JANUARY 23-25, 2010 THUN, SWITZERLAND

EURASIA EMERGING MARKETS FORUM

The Global Economic Crisis of 2008-09 in the Caucasus, Central Asia and Mongolia

Pradeep K. Mitra

Emerging Markets Forum
A nonprofit initiative of the Centennial Group

Bringing people together to accelerate growth and well-being in emerging markets

The Global Economic Crisis of 2008-09 in the Caucasus, Central Asia and Mongolia

Pradeep K. Mitra[1]

Abstract

The global economic crisis of 2008-09 was transmitted, with one exception, to the Caucasus, Central Asia and Mongolia through declines in prices for their commodity exports and a slowdown in destination countries—principally the Russian Federation--which buy their exports and employ migrant workers, with one exception. Unlike the other countries, however, Kazakhstan, which is well-integrated into global financial markets, experienced a sudden stop in capital flows in 2007. Fiscal stimulus has supported weakening economies, and has been financed through official borrowing in energy importers (Armenia, Georgia, the Kyrgyz Republic, Mongolia, Tajikistan) to the extent pre-crisis imbalances and the resulting debt dynamics allow and by stabilization funds in energy exporters (Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan). But more concessional financing will be needed to moderate the tradeoff between stimulus and sustainable debt levels in the event of a weaker than expected global recovery. Distress in banking sectors has been contained through liquidity support and deposit guarantees but regulatory forbearance should be avoided and proactive bank restructuring undertaken so as not to impede financial intermediation and economic recovery. Means-tested safety net programs, which can be scaled up to cushion the poorest households from the effects of the crisis, are in general better developed in the Caucasus than in Central Asia and Mongolia, where significant reform within existing fiscal envelopes and, in some cases, introduction of new programs are called for. Structural reforms to stay competitive in a post-crisis environment, where capital flows to developing countries are likely to be lower, should prioritize infrastructure and labor skills, which have emerged as the tightest bottlenecks to growth. [1]

I. Introduction

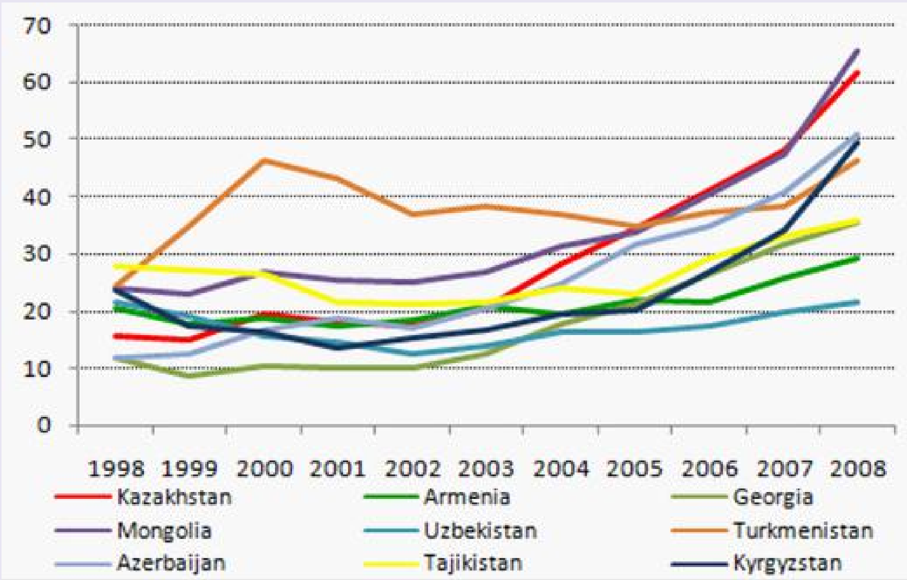
The global economic and financial crisis of 2008-09 did not affect most countries in the Caucasus and Central Asia and Mongolia directly[2]. Its epicenter was in advanced country financial markets with which, with the exception of Kazakhstan, the other countries were not well integrated. The crisis however led to deleveraging from financially integrated transition and developing countries among which the Russian Federation, in the neighborhood of the Caucasus and Central Asia, was for them the most important. The financial crisis also precipitated a worldwide recession. The ways in which its effects were transmitted to the Caucasus, Central Asia and Mongolia include terms of trade losses for commodity exporters (Azerbaijan, Kazakhstan, Mongolia, Turkmenistan and Uzbekistan), a slowdown in the growth of export demand as a result of the global economic downturn (all countries), a fall in remittances due mainly to the downturn in the Russian Federation (Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Tajikistan and Uzbekistan) and, for countries integrated into global financial markets, a "capital account crisis" marked by a sudden stop in and a potential reversal of external capital flows, of which Kazakhstan was an early casualty.

This paper discusses how the Caucasus, Central Asia and Mongolia have been affected by the crisis and what the first round of responses to it has been. The countries of focus are Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan, which vary greatly in their level of per capita income, degree of economic integration and, therefore, the extent to which they have been affected by the crisis. Estimates of gross national income per capita in 2008 at market exchange rates put the Kyrgyz Republic ($740), Tajikistan ($600) and Uzbekistan ($910) in the low income and Mongolia ($1680), Georgia ($2,470), Turkmenistan ($2,840),

1 The author is a former Chief Economist, Europe and Central Asia at the World Bank. Paper prepared for the Centennial Group, Washington DC. I thank Elena Kantarovich for excellent research assistance.

2 The Caucasus include Armenia, Azerbaijan and Georgia, while Central Asia includes Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan.

Figure 1 **Trade Openness Index**



Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Armenia ($3,350), Azerbaijan ($3,830) and Kazakhstan ($6,140) in the lower middle-income group of countries.

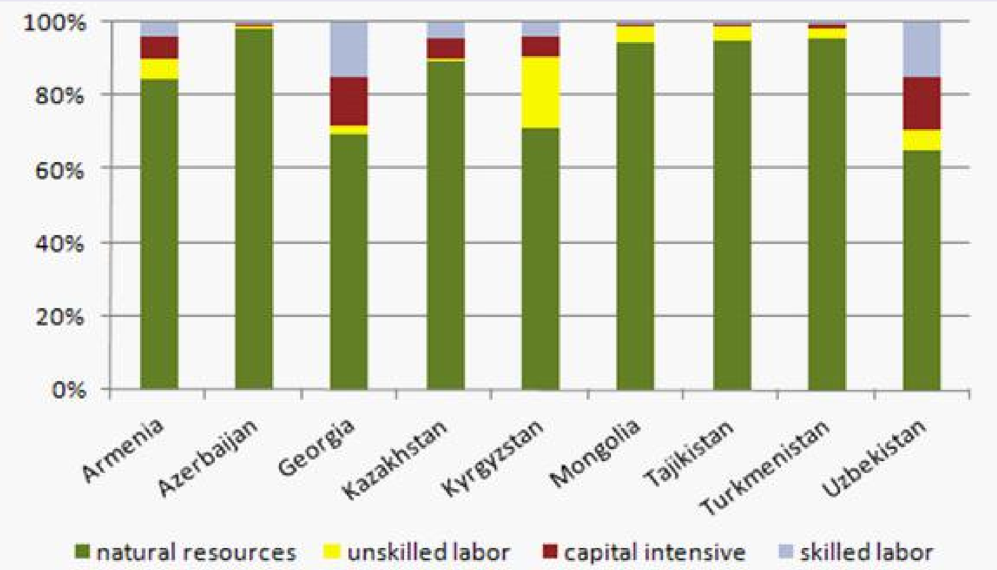
Section II of the paper presents aspects of the integration of the Caucasus, Central Asia and Mongolia in the world economy to provide the context for how they were affected by a crisis which originated in advanced country financial markets. Section III examines pre-crisis economic developments till 2008. Sections IV, V and VI cover recession, recovery and reform respectively. Section VII summarizes some conclusions that can be drawn from this experience and is followed in Section VIII by notes on the impact of the crisis and the policy response in each country.

