oil exporters*** is expected to slow to 3.7 percent in 2018, driven by a slowdown in activity in Kazakhstan, as gains in oil production moderate, while weak credit growth and the conclusion of the large fiscal stimulus will allow only a gradual pickup in non-oil activity. For ***oil importers***, growth is expected to slow sharply to 3.9 percent as continued structural impediments across the region (see below) offset the positive impact of stronger remittances, global demand, copper prices (Armenia), and consumption (Georgia).

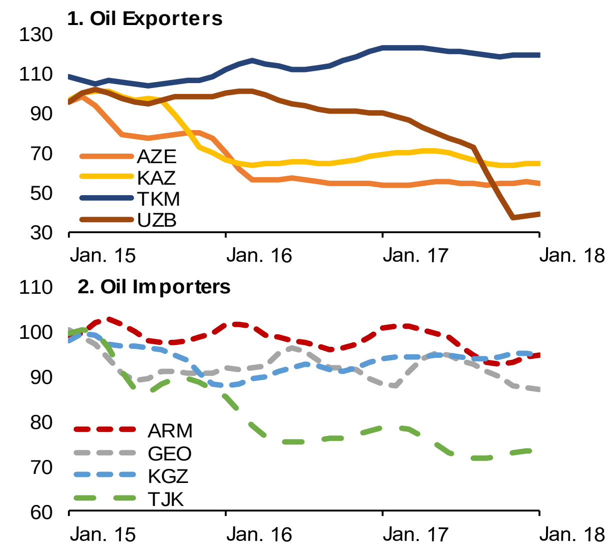
Figure 2
**Revisions in the External Sector for CCA**
*(In percent of GDP)*




Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; RHS = right scale.

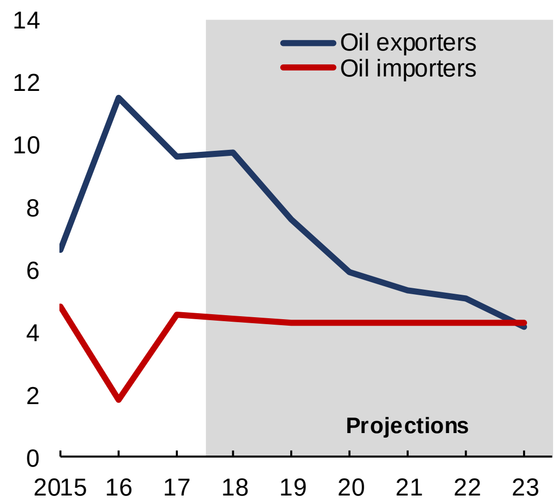
***External positions*** strengthened, with current accounts improving dramatically in most CCA countries in 2017, although deficits remained wide in some (Kyrgyz Republic, Turkmenistan). This reflected strong export growth supported by higher commodity prices, recovering remittances, and further gains in competitiveness in several countries (Figures 2 and 3). Pragmatic

Figure 3
**Real Effective Exchange Rates**
*(Six-month moving average, 2015 = 100)*




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

Figure 4
**Inflation Pressure Subdued**
*(CPI, percent change, year average)*



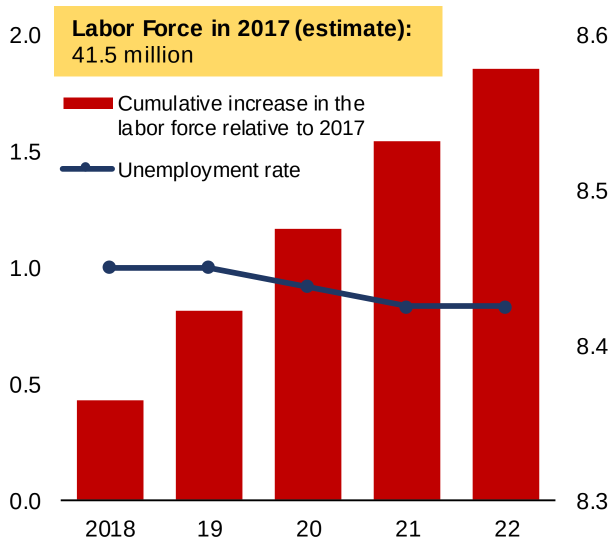

Sources: National authorities; and IMF staff calculations.
Note: CPI = consumer price index.

implementation of more ***flexible exchange rate regimes and monetary policy*** has helped countries manage external pressures while containing inflation (Figure 4). Looking ahead, inflationary pressures will need careful management in several countries, especially Uzbekistan given the impact of recent price liberalization (see box). Meanwhile, monetary policy in some countries will continue to be hampered by high dollarization.

