3. Caucasus and Central Asia: Safeguarding the Recovery

The near-term growth outlook is broadly positive across the CCA region, helped by high oil prices for the oil and gas exporters and the continuing recovery in Russia for the oil and gas importers. However, in line with the global picture, risks are largely to the downside. For the oil and gas exporters, fiscal and monetary policy needs to exit from the current accommodative stance to combat inflation. The oil and gas importers should aim for fiscal consolidation and address external vulnerabilities. In some countries, further monetary policy tightening is needed to contain inflationary pressures. To foster inclusive growth and employment creation in the CCA, countries should focus on improving the business environment, reducing skill mismatches, and addressing weak governance and inequality of access to public services.

Recovery Gaining Speed

In virtually all CCA countries, recovery from the 2008–09 global financial crisis took hold in 2010—with growth registering about 7 percent in the oil and gas exporters and 4 percent in the oil and gas importers. Exports and remittances—key growth drivers in 2010—are continuing to grow solidly, helping the recovery gain firm momentum. By mid-2011, export growth in the region had recovered and broadly stabilized after registering a sharp decline in the aftermath of the global crisis (Figure 3.1). With Russia’s economy continuing to recover, workers’ remittances are also increasing steadily in 2011, particularly among the oil and gas importers (Figure 3.2 and Box 3.1). For the full year, combined remittance inflows to the oil and gas importers are projected to increase by 17 percent—following a strong rebound in 2010—with positive implications for private demand and fiscal (sales and trade tax) revenues (Box 3.2).

Growth Outlook Broadly Positive, but with Downside Risks

The near-term growth outlook is positive for the oil and gas exporters (Figure 3.3). Growth in 2011 is projected to remain strong in virtually all countries—underpinned by high oil and gas exports—but will slow sharply in Azerbaijan because of a temporary disruption in oil production.

In all countries, non-oil GDP growth is forecast to remain robust in 2011, supported by continued public spending and, in Kazakhstan, additionally, prepared by Yasser Abdih with input from country teams.
Box 3.1

Regional Spillovers from Russia’s Economic Recovery

Following a 7 3/4 percent output contraction in 2009, Russia’s growth picked up to 4 percent in 2010. Real growth is projected at 4 3/4 percent in 2011 and about 4 percent in 2012. While high oil prices and large capital inflows powered the boom before the global financial crisis, this set of circumstances does not seem likely to return. In addition, political uncertainty in the run-up to the presidential election in 2012, a still-fragile banking system, and increased risk aversion on the part of investors will moderate growth prospects.

Nonetheless, Russia’s economic recovery is benefiting the CCA mainly through trade and remittances. After plummeting by more than 45 percent from the precrisis peak, the value of Commonwealth of Independent States (CIS) exports to Russia began rising in late 2009, surpassing precrisis levels in the first quarter of 2011 (Figure 1). Remittances from Russia to the CCA are also recovering—those to Armenia, the Kyrgyz Republic, Tajikistan, and Uzbekistan already exceed precrisis levels (Figure 2). Russia’s direct investment in the CIS, on the other hand, which declined substantially following the crisis, has not recovered, possibly reflecting increased risk aversion of Russian investors (Figure 3).

Russia’s export ban on cereals during August 2010–June 2011, and the steep hike in its gasoline export duty in May 2011, had significant repercussions for the CCA. While the poor 2011 harvest in Russia and the subsequent export ban added to global grain price inflation, the adverse impact on inflation has been particularly acute in the CCA, given the large weight of food in consumption baskets and significant dependence on imported food. Inflation pressures in the region, particularly in Tajikistan, were exacerbated by the increase in Russia’s gasoline export duty to a high level.
Remittances and Tax Revenues in CCA Countries

Several CCA countries are major recipients of remittances. In 2010, Tajikistan was the top recipient of remittances in the world, measured in relation to GDP (33 percent); the Kyrgyz Republic ranked third (31 percent), and four others received the equivalent of 2½–10 percent of GDP (Figure 1). These compare to a global average of 4½ percent of GDP in 2010. Remittances to the CCA declined by 27 percent in 2009, and are projected to rebound in 2011 (Table 1).

An analysis of the determinants of remittances shows that fluctuations in economic activity in “host countries,” where the migrants sending remittances reside and receive income, are a key driver of the amount of remittances sent. For the CCA countries, the Russian economy is important. In contrast, for the Mashreq countries, the GCC plays a major role, and for the Maghreb countries, it is Europe that constitutes the major host region (Figure 2).