II. Aspects of Integration

Trade

Trade openness—measured as the sum of exports and imports as a share of GDP (in purchasing power parity)—rose sharply from around 2003 to a range of between nearly 50 and 60 percent, reflecting, inter alia, the rapid rise in oil prices in Azerbaijan, Kazakhstan and Turkmenistan (Figure 1). The corresponding figure for Armenia, Georgia and Tajikistan ranged between 30 to 35 percent, which is broadly comparable to that for developing East Asia, going down to 20 percent for Uzbekistan. An examination of the factor composition of exports reveals that the share of natural resource-intensive products in exports in Azerbaijan, Kazakhstan, Mongolia, Tajikistan and Turkmenistan is nearly 90 percent or more, while that of natural resource-intensive and unskilled labor-intensive products in exports in the Kyrgyz Republic is over 90 percent., Somewhat in contrast, skilled labor-intensive and capital-intensive products account for 30 percent of Uzbekistan's exports and nearly a quarter of Georgia's exports (Figure 2). The dominance of natural resource-intensive products is owed to the massive deindustrialization that occurred after the break up of the former Soviet Union, which led to an increase the share of ores, metals and fuels

Figure 2 **Factor Intensity of Merchandise Exports**



Source: UN COMTRADE, SITC rev. 1

in exports at the expense of manufacturing. Trade in energy and raw materials experienced a boost in resource-rich countries such as Azerbaijan, Kazakhstan and Turkmenistan. Tajikistan's exports are dominated by aluminum, while the Kyrgyz Republic's rely extensively on gold.

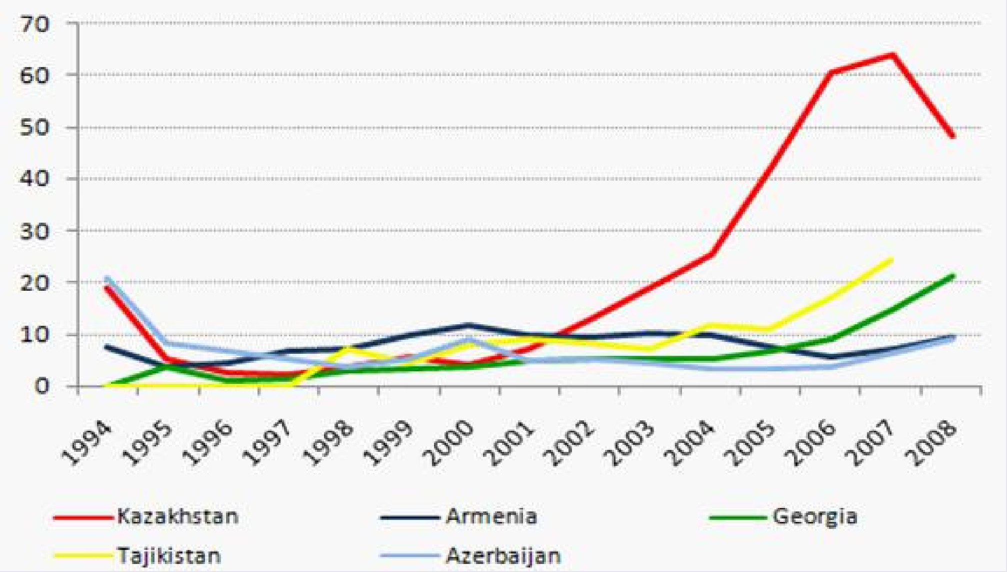
Finance

Financial openness—the sum of foreign assets and foreign liabilities as a share of GDP—is the highest in Kazakhstan, reaching over 60 percent in 2007 and falling to 50 percent in 2008—a number comparable to that for the new member states of the European Union. The corresponding figure for Armenia and Azerbaijan is 10 percent, with Georgia occupying an intermediate position (Figure 3). Furthermore, the nature of financial integration varies greatly across the countries. Over 90 percent and over 70 percent of banking sector assets in Georgia and the Kyrgyz Republic respectively and around 50 percent of banking sector assets in Armenia are foreign-owned. In contrast, Azerbaijan, Kazakhstan, Mongolia and Tajikistan have majority domestic-owned banking sectors, with the extent of foreign ownership being 40 percent in Kazakhstan and Mongolia and in the single digits in Azerbaijan and Tajikistan. Turkmenistan and Uzbekistan have banking sectors that are predominantly state-owned[3].

The reason for the relative unimportance of the financial sector as a channel of transmission for the crisis is not hard to find. Although financial systems have come a long way since the start of the transition from plan to market, they are smaller than that predicted by GDP per capita (Figure 4). This is true for lower middle income countries such as Armenia, Azerbaijan and Georgia, although not Kazakhstan, where extraordinarily rapid credit growth had led to "normal" financial depth by 2007. Indeed, with the exception of Kazakhstan, liquidity and efficiency of financial markets in the Caucasus and Central Asia are lower than in countries at similar per

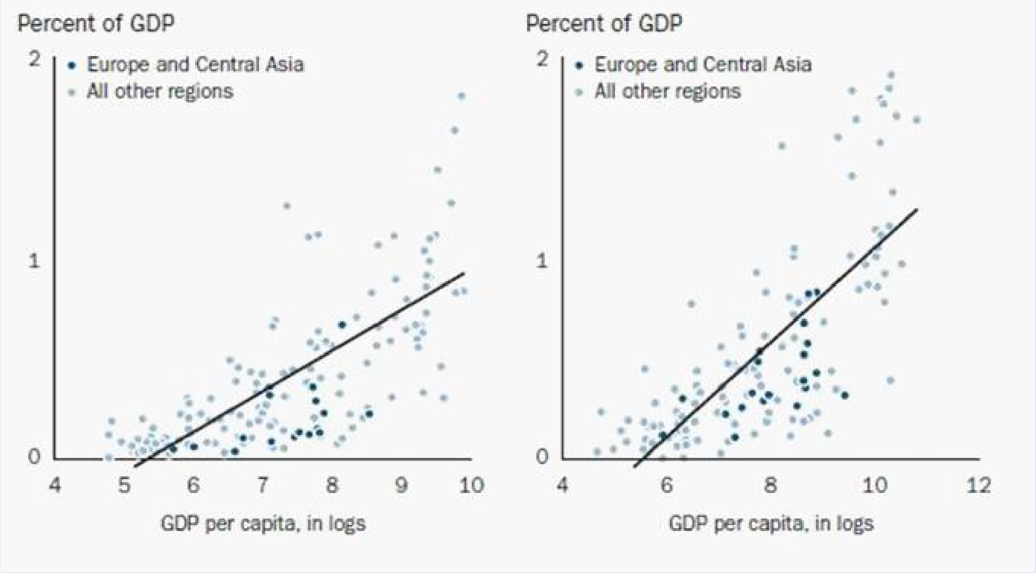
3 EBRD (2009).