## … If Policy Action Is Not Taken Now

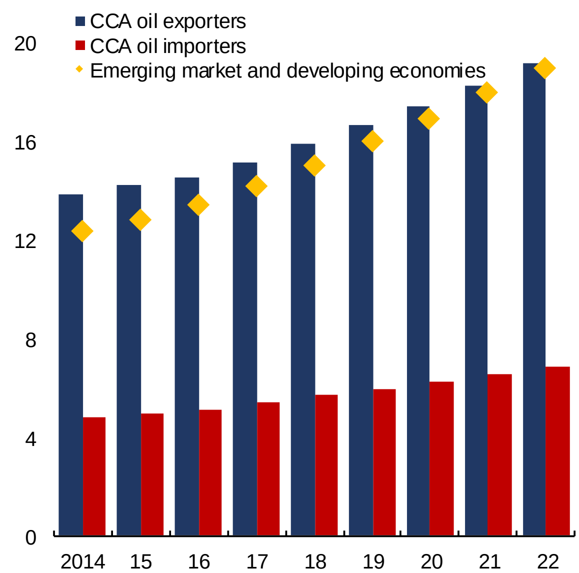
Factors that constrain the medium-term growth outlook include persistent vulnerabilities in financial sectors in some countries, delays in implementing structural reforms that could unleash private sector activity and job creation, limited fiscal space, and, for oil exporters, oil prices lower than those during the 2010–14 boom years. Assuming current policies, GDP growth is projected at 3.9 percent in 2019, and to average 4.1 percent over 2020–23. This level of medium-term growth, which is less than half the average growth the region posted in the first decade of this century, is likely to be too slow to reduce unemployment meaningfully (Figure 5), especially in countries that could experience returning migrant labor. It is also weaker than most other emerging markets, falling short of what is necessary to lift GDP per capita much, particularly for oil importers (Figure 6).

Figure 5
**Projected Labor Force Increase and Unemployment Rate**
*(Percent of total working age population — left scale; percent of total labor force — right scale)*




Source: International Labour Organization, estimates from 2017.

Figure 6
**PPP GDP per Capita in CCA countries**
*(Thousands of dollars at purchasing power parity)*




Sources: National authorities; and IMF staff calculations.

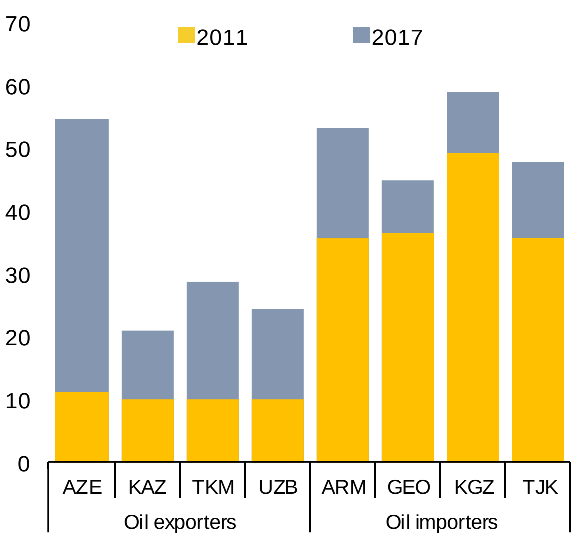
The current ***growth model***—which is driven largely by oil and gas, mining, remittances, construction, and public spending—appears increasingly incompatible with the goal of securing high, sustainable, and inclusive growth over the medium term. To escape this new reality of subdued growth and to build on the recent momentum, CCA countries need to make a stronger effort to transition to a new private-sector-driven growth model by pushing forward with structural reforms. An environment that fosters the development of a dynamic private sector, which contributes more to growth and job creation, will be better suited to capturing the full benefit of global and regional trade integration, and of ongoing technological developments.