Remittances appear to have sizable effects on fiscal revenues. They raise domestic consumption and imports and therefore bolster sales and trade tax receipts. A simulation exercise that measures the predicted fiscal impact of foreign income shocks reveals that, owing to a strong decline in host country income—particularly in Russia—CCA countries lost ¾ of a percentage point of GDP or more in revenues due to the decline in remittance inflows in 2009 (Table 2). For the Kyrgyz Republic, this decline represented about one-quarter of the deterioration of its primary balance in that year, and for Tajikistan, it represented over one-half. In contrast, the revenue loss was more modest in MENA countries, primarily because of the smaller decline in host country income. However, revenue losses through the remittance channel were still substantial, amounting to about ½ of 1 percent of GDP for Jordan and ¼ of 1 percent of GDP for Lebanon.

Table 1

<table>
<thead>
<tr>
<th>Remittance Flows to the CCA</th>
<th>Percent change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2009</td>
</tr>
<tr>
<td>Selected CCA countries</td>
<td></td>
</tr>
<tr>
<td>Armenia</td>
<td>-28.3</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>-16.6</td>
</tr>
<tr>
<td>Georgia</td>
<td>4.0</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>-27.4</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>-33.4</td>
</tr>
<tr>
<td>Total CCA 1</td>
<td>-26.9</td>
</tr>
</tbody>
</table>

Sources: National authorities; and IMF staff calculations.
1Includes net remittance flows in the case of Tajikistan and Turkmenistan.

by a recovery in agriculture from a severe drought in 2010. With oil prices foreseen to remain high in 2012, CCA oil and gas exporters should see robust growth rates, with current projections pointing to growth of about 6½ percent.

The growth outlook for the oil and gas importers is also favorable. Activity is projected to pick up in 2011, reflecting a recovery from last year’s collapse in agricultural production in Armenia, and a rebound from the civil unrest–induced economic contraction in the Kyrgyz Republic. In Tajikistan and Georgia, growth is forecast to ease slightly in 2011 but remains strong. Continued growth in Russia is also benefiting the region through trade and remittance channels and is forecast to continue to do so in 2012. Current projections see growth in 2012 for CCA oil and gas importers at about 5½ percent.

Against this background, external risks to the outlook in the CCA region have increased and derive from a heightened perception of fragility in the global recovery. Such risks relate mainly to the possibility of a double-dip recession in the United States, much weaker than expected growth in Europe, and their impact on global growth. If these risks materialize and global growth deteriorates sharply—particularly in China and Russia—economic activity in the CCA region would weaken severely. This would occur mainly through a fall in commodity prices, a decline in export demand, and a decrease in remittances and capital flows. Should those external risks not materialize, however, growth in the CCA region would be expected to be fairly robust.

**Inflation Remains Elevated in Several Countries**

Headline inflation has been rising in the CCA, roughly since mid-2010. Surging food prices have
played a key role in driving inflation, especially as food comprises about half of the consumption basket in CCA economies. Rising fuel prices have also played a role. In several countries, demand (including fiscal) pressures have also contributed.

In recent months, domestic food price inflation has slowed in many countries (Figure 3.4)—the effect of a slowing in international food price inflation and good harvests in the region—and has contributed to the stabilization, or even moderation, in headline inflation, as has monetary policy tightening in some countries. However, headline inflation continues to be high in a number of countries, most notably in the Kyrgyz Republic, Tajikistan, and Uzbekistan, where it remains in double digits (Figure 3.5).

Policy Options and Challenges

With the recovery gaining speed, oil and gas importers should aim for fiscal consolidation, also in light of fiscal sustainability concerns. In response to surging inflation, monetary policy was tightened, but additional tightening is still needed in some countries (the Kyrgyz Republic and Tajikistan). The key challenge ahead is to rein in large current account deficits and thereby preserve external sustainability.

Oil and gas exporters need to guard against overheating. With rapid economic growth and expansionary macroeconomic policies, there are heightened risks of inflationary pressures. Monetary policy needs to exit from an accommodative stance, and fiscal policy should play a supportive role in safeguarding price stability. If, however, global growth deteriorates sharply, then tightening of macroeconomic policy might have to be delayed.