Figure 3 **Financial Integration**



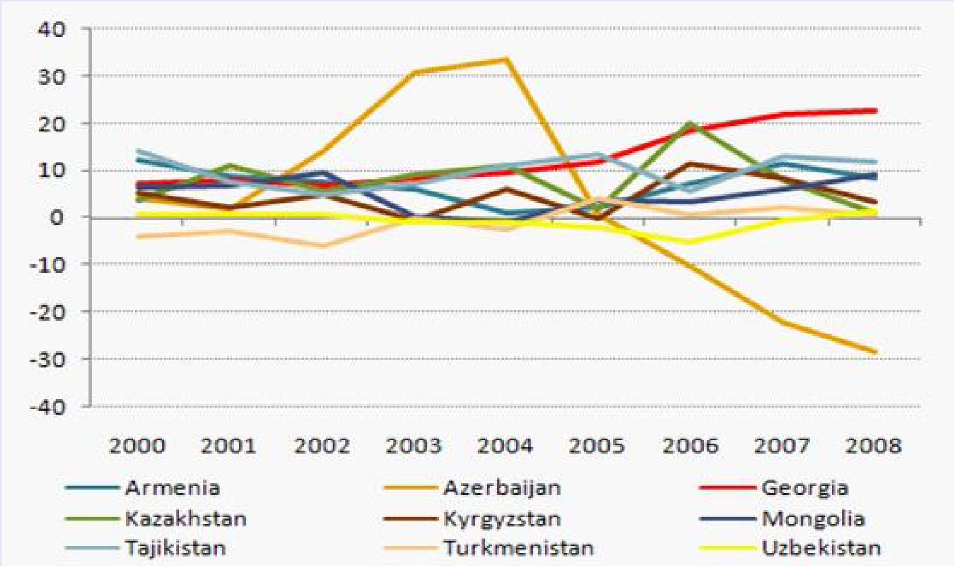
Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Figure 4 **Private credit to GDP versus GDP per capita**
ECA's transition economies versus other regions, 1995 and 2007



Source: Beck and Demirguc-Kunt 2009

Figure 5 **Total Capital Flows, net (% of GDP)**



Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

capita income levels[4]. This is the result of bank restructuring in those countries having been postponed for the most part to the second decade of transition. However, financial shallowness also limited the costs imposed by financial distress triggered by the global crisis on the rest of the economy.

III. Economic Developments till 2008

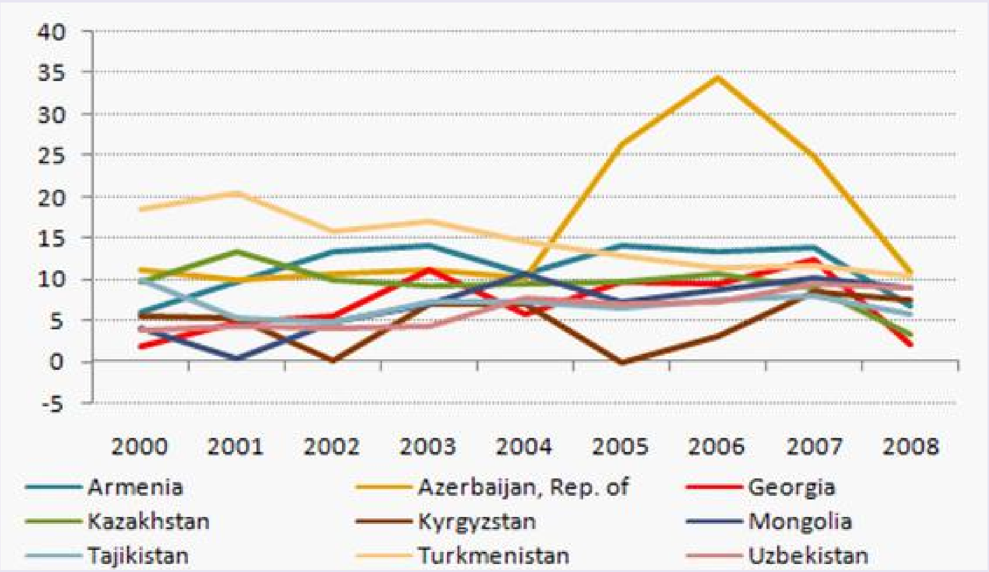
Armenia, Georgia, Mongolia, Tajikistan and, until 2007, Kazakhstan enjoyed substantial capital flows on a scale higher than in developing East Asia and Latin America, while Turkmenistan and Uzbekistan were not reliant on them. Azerbaijan became a net capital exporter after 2005 (Figure 5). Countries grew robustly during much of the period—part of transition-based output recovery in the Caucasus and Central Asia—generally slowing in 2008 as the effects of the global economic crisis began to take hold (Figure 6).

Armenia, Azerbaijan, Kazakhstan and Turkmenistan grew at double-digit or near-double-digit rates, while there was an uptick in growth in Georgia, Mongolia and Uzbekistan after 2003-2004, which was a period of unusually high global liquidity. There was some increase in inflation after 2005 in a majority of the countries under consideration, reaching double digits in Azerbaijan, Tajikistan and Uzbekistan and, after 2006 in the Kyrgyz Republic, a trend also seen in other developing economy regions (Figure 7).

Growth was accompanied by an accumulation of current account imbalances after 2005 in Armenia, Georgia, Kazakhstan and Tajikistan after 2005, with the sudden stop in capital flows to Kazakhstan bringing about a reversal in 2008 (Figure 8). With the possible exception of Tajikistan, these could not be explained, by

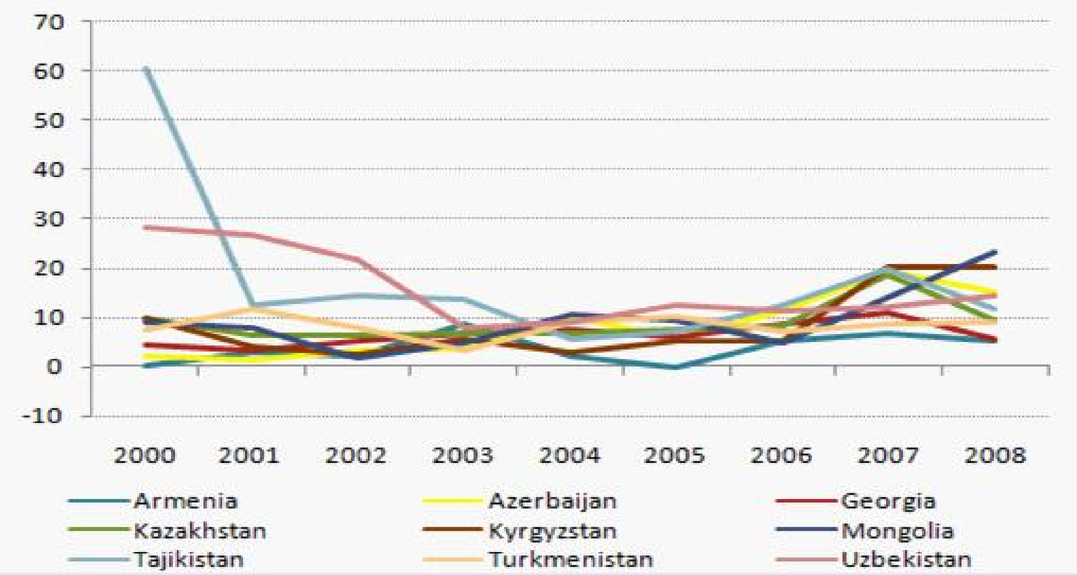
4 Liquidity is measured by the liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of bank and nonbank financial intermediaries) divided by GDP. Efficiency is measured by net interest margin, (net interest revenue relative to total earning assets averaged over all banks for each country) and by overhead costs (total operating costs relative to total assets averaged over all available data). For details see Mitra, Selowsky and Zalduendo (2009). It should be noted that references to "Caucasus and Central Asia" in the paper exclude Mongolia.