More specifically, this strategy should include (1) completing the clean-up of the banking system in some countries while preserving the important progress others have achieved in restoring banks' soundness; and (2) making steady progress on implementing reforms to improve the quality of institutions, reduce red tape, and expand product and trade diversification.

## Credible Medium-Term Fiscal Frameworks Are Key to Macro Stability

Lower commodity prices, slower growth, and the use of expansionary fiscal policies to offset the impact of earlier external shocks have contributed to ***rising public debt*** in CCA countries over the past seven years. For oil exporters, debt is almost three times higher, albeit starting from very low levels. For oil importers, debt has reached higher levels, although at a slower rate (Figure 7).[1] In addition, ***contingent fiscal liabilities***—deriving from guarantees, state-owned enterprises (SOEs), the financial sector, and public-private partnerships (PPPs)—are considered large, and could aggravate any debt sustainability challenges, particularly for oil importers.

Figure 7
**Total Public Debt in CCA**[1]
*(Percent of GDP)*




Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. [1]it includes government guarantees.

Consequently, to complement the structural reform agenda, countries need to pursue ***growth-friendly fiscal adjustment***, including by strengthening revenues in a fair and equitable way and providing scope for productive public investment and critical social spending. This adjustment will put public finances on a sounder footing in some countries where fiscal sustainability risks are larger, and rebuild buffers to counter future shocks in others.

Against this backdrop, once large-scale support to the banking sector in Kazakhstan is accounted for, the ***fiscal position in oil exporters generally improved***. However, deficits were higher in Turkmenistan, including because of spending pressures related to the 2017 Asian Indoor and Martial Arts Games, while larger than expected on-lending to SOEs also contributed to the wider deficit in Uzbekistan. Budgets for 2018 and projections for the outer years appear broadly consistent with further fiscal consolidation (Figure 8). Plans for a substantial increase in capital expenditure in Azerbaijan could, however, exceed the economy's absorption capacity, while the potential use of off-budget expenditures could compromise the targeted consolidated fiscal surplus in Uzbekistan.

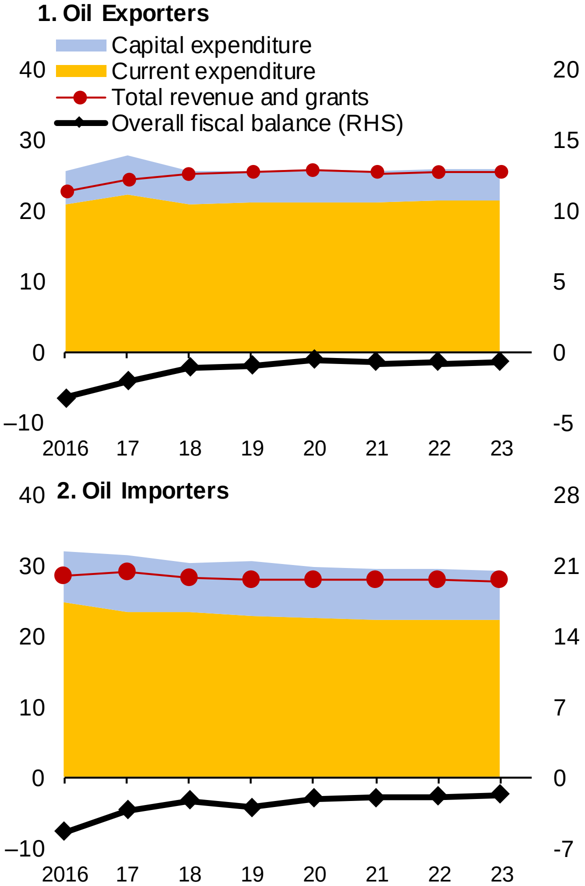
***Most oil importers in the region maintained a prudent fiscal policy*** in 2017. In Armenia, the underlying fiscal performance was in line with expectations, in part owing to tax revenue

[1] Large exchange rate depreciation explains the rise in debt levels in several countries. See the April 2017 *Regional Economic Outlook Update: Middle East and Central Asia* for a discussion.