In the medium term, meeting the challenge of creating jobs and fostering high, sustained, and inclusive growth will depend on progress toward addressing skill mismatches (see Box 3.3 for the south Caucasus), improving the business environment, enhancing governance and institutional quality, and promoting equality of access to public services.

Oil and Gas Importers

Fiscal Consolidation Is Under Way or Planned

In Armenia and Georgia, economic recovery is gaining momentum and providing room for needed fiscal consolidation, with fiscal deficits forecast to
decline further in 2011 and 2012 (Figure 3.6). Fiscal deficits are projected to widen, however, in the Kyrgyz Republic in 2011—in reaction to last year’s economic contraction induced by the political and civil unrest—and in Tajikistan, reflecting, in part, anticipated disbursements of external loans under the public investment program. Fiscal consolidation is needed—and indeed planned—in both countries to rebuild fiscal buffers and ensure medium-term fiscal sustainability.

Further Monetary Policy Tightening Needed in Some Countries

Driven largely by high food prices, headline inflation picked up in Armenia and Georgia through early 2011. To curb inflation expectations and a potential broadening of price pressures, the authorities tightened monetary policy (Annex 3.1). Since mid-2011, headline inflation has been declining rapidly and is projected to decline further as the agricultural sector recovers and global food price inflation moderates (Figure 3.7). In this light, and given that core (or nonfood) inflation remains largely subdued (Figure 3.8), the Georgian and Armenian authorities have recently started easing monetary conditions. Monetary easing should proceed cautiously, particularly in light of strong credit growth.

In Tajikistan, headline inflation surged with the pass-through of higher food and fuel prices and was exacerbated by the recent sizable increase in Russian export taxes on fuel. Even though monetary policy has tightened, a further tightening is warranted given the currently high headline inflation (14 percent at end-July) and its projected persistence, the recent pickup in core inflation, growing private-sector credit, and pressures for additional public spending.

In the Kyrgyz Republic, headline inflation pressures—stemming from food and fuel
prices—have spilled into core inflation, which remains in double-digit territory despite monetary policy tightening. Russia’s removal of its fuel export duty, an improved security situation, an expected recovery in agriculture, and a softening of international food and fuel prices should help moderate inflation. However, additional monetary tightening is needed to offset potential inflationary pressures stemming from increased fiscal spending during the second half of 2011.

External Vulnerabilities Will Need to Be Addressed

Current account deficits remain elevated in several CCA oil and gas importers in 2011, particularly Armenia and Georgia (Figure 3.9). In all countries, foreign direct investment inflows have not yet recovered to precrisis levels (Figure 3.10), and external debt—which has risen during the global crisis—remains high, ranging from 35 percent of GDP in Armenia and 51 percent in Tajikistan, to almost 60 percent in Georgia and the Kyrgyz Republic. Accordingly, policy needs to focus increasingly on reining in current account deficits to help preserve external sustainability. To this end, maintaining a flexible exchange rate in Georgia, the Kyrgyz Republic, and Tajikistan, and allowing for more flexibility in Armenia, are needed. Stepping up structural reforms to boost competitiveness is also crucial. Continuation of the fiscal consolidation that has already commenced in a number of countries will also help achieve external sustainability.

Oil and Gas Exporters

Macroeconomic Policy Remains Largely Accommodative …

The fiscal stance remains expansionary in virtually all oil and gas exporters in 2011. Largely on account of increased government spending, the non-oil fiscal deficit is projected to widen in 2011 in Azerbaijan and Turkmenistan (Figure 3.11).
Notwithstanding high commodity prices, the overall fiscal surplus in Uzbekistan is shrinking in 2011, implying a somewhat expansionary fiscal stance. In Kazakhstan, the non-oil fiscal deficit is projected to remain broadly unchanged. For 2012, while non-oil fiscal deficits are projected to decline, they remain significantly higher than precrisis levels.

Monetary policy remains accommodative in the group of oil and gas exporters. Despite the recent modest increases in the policy rate in some countries (Azerbaijan, Kazakhstan), real rates remain negative in all countries. Reserve requirements are lower than precrisis levels and, in Turkmenistan and Uzbekistan, sizable directed lending continues.

... with Heightened Risks of Inflationary Pressures

The oil and gas exporters are growing fast, and this growth, coupled with an accommodative policy stance, implies sizable upside risks of overheating. Indeed, despite an expected moderation in international food and fuel prices, headline inflation is forecast to continue to rise in 2012 in Azerbaijan and Turkmenistan, and to remain in double-digit territory in Uzbekistan (Figure 3.12). In Kazakhstan, headline inflation is projected to moderate in 2012, but risks remain to the upside. The prices of key food items remain elevated, underscoring the risks to inflation expectations.