Figure 6 **Real GDP Growth**



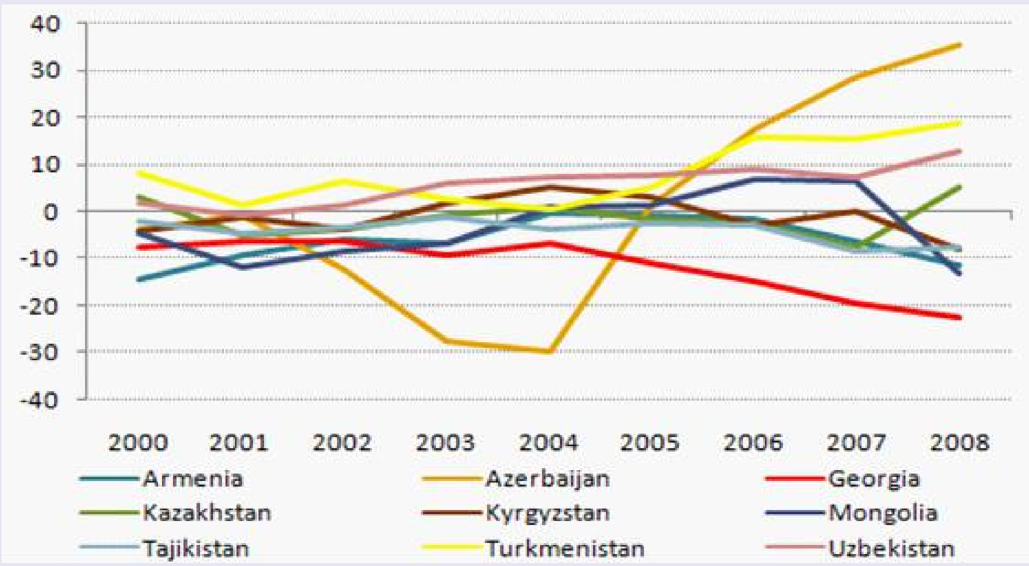
Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Figure 7 **Inflation, end of period consumer prices (annual percent change)**



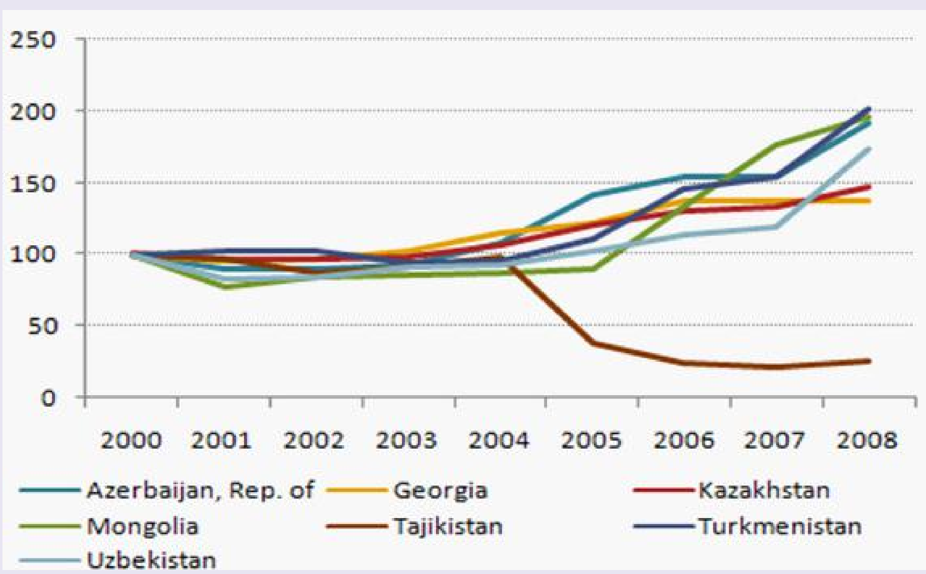
Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Figure 8 | **Current account balance (% of GDP)**



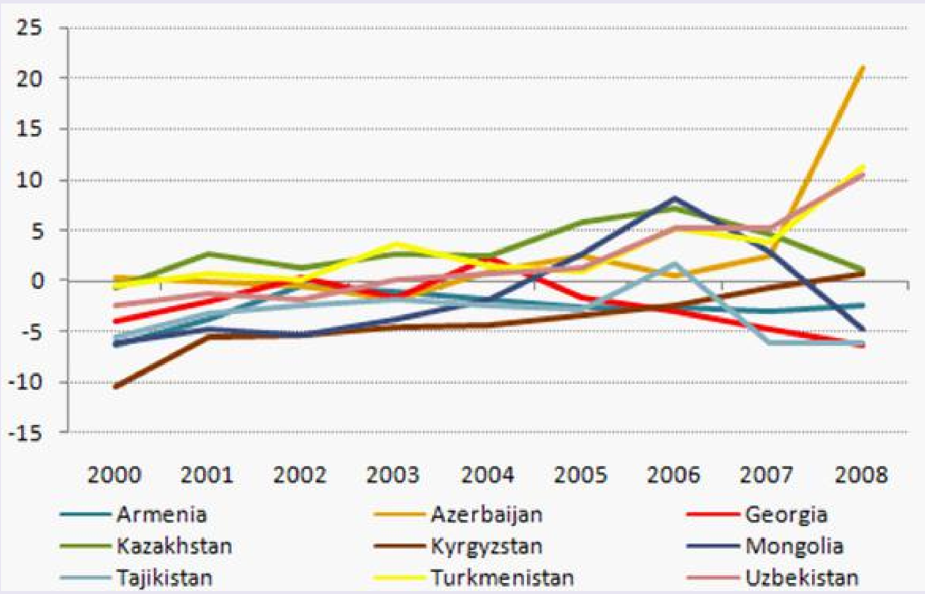
Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Figure 9 | **Terms of trade, goods (index)**



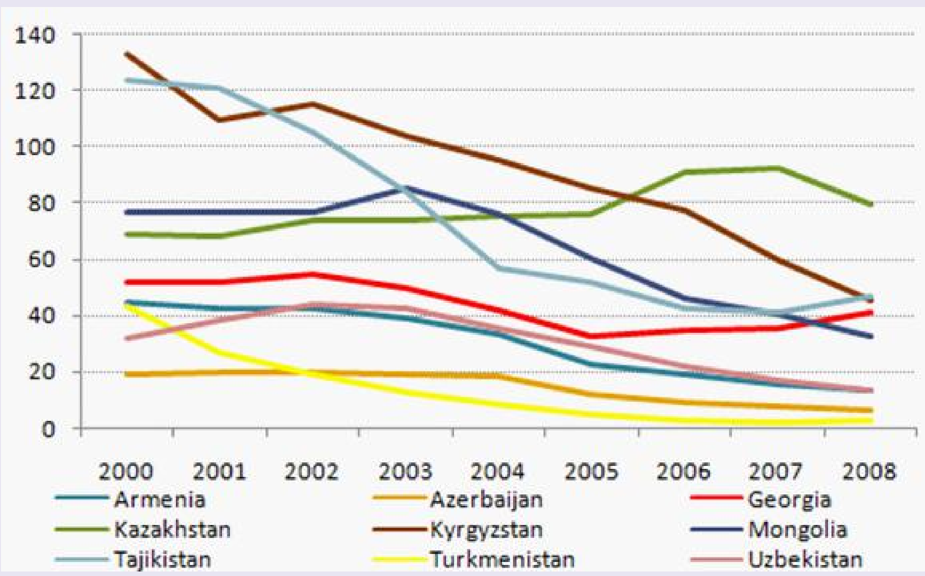
Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Figure 10 **Fiscal balance (% of GDP)**



Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Figure 11 **External debt to GDP**



Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Table 1 | **Savings - Investment Balance (% of GDP)**