Figure 8

**Overall Fiscal Balances in CCA**

*(Weighted averages, percent of GDP)*




Sources: National authorities; and IMF staff calculations.
Note: The overall fiscal balance excludes the one-time fiscal transfer to the financial sector in Kazakhstan in 2017 and the expected one-time fiscal transfer in Tajikistan in 2018. The graph uses the general government fiscal balance for all countries. Country-specific weights correspond to purchasing-power-parity-adjusted GDP. RHS = right scale.

overperformance. In Georgia, broad-based revenue strength and containment of current primary expenditure resulted in a better-than-expected performance, as was the case in Tajikistan, where the anticipated intervention in the banking sector did not materialize. By contrast, large slippages in the run-up to the presidential elections in the Kyrgyz Republic contributed to a larger-than-expected deficit in 2017, despite some corrective measures. Prudent fiscal policies are expected to be continued in 2018, including in the Kyrgyz Republic where the authorities are working on incorporating a fiscal rule into the budget code.

To support growth-friendly fiscal adjustment, ***credible medium-term fiscal management frameworks***—anchored where appropriate by fiscal rules—are needed to guide the pace of adjustment, while making sure that resources are efficiently spent (see IMF, forthcoming-a). Despite progress in many countries (Table 1), more is needed to enhance revenues, strengthen expenditure policy and ensure that contingent liabilities do not undermine macroeconomic stability. Moreover, proper functioning of fiscal rules goes beyond the simple introduction of numerical targets; it entails developing and committing to consistent medium-term fiscal plans, including by improving public finance management frameworks and fiscal transparency. Useful in this regard are project management frameworks, such as the one currently being developed in the Kyrgyz Republic.

Table 1

**Overview of Fiscal Management Frameworks**

| | Fiscal Rules | Medium-Term Fiscal Framework |
|---|---|---|
| Armenia | Yes | Yes |
| Azerbaijan | In progress | No |
| Georgia | Yes | Yes |
| Kazakhstan | Yes | Yes |
| Kyrgyz Republic | In progress | No |
| Tajikistan | No | Yes |
| Turkmenistan | Yes | No[1] |
| Uzbekistan | Yes | No |

Sources: IMF staff.

[1] Medium-term budgeting is planned to be introduced in 2019.

Note: Fiscal rules are a mechanism for placing durable constraints on fiscal discretion through procedural and numerical limits on budgetary aggregates. Medium-term fiscal frameworks consist of institutional arrangements and procedural or numerical rules that provide incentives for overcoming the deficit bias.