Moreover, this year's 30 percent hike in Kazakhstani public-sector wages and pension outlays will also likely add to the risks of broadening price pressures. Indeed, in Kazakhstan and all other oil and gas exporters, core inflation is projected to rise in 2012 (Figure 3.13).

Monetary Policy Should Exit from Its Accommodative Stance ...

With the economic recovery gaining speed and inflationary pressures heightening, monetary policy should exit from its accommodative stance. However, monetary policy itself has only limited traction in most countries; hence policymakers should pursue reforms aimed at enhancing its effectiveness. In Turkmenistan and Uzbekistan, directed lending and interest rate controls should be phased out, as they impede financial intermediation, credit allocation, and the conduct of monetary policy. In all countries, fostering financial deepening, enhancing central bank independence, improving the capacity of monetary policy tools, promoting more competition in banking systems, and avoiding unnecessary government intervention are all key to strengthening the transmission mechanism of monetary policy.¹

¹ See also IMF, October 2010 Regional Economic Outlook: Middle East and Central Asia.
Unemployment rates are even higher—close to 15 percent in Azerbaijan, and in the range of 35–40 percent in Georgia and Armenia (Box 3.3).

Unemployment in the south Caucasus appears to be largely structural in origin. The precrisis boom period did not help to reduce officially recorded unemployment significantly, nor did the global economic crisis lead to a substantial increase. The observed weak association between growth and unemployment partly reflects low labor intensity of growth—in the precrisis boom period, more jobs were created in financial services, for example, than in sectors, such as agriculture, that have high labor intensity. However, the weak link could also reflect other structural factors, most notably a mismatch between the skills provided by national education systems and those required in the modern job market, particularly in Armenia and Georgia.

Unemployment rates tend to be highest among the educated. More than 20 percent of firms in Armenia and 25 percent of firms in Georgia report lack of worker skills as a major constraint on their business operations—not insignificant numbers.

Strengthening the quality of labor statistics is needed to facilitate policy formulation. In the south Caucasus, the skill mismatch problem calls for education reforms and training programs. To achieve a sustainable reduction in unemployment, policymakers could help boost investment in employment-intensive sectors such as agriculture.

Medium-Term Challenges: Jobs and Inclusive Growth

Unemployment is a matter of concern in the CCA, but data are sparse, particularly in central Asia. There, massive emigration to Russia has partially mitigated the problem—especially in Tajikistan and the Kyrgyz Republic. In some countries, impediments to private-sector activity constrain job creation and employment opportunities. In others, hidden unemployment or underemployment is a concern, given the prevalence of a large number of informal workers, many of whom are the rural poor.

In the south Caucasus, available data suggest that unemployment is high. In Azerbaijan, the unemployment rate is near 10 percent, and in Armenia, it stood at 19 percent in 2009. Georgia’s unemployment rate in 2009 was about 17 percent according to official estimates. There, alternative estimates of unemployment are higher, in the range of 20–30 percent. In all countries, youth unemployment rates are even higher—close to 15 percent in Azerbaijan, and in the range of 35–40 percent in Georgia and Armenia (Box 3.3).

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While CCA countries have made important strides in improving the business environment in recent years, many still lag behind on several indicators, most notably the ease of trading across borders—in such areas as the number of documents, procedures, and days needed to export and import. In addition, despite some improvements in governance over the past decade, the region scores low on several widely cited governance indicators that capture rule of law and control of corruption. In several countries in the region, there are also concerns related to inequality of access to public services (Box 3.4).

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4 See also IMF, April 2011 *Regional Economic Outlook: Middle East and Central Asia.*
Unemployment is high in the south Caucasus. Official data for 2010 indicate unemployment rates in Armenia, Azerbaijan, and Georgia of 7.0 percent, 6.0 percent, and 16.3 percent, respectively. However, alternative estimates, available for Armenia and Georgia in 2009 and Azerbaijan in 2008, which take into account factors such as underemployment, suggest that unemployment rates could be significantly higher—by more than half as much in Azerbaijan and Georgia, and by more than twice as much in Armenia (Figure 1). Youth unemployment is particularly high. About 35–40 percent of the youth labor force in Armenia and Georgia, and 15 percent in Azerbaijan, is unemployed (Figure 2). Youth employment is largely concentrated in service sectors and tends to be informal.