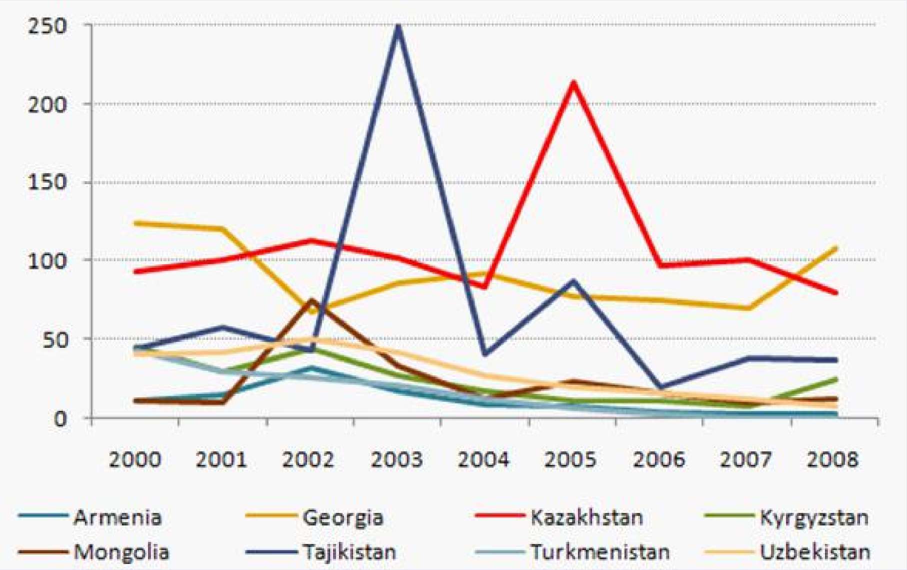
	Europe and Central Asia Region								
	Armenia	Azerbaijan	Georgia	Kazakhstan	Mongolia	Tajikistan	Turkmenistan	Uzbekistan	Kyrgyzstan
					2003-05				
National Savings	22.4	32.1	16.3	27.0	30.4	20.0	-	31.3	24.2
Public	2.9	5.8	2.2	9.3	7.6	5.1	-	4.1	0.3
Private	19.6	26.3	14.1	17.7	22.8	14.9	-	27.2	23.9
National Investment	25.2	50.9	26.1	27.7	31.9	22.6	-	24.4	21.1
Public	4.2	4.6	2.8	4.9	4.5	7.5	-	3.7	-
Private	21.1	46.3	23.3	22.7	27.3	15.1	-	20.7	-
(S-I) public	-1.3	1.2	-0.6	4.3	3.1	-2.4	-	0.4	-
(S-I) private	-1.5	-20.0	-9.2	-5.0	-4.6	-0.2	-	6.5	-
Current Account	-2.8	-18.8	-9.7	-0.6	-1.5	-2.6	2.8	6.9	3.7
Total Capital Flows	2.8	21.5	10.0	7.1	0.8	10.5	0.5	-1.3	1.8
Δ FX reserves	0.0	2.8	0.3	6.5	-0.7	8.0	3.3	5.6	5.5
('+ increase)									
					2006-08				
National Savings	31.6	51.2	5.2	30.8	38.4	24.5	-	32.1	18.5
Public	2.1	19.0	4.1	10.1	11.7	8.9	-	3.5	3.6
Private	29.5	32.2	1.0	20.7	26.7	15.6	-	28.6	14.9
National Investment	38.2	23.9	24.6	32.5	38.4	31.0	-	22.4	21.7
Public	4.1	8.7	3.4	5.7	8.4	12.1	-	2.2	4.4
Private	34.1	15.2	21.2	26.8	30.0	18.8	-	20.2	17
(S-I) public	-2.0	10.4	0.7	4.4	3.3	-3.2	-	1.3	-0.8
(S-I) private	-4.6	17.0	-20.2	-6.1	-3.3	-3.2	-	8.4	-2.5
Current Account	-6.6	27.3	-19.4	-1.7	0.1	-6.4	16.7	9.7	-3.3
Total Capital Flows	8.8	-20.2	21.2	9.6	6-1	10.2	1.2	-1.4	9.8
Δ FX reserves	2.2	7.1	1.8	7.9	6-2	3.8	17.9	8.3	6.5
('+ increase)									

Source: IMF World Economic Outlook, IMF country reports, World Bank World Development Indicators and author's calculationss

terms of trade movements (Figure 9), nor, for the most part, by fiscal imbalances, despite their deterioration in Georgia and, to a lesser extent, Armenia. (Figure 10). In fact, the worsening of external imbalances in Armenia, Georgia, Kazakhstan and Tajikistan between 2003-05 and 2006-08 was due for the most part to increasing private sector imbalances, with the qualification that in Tajikistan, higher public sector imbalances played an equally important role (Table 1).

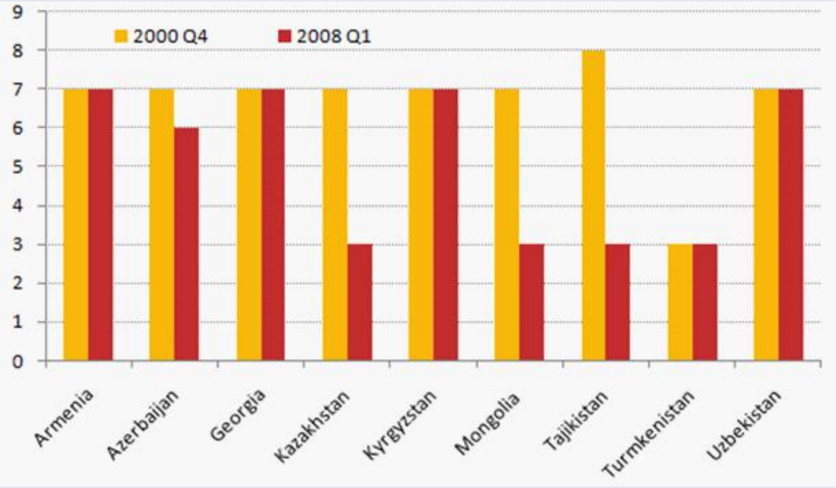
As in other developing economy regions, external indebtedness was generally reduced since the turn of the century, particularly sharply in the cases of Armenia, the Kyrgyz Republic and Tajikistan, signaling improved external solvency, but was to increase from

Figure 12 **Short-Term Debt to Foreign Exchange Reserves**



Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

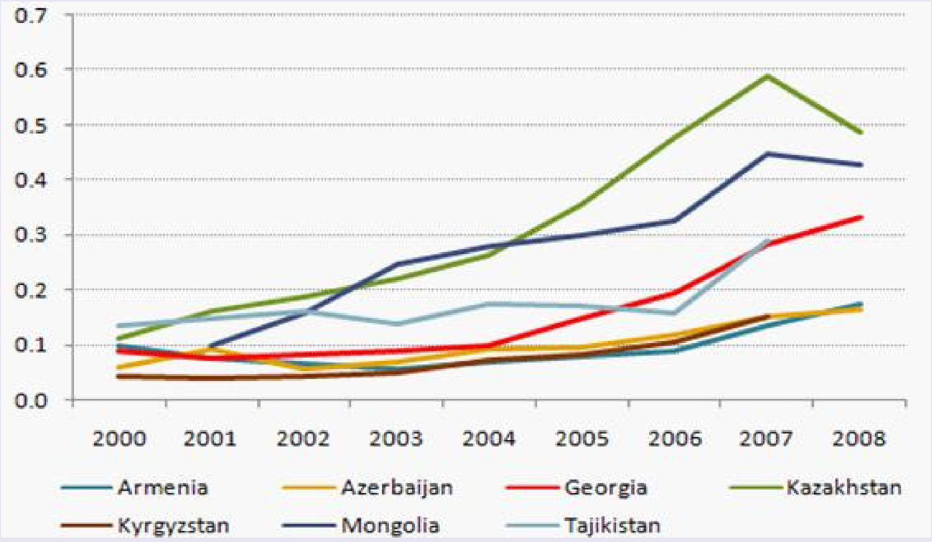
Figure 13 **Exchange Rate Regimes**



Note: 1 no separate legal tender; 2 is a currency board; 3 conventional pegged arrangement; 3.5 conventional peg to a basket; 4 pegged exchange rate within horizontal bands; 5 equals crawling peg; 6 equals crawling band; 7 equals managed floating with no predetermined path; and 8 equals independently floating.