## Banking Intermediation Is Critical to Private Sector Development …

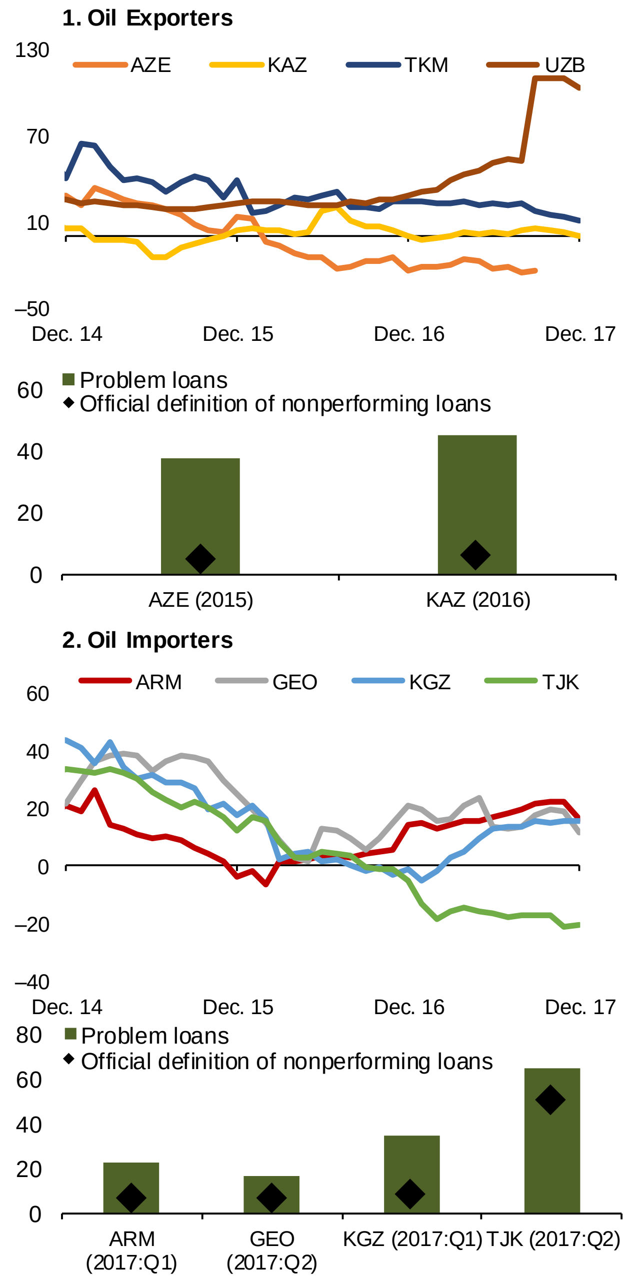
Over the past few years, external shocks exposed ongoing ***banking sector vulnerabilities*** in the region, hampering growth and leading to the materialization of fiscal contingent liabilities in some countries. Some progress in enhancing regulation and supervision, improving bank resolution frameworks, and strengthening governance has been made in several countries, including Armenia and Georgia, while some troubled banks have been addressed in Azerbaijan, Kazakhstan, the Kyrgyz Republic, and Tajikistan.

Although ***growth in credit*** to the private sector has resumed in several countries, in others, banks remain constrained in their intermediation role and, hence, in their capacity to support private-sector-led economic activity (Figure 9). Against this backdrop, CCA countries should persevere in their efforts to address financial sector weaknesses with a view to containing risks to depositors and to the public-sector balance sheet, and ensuring that new lending occurs on commercial terms and within sound and transparent business practices going forward. Bank balance sheet vulnerabilities should be properly diagnosed and promptly addressed, remaining weak banks should be effectively intervened in a timely fashion, and support for bank resolution should be provided under strict conditions and within a sound legal framework.[2] To this end, Georgia has recently strengthened consolidated supervision, raised capital requirements for systemically important banks, and enhanced the oversight authority of credit bureaus.

Figure 9

**Credit Growth and Problem Loans**

*(Credit growth, percent, year-over-year; problem loans as percent of total loans)*




Sources: National authorities; and IMF staff calculations.

Note: These values are not adjusted for exchange rate effects. Country abbreviations are International Organization for Standardization (ISO) country codes. Problem loans include (1) overdue loans > 90 days; (2) watch loans < 90 days; (3) restructured/prolonged loans; (4) write-offs; and (5) transfers to special-purpose vehicles or other vehicles. In UZB, the rapid increase in credit growth in 2017 reflects currency depreciation. NPLs = nonperforming loans.

[2] For a comprehensive discussion of developments and risks in the financial system in the CCA region, see IMF (forthcoming-b).

## … As Is Capturing the Opportunities Provided by Regional and Global Integration

To reap the benefits of being part of a dynamic global economy—including through the opportunities offered by the Belt and Road Initiative, further integration within the Eurasian Economic Union and ongoing reforms in Uzbekistan (see box)—countries in the CCA need to ensure further product and trade diversification.[3] This means promoting fair competition through trade and better regulation, supported by efforts to invest in talent by modernizing education and training, and improving access to finance. Several countries have taken steps to broaden and deepen market-oriented reforms: examples are Kazakhstan's *100 Concrete Steps* and *3rd Modernization Initiative*, Turkmenistan's seven-year development plan, and Armenia's establishment of the *Center for Strategic Studies* last year.