Growth during the past decade’s economic boom did not help to reduce unemployment significantly. While the south Caucasus countries saw phenomenally high average output growth—ranging from about 8 percent in Georgia to nearly 13 percent in Armenia and Azerbaijan (for the latter in non-oil terms) during the economic boom period (2001–08)—this high growth was not associated with a commensurate decline in unemployment, which fell, on average, by only about 3–4 percentage points in Armenia and Azerbaijan, and, surprisingly, rose slightly in Georgia (Figure 3). In contrast, many comparator countries in eastern Europe were able to achieve a similar or larger reduction in unemployment over the same period, with lower growth.

However, there appears to have been an increase in working hours during the boom years, and this, combined with rising real wages, could explain why unemployment did not decline as much. In Azerbaijan—for which detailed data are available for the pre- and postboom periods—mean hours worked per week in nonagricultural jobs rose to 43 in 2008 from 38 in 2001,  1

Prepared by Nadeem Ilahi with input from Anna Bordon, Alina Luca, Nia Sharashidze, and Chunfang Yang.

1 According to the official definition, a person is classified as unemployed in Armenia if he or she is registered as such. In Azerbaijan and Georgia, a person is employed if he or she worked for at least an hour in the previous week. Differences in data collection practices make cross-country comparison of unemployment rates difficult.

2 While alternative estimates are based, for the most part, on an internationally accepted methodology, they may not be directly comparable to official unemployment statistics as they are often based on survey data which suffer from seasonality bias.

3 A lack of continuous data series makes it difficult to analyze these relationships using output gap techniques.
with the share of the employed who worked less than 20 hours in the previous week declining, implying a reduction in underemployment (Figure 4). Real wages also saw a sharp rise in Azerbaijan and Georgia over the same period.

Low growth in labor-intensive agricultural sectors and a heavy reliance on remittances may also explain the lack of association between aggregate growth and unemployment. Boom period growth in the south Caucasus appears to have been concentrated in sectors with low labor intensity (for example, financial services), while agriculture—typically a large employer—did not benefit as much (Figure 5). The increase in unemployment in Georgia during the period was partially a consequence of downsizing associated with public-sector reform and privatization. The heavy reliance of household incomes on remittances, especially in Armenia, may also have induced workers to stay out of work for longer periods by raising their reservation wages. The weak relationship between economic growth and unemployment also suggests that, for the most part, the poverty reduction achieved in these countries over the period—which was particularly impressive in Armenia and Azerbaijan—was driven by external factors (remittances, especially in Armenia), government transfers, and an increase in hours worked (particularly in Azerbaijan).

Official statistics show a small increase in unemployment in south Caucasus countries during the global economic crisis, though alternative sources suggest a different perspective. The association between economic shocks that lead to a significant decline in GDP growth, and officially measured unemployment, is weaker in Armenia and Azerbaijan than in many other comparator countries (Figure 6). GDP growth rates fell in Armenia and Azerbaijan

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4 A similar comparison for agricultural jobs is not possible, as the data suffer from seasonality differences.
by more than 20 and 10 percentage points in 2009, respectively, but there was barely a one percentage point increase in the official unemployment rate in Armenia and no change in Azerbaijan. In contrast, Georgia’s official unemployment rate increased significantly as a consequence of the war in 2008 and the subsequent global economic slowdown. Results from a survey by the European Bank for Reconstruction and Development, which asked households about the impacts of the crisis, suggest a different picture. They show that between one-quarter and one-third of households in the three countries experienced job losses as a result of the crisis, significantly higher than has been observed in many comparator countries (Figure 7).5 Also, compared to that in other countries, labor market adjustment to the crisis in these three countries appears to take place more through layoffs than wage cuts.

To achieve more inclusive growth, policymakers in the countries of the south Caucasus need to pay greater attention to the sectoral composition of growth and to skill mismatches. Increasing investment in the agricultural sector, which employs a high proportion of the workforce, and reducing barriers to intraregional trade could also help with job creation. The problem of youth unemployment underscores the need to place greater emphasis on improving education standards and attuning skills to labor demand. It is equally important to strengthen the quality of labor statistics, which are particularly deficient in all three countries.