Source: IMF's AREAER, Bubula and Otker-Robe, and author's calculations

Figure 14 **Private Sector Credit to GDP Ratio**

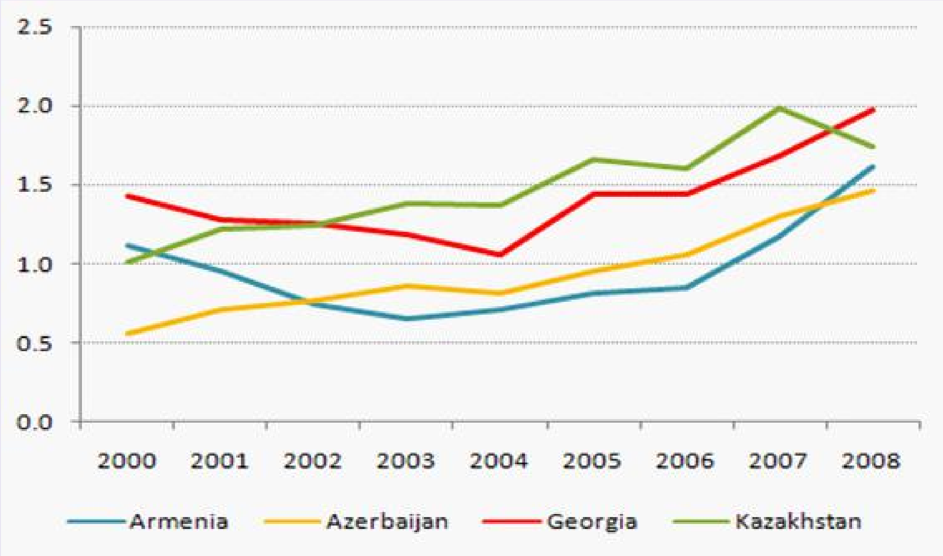


Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

2005 in Kazakhstan and towards the end of the period in Georgia (Figure 11). The ratio of maturing short-term debt to foreign exchange reserves—a measure of external liquidity—was well below one, with the exception of Georgia and Kazakhstan (Figure 12). The picture on external solvency and liquidity is rounded out by looking at countries' choice of exchange rate regimes (Figure 13).

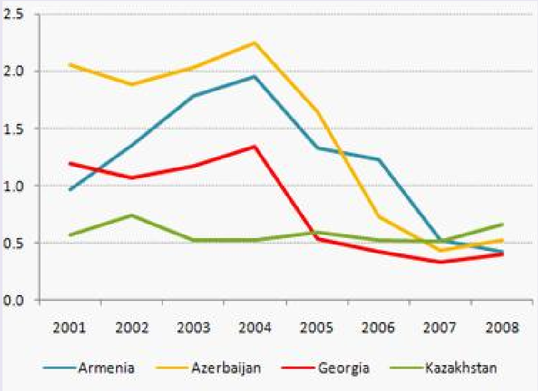
There was a notable increase in private sector credit-to-GDP ratios in all countries, particularly since 2005, with some scaling back in Kazakhstan after the sudden stop in external capital flows (Figure 14). However, given the comparative shallowness of the financial sector, part of the increase is attributable to financial deepening in countries that lacked financial sectors at the beginning of the transition. The annual growth of real credit to the private sector was 49 percent in Georgia, 36 percent in Kazakhstan, 42 percent in Armenia and 39 percent in Azerbaijan during 2005—08. Financial depth was much lower in Armenia and Georgia in 2004 compared to Kazakhstan. Hence even with extremely high growth of real private sector credit during 2005—08, their financial sectors by the end of the period were smaller than what would be expected on the basis of their incomes per capita (Figure 4). The same is a fortiori true of Azerbaijan, which is richer than Armenia and Georgia, but has a financial depth similar to those two countries. The share of households in bank loans to households and nonfinancial corporates rose very sharply from 12 percent in 2003 to 30 percent in 2008 in Kazakhstan—an increase comparable to that seen in Russia and a correlate of financial deepening. And although comparable data are available for only four countries, private sector credit expansion was also accompanied by loan growth in excess of growth in deposits, leading to an increase in the loan-to-deposit ratio which came to exceed unity in all countries, but was nearly 2 in Georgia and Kazakhstan, making banks in those countries particularly vulnerable to reversals in market sentiment (Figure 15). The implication of a loan-to-deposit ratio

Figure 15 **Loan to Deposit Ratio**



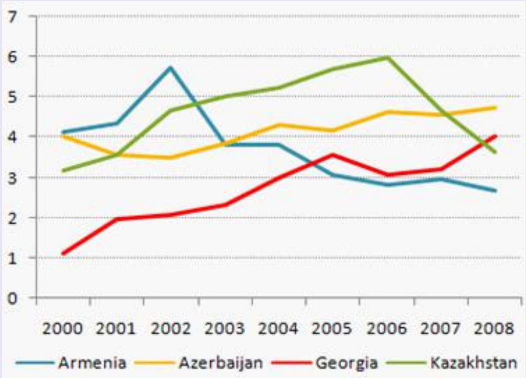
Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Figure 16A **Foreign Exchange Assets to Liabilities**



Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

Figure 16B **Liabilities to Equity Ratio**



Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

greater than one is that credit expansion was financed, depending on the country concerned, by parent bank or wholesale funding, generally a riskier strategy than relying wholly on domestic deposits. Foreign liabilities of banks generally increased, with the exception of Kazakhstan (Figure 16a). Leverage ratios (liabilities-to-equity) increased in Azerbaijan and Georgia and till 2006 in Kazakhstan but are lower for example than in East Asia in the 1990s (Figure 16b).

IV. Recession

Channels of transmission

First, the sharp contraction in GDP in 2009 in the Russian Federation, Turkey and Ukraine, estimated at 7.5 percent, 6.5 percent and 14 percent respectively, has depressed export demand in all the countries of the Caucasus and Central Asia, for whom they are the major export markets[5].

Second, a fall in oil prices from nearly $150/bbl to nearly $40/bbl during the second half of 2008, affected Azerbaijan, Kazakhstan and Turkmenistan adversely, while benefiting the oil importing countries in the region. At the same time, Mongolia suffered a shock due to a vertiginous drop in copper prices between the middle of 2008 and January 2009.

Third, a fall in remittances, preliminarily estimated at between one-third and one-half, affected Tajikistan, the Kyrgyz Republic, Armenia, Uzbekistan, Georgia and Azerbaijan, where remittances as a share of GDP in 2008 were 47 percent, 25 percent, 18 percent, 7 percent, 6 percent and 3 percent respectively. Over 90 percent of remittances in the Kyrgyz Republic and Tajikistan, three-quarters in Armenia and somewhat over half of those to Azerbaijan and Georgia originate in the Russian Federation.

Finally, Kazakhstan, which among all the countries under consideration, has a financial sector that is most integrated into global financial markets experienced a sudden stop in capital flows in August 2007.

In addition, the capital account crisis in the Russian Federation, had knock on effects: first, the adverse effects of a sizeable ruble devaluation on external competitiveness in countries with important trading links with the Russian Federation and second, on the financing side, a decline in Russian foreign direct investment. Evidently countries were hit by more than one transmission channel. Furthermore, the same transmission channel, for example, global deleveraging by banks, with its attendant consequences, while it most affected Kazakhstan, was felt in Armenia, Azerbaijan and Georgia as well, but to a considerably lesser extent because their banking sectors, though developing rapidly, are comparatively smaller.

The role of transition

The reason countries were hit by similar shocks but to differing degrees with regard to both trade and finance owes something to the history of transition.