Looking forward, ***removing tariff and non-tariff barriers***, as well as inefficient customs systems and uncertainty around changes to tariff schedules, are steps in the right direction. Actions to ***address loss-making SOEs***, including restructuring and privatization, could also create opportunities for the private sector to provide the related services and further contribute to a successful transition to a new private-sector-led growth model. For instance, a key element of this strategy in Kazakhstan is the implementation of the first wave of its privatization plan in 2018. In addition, for CCA countries to benefit fully from regional integration initiatives, it will be critical to ensure that any additional public investments are consistent with the available fiscal space and that their potential impact on debt sustainability is carefully monitored.

## … and Strengthening Resilience to Risks

The benign global outlook should not lead to complacency but should be seen as an opportunity to implement structural reforms that will strengthen each country's economic resilience by fostering integration, generating jobs, and improving living standards for all sectors of society.

Global and regional risks remain. At the global level, ***commodity price uncertainty***[4] and pursuit of ***inward-looking policies*** could threaten the growth momentum and amplify fiscal and external vulnerabilities. Regionally, reform fatigue or vested interests could also threaten the recovery, particularly since persevering with structural reforms whose benefits may take time to materialize is not easy.

More specifically, the current growth model has made CCA economies vulnerable to ***fiscal risks***, including because long-standing weaknesses in governance and oversight have compromised the financial position and performance of key SOEs across the region. These could entail a large and persistent impact on macroeconomic conditions. In this regard, Georgia's move to publish an extended fiscal risk statement to cover PPPs, power purchase agreements, and contingent

[3] For a discussion of the opportunities and requirements of regional and global integration, see IMF (forthcoming-c).

[4] Some illustrative estimates suggest that, for oil exporters, a $10 decrease (increase) in oil prices in 2018 would have an immediate negative (positive) impact on the fiscal and current account balances of roughly ½ to 4 percent of GDP and 1 to 6 percent of GDP, respectively, depending on the country. For oil importers, the positive (negative) impact on the current account would be roughly up to 1.5 percent of GDP depending on the country.

liabilities related to SOEs is welcome, as is its submission to Parliament of a PPP law to control government fiscal risks. Efforts to enact a new PPP law in line with best international practice and a stronger role for the Fiscal Risks Assessment Division in the Ministry of Finance in Armenia are also steps in the right direction. In addition, corporate governance reform, performance-based management contracts, elimination of quasi-fiscal activities, and capping of government guarantees extended to SOEs would strengthen the monitoring and management of fiscal risks.[5]

As reported in the October 2017 *Regional Economic Outlook*, ***financial stability risks*** persist and, while varying across the CCA region, could trigger potentially disruptive macroeconomic and social effects in some countries. Since major banks in some of these countries have been frequently recapitalized at the expense of taxpayers over the years, independent monitoring and enforcement activities by the supervisory authorities would remain essential to avoid the buildup of vulnerabilities.

On the positive side, the recent ***political transition in Uzbekistan*** and expectations of greater economic integration within the region and beyond could, over the medium term, generate significant economic dividends not only domestically but also for other CCA countries.

[5] See IMF (2016).

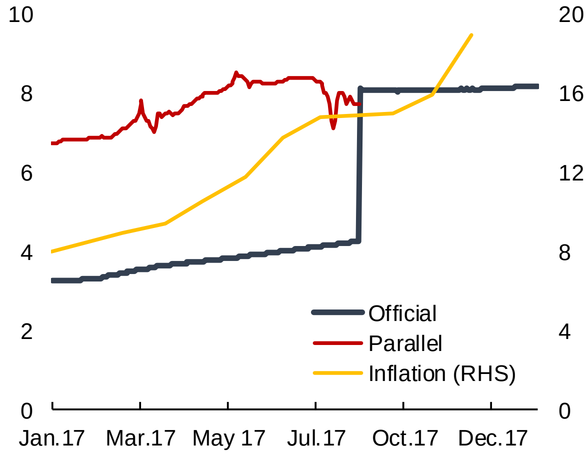
**Uzbekistan: Reforms, Challenges, and Spillovers in Central Asia**[1]

Uzbekistan has large unrealized economic potential. After independence in 1991, it followed prudent fiscal policies resulting in the accumulation of large foreign exchange reserves and low public and external debt. However, its policies of state intervention, foreign exchange restrictions, import substitution, and self-reliance did not deliver increases in living standards commensurate with the country's goal of reaching upper middle-income status. In addition, millions of nationals had to look for jobs abroad.