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5 Job losses in Figure 7 are not directly comparable to changes in the unemployment rate, because they do not include job creation.
Looking ahead, policy should focus on reforms aimed at improving transparency and institutional quality, promoting equity in the provision of government services, and creating an environment that fosters a level playing field for all. Such reforms would facilitate private-sector development and lay a solid foundation for an inclusive and sustainable improvement in living standards.

**Box 3.4**

**Business Environment and Governance in the CCA**

The business environment in the CCA has improved over the past half decade. Georgia, Azerbaijan, the Kyrgyz Republic, and Kazakhstan each improved their positions in the World Bank’s Doing Business (DB) rankings by 27 places or more during 2006–11, and Georgia rose in the rankings by 88 places to 12th position, by far the largest increase by any country worldwide and the highest ranking in the CCA (Figure 1). Kazakhstan jumped 15 places in the 2011 rankings, the largest improvement for any country.

Still, most CCA countries score poorly on some DB indicators. Several rank relatively low on indicators for trading across borders, such as the number of documents and days needed for export or import procedures. This drives up costs and impedes regional and international trade. DB scores are also relatively low for some CCA countries on “paying taxes” and “dealing with construction permits” (Figure 2); for these indicators a handful of CCA countries have rankings below the averages for emerging markets and low-income countries. CCA scores are relatively better for “starting business” (except Tajikistan and Uzbekistan), “registering property,” and “enforcing contracts” (all CCA countries score in the top third of countries globally and rank ahead of emerging-market and low-income country averages).

On average, there is little disparity in the CCA between rules-based measures of the business environment (such as DB) and practice-based ones (such as the World Bank and European Bank for Reconstruction and Development’s Business Environment and Enterprise Performance Survey [BEEPS]). DB rankings are based on an assessment of rules and regulations that foster a level playing field for all. Such reforms would facilitate private-sector development and lay a solid foundation for an inclusive and sustainable improvement in living standards.

Prepared by Mark Horton, based on work by Carlos Caceres, Nadeem Ilahi, Anna Kochanova, Kamal Krishna, and Chunfang Yang.

1 DB rankings cover the regulatory environment related to nine key steps needed to set up, operate, and close a business. See www.doingbusiness.org.

2 Turkmenistan is not included in the World Bank’s Ease of Doing Business rankings.
in place, but on-the-ground experience with these rules may be different. Firm survey responses are a useful confirmation of whether a country’s formal rules and regulations for business activities are working in practice. These deviations appear to be less significant for the median firm surveyed by BEEPS, in comparison with countries in the Middle East and North Africa. A comparison of the time it takes on average for a firm to receive a business license reveals that in Armenia, Azerbaijan, the Kyrgyz Republic, Tajikistan, and Uzbekistan, the median firm receives its license in fewer days than the number required to start a business according to DB (Figure 3).

However, there is a wide divergence in practice on the ground within each country, suggesting smaller firms may be discriminated against. Firm-level responses also provide a way of assessing inclusivity, by investigating equality of treatment or access of firms to government services. The variation among firms in the number of days it takes them to obtain a license is quite significant in some CCA countries (Figure 4). A comparison of the time it takes for the fastest 20 percent of firms to receive a license with that for the slowest 20 percent reveals wide dispersion, particularly in the Kyrgyz Republic and Kazakhstan, where the difference is about 30 days (and more than 50 days for the fastest and slowest 10 percent of firms in those two countries, plus Georgia and Tajikistan). This suggests lack of equal access, and such a disparity of treatment will need to be addressed to durably improve the business environment.

The business environment in CCA countries lags others on trade linkages, local markets, and research and development. The Global Competitiveness Indicator (GCI) of the World Economic Forum takes into account a broader range of business environment factors than DB. While CCA countries rank on the overall GCI at par with or higher than low-income countries, they score well below the average rankings for emerging market economies. With the exception of Azerbaijan, the GCI subindicator rankings for CCA countries are notably

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3 See also Annex 2.2.

4 This includes public and private institutions; transport, energy, and communications infrastructure; the macroeconomic environment; health and education quality; efficiency of goods, labor, and financial markets; technological advancement; and business sophistication and innovation. See www.weforum.org.
lower in the areas of “innovation” and “sophistication,” which depend upon international trade linkages, the extent and quality of local suppliers, and indicators of research and development (Figure 5).

Despite significant progress over the past decade, governance remains weak in the CCA relative to the rest of the world. As noted previously, CCA countries have made progress over the past decade in improving governance and institutions. However, according to global indicators, such as the World Bank’s World Governance Indicators, the rule of law and control of corruption remain relatively weak in the region, with the exception of Georgia (Figures 6 and 7).