The reintegration into world trade since the disintegration of trading blocs at the beginning of the transition has led to the countries of Caucasus and Central Asia trading less with the large middle income countries of the Commonwealth of Independent States, viz., Belarus, Kazakhstan, Russia and Ukraine (the middle income CIS) than at the beginning of the transition, although the middle income CIS continues to be their major trading partner[6]. However, this group of countries trades below its potential and trades too little with the rest of the world[7]. While a geographically more diversified pattern of trade would not have prevented a trade-induced recession in the context of a coordinated worldwide downturn, continued diversification would lessen vulnerability to more localized episodes in the future.

On finance, the proximate reason for the degree of capital account crisis depending on the size and

5 China, where GDP growth slowed in 2008 to 9 percent, but not significantly in 2009, is by far the dominant market for Mongolia's exports.

6 For the purposes of this and the following sentence, "Caucasus and Central Asia" excludes Kazakhstan and Turkmenistan.

7 Potential trade is that predicted by a gravity model where trade between any two countries depends on their populations, geographic distance between their capitals, GDP, a trend variable and dummies for trading blocs. The results are presented in Maurel (2009).

integration of the financial sector was the extraordinary growth of private sector credit made possible by large external flows intermediated by banks. The annual growth rates of real private sector credit during 2000—2004 and 2005—2008 were respectively 2 percent and 42 percent in Armenia, 24 percent and 39 percent in Azerbaijan, 14 percent and 49 percent in Georgia and 43 percent and 36 percent in Kazakhstan. With the exception of Kazakhstan where growth in the second period was lower than in the first, these growth rates were in excess of those in all developing countries during this period, even allowing for initially shallow financial sectors[8]. This was a process of catch up by countries which had experienced deep and protracted transition recessions following the break up of the former Soviet Union. In Azerbaijan and Kazakhstan, for example, the credit boom was driven by households. It was facilitated by their ability to borrow in foreign currency, which typically had lower interest rates and longer maturities than those in local currency. And, on the supply side, 2003—2006 was a period of historically high global liquidity, with fierce competition in international banking and abundant supplies of credit to emerging market economies. This combination of demand and supply incentives allowed loan-to-deposit ratios to become substantially greater than one, implying that external financing made up the difference between the credit extended by banks and what they were taking in from depositors (Figure 14). The continuing long-term process of financial deepening implies that more of the countries under consideration might have experienced capital account crises had the global financial crisis erupted later than it did.

V. Recovery

Adjustment vs. financing

Terms of trade losses, slower growing or declining exports and sharply falling remittances in a recessionary environment have led most countries to pursue expansionary fiscal policies to support weakening economies, while seeking external financing to finance a larger fiscal deficit. Sharp reductions in tax revenue that typically occurred due to collapsing imports, declining asset prices and weakening demand generally did not elicit corresponding cuts in expenditure. This is the profile of adjustment, for example, in Armenia, Georgia, Mongolia and Tajikistan where, notwithstanding increases in fiscal deficits in 2009, automatic stabilizers were not allowed to operate fully. This was because fiscal policy had been strongly pro-cyclical in Mongolia prior to the crisis and the requisite finance was unavailable, whereas in Armenia, Georgia and Tajikistan, the additional financing required to have done so risked building unsustainable debt dynamics in varying degrees. A partial exception is provided by the Kyrgyz Republic, where the availability of large concessional donor support makes the tradeoff between fiscal easing and debt sustainability less acute. Fiscal accommodation was appropriate, because it may have been the only policy instrument available to provide stimulus. This is because monetary policy was ineffective in reducing lending rates in countries where banking sectors are small, risk-averse banks prefer to stay liquid as asset quality deteriorates in a slowing economy, there is a degree of deposit dollarization as high as between a half and three-quarters and demand for credit was, in any event, falling during the recession.

All five countries allowed major depreciation of their currencies. Faced with a significant ruble depreciation in the Russian Federation owing to that country's capital account crisis, Armenia, Georgia, the Kyrgyz Republic and Tajikistan did so, not only to avoid becoming uncompetitive but also to reduce uncertainty and discourage further deposit dollarization. Mongolia attempted to maintain its dollar peg initially but unsuccessfully and the currency was then allowed to depreciate substantially. In all cases, a weaker currency had adverse effects on unhedged borrowers and, given high loan dollarization in a number of countries, potentially exposed banks to indirect credit risk.

8 Details of the comparison with developing countries and the definition of what constitutes excessive credit growth are developed in Mitra, Selowsky and Zalduendo (2009).

The tradeoff between supporting demand in a recessionary environment and maintaining sustainable debt levels has been addressed by allowing fiscal accommodation in 2009, while preparing for fiscal consolidation to begin in 2010 and continue into the future. The IMF projects that the public debt to GDP ratio will reach a peak of around 47 percent in 2011 in both Armenia and Georgia and decline thereafter, which represents a manageable debt dynamics. But this strategy could become more complicated were the recovery to be weak and protracted. More concessional lending would alleviate the tradeoff between prolonged support to the economy and maintaining debt at sustainable levels in Armenia and Georgia. While Tajikistan is judged to be at high risk of debt distress, the debt remains at sustainable levels provided the external debt ceiling of 40 percent, which includes concessional lending, is respected. Tajikistan would benefit from grant financing.

The time phasing of adjustment and financing has been accompanied by expenditure reallocation as well. Armenia has protected social spending, strengthened social safety nets and increased capital spending on foreign-financed projects, Georgia has reallocated resources to social and capital spending from defense spending, while Tajikistan has reallocated them to protect social spending and ease infrastructure bottlenecks.

Adverse terms of trade movements, slower growing or declining exports and falling remittances affected Azerbaijan and Uzbekistan as well and raise similar issues for economic policy. However, instead of resorting to external finance, those countries, having entered the crisis with strong fiscal and foreign exchange positions, were able to use their stabilization funds to support accommodative fiscal policy. Furthermore, faced with ruble depreciation and those of other currencies in the region, Uzbekistan allowed a major depreciation of the currency in 2009. After a brief spell of pegging to a two-currency basket, Azerbaijan continues to maintain its dollar peg at the pre-crisis level.

A capital account crisis…

Kazakhstan experienced three sets of external shocks: first, a sudden stop in wholesale external funding in August 2007, precipitating a capital accounts crisis, and, in common with other countries in the region, second, a slowdown in the growth of export demand in 2008; and third, a collapse in its external terms of trade as oil prices fell rapidly in the second half of 2008. A capital account crisis, which is marked by an abrupt stop in and typically a reversal in capital flows, carries the potential of a loss of confidence. Creditors head for the exits. The currency comes under intense pressure. And the banking system experiences distress, both on the liability side as wholesale and interbank funding dry up and, in some cases, the deposit base erodes, as well as on the asset side as borrowers face financial difficulties. The latter are manifested in a rising share of non-performing loans in total loans which, in the capital account crises in East Asia in 1997-98 for example, peaked at 32 percent in Indonesia, 35 percent in Korea, 30 percent in Malaysia and 23 percent in Thailand.

As capital flows reversed, the central bank used 25 percent of reserves to defend the currency both to maintain depositor confidence and to limit risks to corporate balance sheets. It was only after the fall in oil prices in 2008 and the ruble depreciation that the tenge was devalued in February 2009. Banks in Kazakhstan owed nearly 40 percent of GDP in external liabilities, a quarter of which matured in 2009. Two of the four major banks stopped making payments on principal.

…and the financial sector

Restoring the financial system to health was important because both consumption and investment depend on credit. Policy responses to systemic banking crises typically distinguish between a containment phase (primarily related to the liability side of banks' balance sheets) where the priority is to restore confidence by depositors and investors in the banking system and a resolution phase (primarily related to the asset side of banks' balance sheets) focusing on the financial restructuring of banks and their borrowers. The central bank attempted to contain the banking crisis by providing liquidity support through a variety of means and increased the limit up to which retail deposits were guaranteed. The provision of liquidity support and deposit guarantees needs to be accompanied by intervention in banks deemed insolvent. In Kazakhstan, the regulators took over the largest bank under their enhanced powers of bank resolution.