In 2017, the new government announced a dramatically different policy course, initiating reforms aimed at building a more open and market-oriented economy.

- In September 2017, the official and black-market exchange rates were unified and surrender requirements abolished. As a result, the official rate depreciated by about 50 percent, removing a bias toward domestically oriented production (Figure 1.1). Price liberalization has started, with prices for most goods liberalized and energy prices raised in several steps. Although these measures were accompanied by a surge in inflation, they should allow for more efficient resource allocation going forward.
- The government plans to continue raising energy prices toward market levels. Reforms to the tax system and to make monetary policy more effective are also planned to help stabilize inflation.

Figure 1.1
**Uzbekistan: Exchange Rates and Inflation**
*(Thousands of Uzbek sum per US Dollar; and percent change, year over year)*




Sources: National Authorities; and, IMF staff calculations.
Note: RHS = right scale.

Like other transition economies, Uzbekistan faces a range of risks and challenges, including to improve governance, the rule of law, and the business environment to promote private sector growth. In the short term, the main challenges are containing inflation, restructuring state enterprises, and consolidating fiscal accounts to transparently target priority spending on education, health, and public infrastructure in line with the United Nations Sustainable Development Goals. Over the medium term, the authorities will need to adapt fiscal and monetary institutions to a more open economy, and foster a banking system that can sustainably finance growth and job creation without reliance on large-scale public funding and provision of capital.

Uzbekistan is central to the CCA region. Its share of regional trade has risen from 12 to 18 percent over the past 10 years, while its population size is by far the largest in Central Asia. Therefore, successful reforms in Uzbekistan could catalyze change and prosperity in the wider region, including through a powerful demonstration effect and increased regional trade and integration in supply chains. Recent steps to ease restrictions on border crossings with its CCA neighbors will facilitate these spillovers.


Sources: IMF staff; and IMFMAP tool.

[1] This box was prepared by Lawrence Dwight.

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## CCA Region: Selected Economic Indicators, 2000–19

*(Percent of GDP, unless otherwise indicated)*

| | Average 2000–14 | 2015 | 2016 | 2017 | Projections 2018 | 2019 |
|---|---|---|---|---|---|---|
| **CCA** | | | | | | |
| Real GDP (annual growth) | 8.1 | 3.1 | 2.5 | 4.1 | 3.7 | 3.9 |
| Current Account Balance | 0.9 | -3.7 | -6.4 | -2.5 | -2.0 | -1.7 |
| Overall Fiscal Balance | 2.4 | -4.3 | -3.5 | -4.3 | -1.6 | -1.3 |
| Inflation (year average; percent) | 8.9 | 6.4 | 10.4 | 9.0 | 9.1 | 7.2 |
| **CCA oil and gas exporters** | | | | | | |
| Real GDP (annual growth) | 8.4 | 3.0 | 2.4 | 3.9 | 3.7 | 3.8 |
| *of which non-oil growth* | 8.7 | 2.8 | 1.2 | 3.6 | 3.8 | 3.6 |
| Current Account Balance | 2.1 | -3.1 | -6.2 | -2.0 | -1.2 | -1.0 |
| Overall Fiscal Balance | 3.3 | -4.5 | -3.3 | -4.4 | -1.3 | -1.1 |
| Inflation (year average; percent) | 9.2 | 6.6 | 11.5 | 9.6 | 9.7 | 7.6 |
| **CCA oil and gas importers** | | | | | | |
| Real GDP (annual growth) | 6.3 | 3.9 | 3.4 | 5.9 | 3.9 | 4.3 |
| Current Account Balance | -7.8 | -8.9 | -8.2 | -6.0 | -8.0 | -7.3 |
| Overall Fiscal Balance | -3.0 | -2.8 | -5.2 | -3.4 | -3.3 | -2.8 |
| Inflation (year average; percent) | 7.1 | 4.8 | 1.8 | 4.5 | 4.4 | 4.3 |

Sources: National authorities; and IMF staff calculations and projections.
CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.
CCA oil and gas importers: Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.