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5 See IMF, April 2011 Regional Economic Outlook: Middle East and Central Asia.
Annex 3.1. Commodity Price Inflation and Monetary Policy in the CCA

Recent developments in global commodity prices have renewed interest in discussion of appropriate monetary policy responses to food-price-based inflation pressures. Given the importance of food and fuel commodities in the consumption baskets of the CCA, closely monitoring the main drivers of inflation and suitably designing monetary policy responses will be essential to maintaining macroeconomic stability.

Inflation: Stylized Facts for the Region

The inflation process in CCA countries shares many features common to small open economies with large food shares in national consumption baskets. First, there is a positive comovement between headline inflation and international oil and food prices. Second, there is a positive comovement between international food prices and domestic food inflation (Figure 1). Third, food inflation in CCA countries is higher, more volatile, and more persistent than nonfood inflation (see table). Fourth, headline (or overall) inflation in CCA countries is higher, more volatile, and more persistent than core inflation (which typically excludes food prices from measured inflation).

One of the most striking features of the CCA region is the very large share of food in national consumption baskets. Food shares of CCA countries are considerably larger than those of advanced economies and also larger than those of MENA countries (Figure 2).¹

The correlation between headline inflation and food inflation is typically high and positive for all the countries in the region (Figure 3). This strong positive association between food inflation and headline inflation for CCA countries is far more pronounced than that in many advanced and emerging market economies, where monetary policymakers tend to focus on the evolution of core inflation in their policy deliberations.

As a result, a traditional argument in favor of core inflation—that it is a good predictor of future headline inflation and thereby a good indicator of the trend in overall inflation—is invalid for many food-consumption-dominated CCA countries.

Prepared by Agustín Roitman and Paul Cashin.

¹ Note that the CCA countries—Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan (oil and gas exporters)—and Armenia, Georgia, the Kyrgyz Republic, and Tajikistan (oil and gas importers)—are denoted by red bars in figures in this Annex.
The Core Is Not Enough

Households in small open economies, subject to international commodity price fluctuations, are often financially constrained and tend to hold large amounts of cash to complete everyday retail transactions. Accordingly, accommodating international and domestic food price shocks, by emphasizing core (or nonfood) inflation, may harm the purchasing power of poor households and adversely affect the distribution of income. For countries where inflation is elevated, even before a commodity price spike, an accommodative monetary policy response may not be robust enough to contain inflation, as it will not be sufficiently countercyclical and so not “lean against the wind” when it is most needed (by disregarding volatility caused by commodity price shocks).

A focus on headline inflation implies taking into account available prices of all items included in national consumption baskets. In practice, many central banks focus on a subset of prices, or on stabilizing intermediate targets as a way of conducting and implementing monetary policy. This can certainly be complementary to, and should be in close connection with, the behavior of overall (headline) inflation. Furthermore, achieving lower headline inflation levels in the medium and long term might come at the cost of some output losses in the short term. The magnitude and duration of these output losses will depend chiefly on the extent of market rigidities (for example, labor market constraints), as well as the share of food and nonfood in domestic consumption baskets. In addition, in countries where monetary transmission mechanisms are somewhat weak and not fully developed, social safety nets can be used as an additional policy instrument to mitigate the impact of high food prices on poor households.

For food-consumption-dependent CCA countries, focusing monetary policy responses on headline inflation, while not ignoring core inflation as an important indicator of domestic inflation, can provide a realistic and accurate picture of overall inflation in the economy, help anchor inflation expectations, and allow monetary policymakers to react rapidly to help ensure price stability. Those central banks monitoring a subset of prices (nonfood or core inflation) should certainly continue to do so, but should also use headline inflation as a key measure of potential future pressures on domestic prices to ensure a timely monetary policy response.

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Finally, a “one-size-fits-all” policy prescription for CCA and MENA countries is unlikely to be appropriate, because countries face different constraints and use different tools to implement monetary policy in tackling inflation. Nonetheless, having a clear, simple, and transparent monetary framework—looking not only at nonfood (or core) inflation, but paying greater attention to headline inflation—would enhance monetary policy credibility and help keep inflation and inflation expectations muted. It will also better connect monetary policymakers with their citizens, households, and businesses, who see price changes in the components of a broad measure of inflation.