Asset quality in the banking system is deteriorating, as seen in the rising share of nonperforming loans and loan loss provisions in Kazakhstan. The resolution phase requires a triage of banks into those that are viable and meet regulatory requirements, those that are viable but undercapitalized, and those that are nonviable and insolvent. Solvent and undercapitalized banks need to be capitalized on a timetable agreed with regulators. Unless market players are prepared to absorb the assets of fragile banks prior to bankruptcy, nonviable and insolvent banks need to be taken over by regulators and a decision taken on their future. In Kazakhstan, the sovereign wealth fund entrusted with crisis response injected capital into the top three banks and took a controlling share in the largest of them. Agreement involving burden-sharing with creditors was also recently reached on the restructuring of the two large banks that had been in default[9].

Other countries in the Caucasus and Central Asia and Mongolia did not experience a capital account crisis. But inasmuch as banks in some countries were borrowing abroad and have been affected by the drying up of external wholesale funding since the global financial crisis intensified in September 2008, they have been required to take the kind of policy measures to address the liability side that had been adopted a year earlier in Kazakhstan. And the deterioration of asset quality brought about by the global crisis is reflected in rising nonperforming loans in all countries and has called for policies appropriate for the resolution phase of banking crises. Indeed all countries have made sure that the supervisory authorities have necessary powers of intervention.

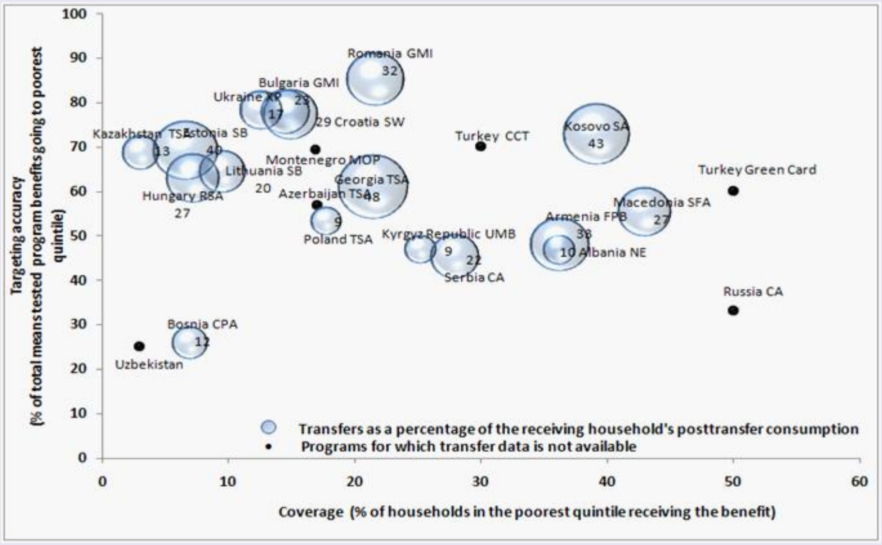
It is important in all these cases however that the authorities avoid regulatory forbearance to prevent the emergence of zombie banks. Bank restructuring should be accompanied by processes to catalyze debt workouts between banks and their corporate and household borrowers, so that problem loans do not impede financial intermediation and the recovery in what is expected to be a global environment of weak economic growth.

There is also an agenda of improving bank regulation and supervision in countries whose financial sectors have been affected by the crisis. Higher overall ratios of capital to risk-weighted assets—larger than the minimum 8 percent under Basel I and Basel II—are desirable for financial institutions in countries that face volatile capital movements, such as Kazakhstan and other lower middle income countries in the region with growing financial sectors that are integrating into the international financial markets. This would provide a first line of defense to protect against operational and market risks and foreign currency loans, all of which are important in countries that are integrating financially—even though it would err on the side of financial stability at the expense of some loss in financial intermediation. Strengthening supervision of cross-border banks through better coordination between home and host supervisors is desirable, while recognizing that there incentives to keep the supervisors apart when a bank is in distress. Beyond crisis management, however, there is an extensive agenda for modernizing banking sector institutions. The World Bank-IMF Financial Stability Assessment Programs (FSAPs) and the Reviews of Standards and Codes (ROSCs) provide numerous recommendations on how to improve bank supervision in the Caucasus, Central Asia and Mongolia[10].

9 This is pending the approval of all the creditors in one case.

10 The agenda for modernizing banking sector institutions is discussed in Mitra, Selowsky and Zalduendo (2009).

Figure 17 | **Means-Tested Safety Nets: Targeting Accuracy, Coverage, and Transfers to the Poorest Quintile**



Note: The figure shows the targeting accuracy and coverage of means-tested safety net programs. The size of the bubbles is a measure of their generosity—the transfer received by households in the poorest quintile as a share of the post-transfer consumption of all beneficiary households in that quintile.

Source: Mitra, Selowsky and Zalduendo (2009)

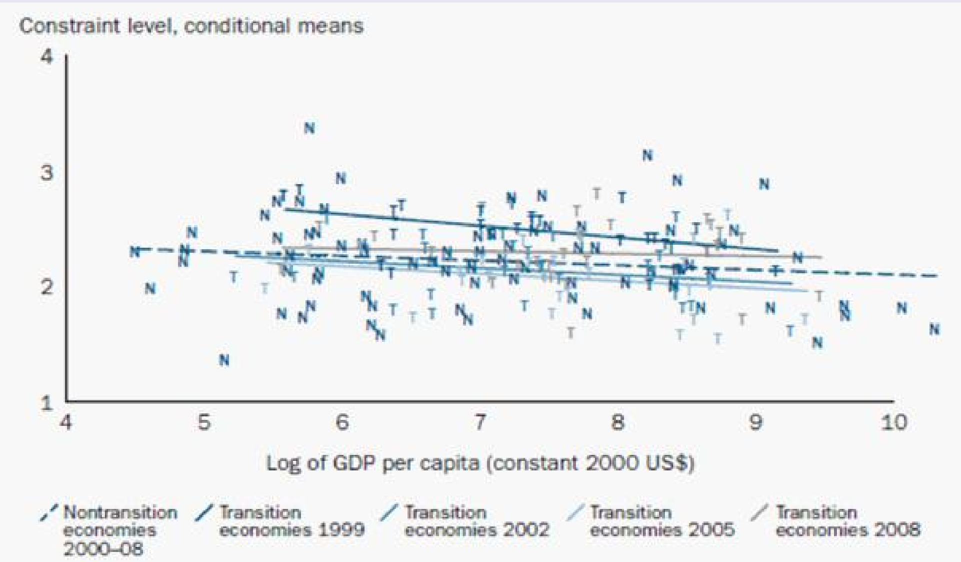
Scaling up social safety nets

Poverty is on the rise throughout the region, including among erstwhile recipients of remittances and employees in booming construction sectors. An example of the poverty-increasing effects of the crisis is provided by Armenia, where poverty has increased from 25.6 percent in the second quarter of 2008 to 28.4 percent in the second quarter of 2009 and extreme poverty from 3.6 percent to 6.9 percent over the same period, using national poverty lines[11]. This calls for social safety nets to be strengthened. The countries in the Caucasus, which spend between 1—1.5 percent of GDP on social assistance, have at least one well-targeted program where a high proportion of benefits reaches the poorest quintile of households and that could be scaled up in response to the crisis. The Family Benefit Program in Armenia and the Targeted Social Assistance Programs in Azerbaijan and Georgia deliver between 55 and 60 percent of their benefits to the poorest quintile of households, a degree of targeting accuracy on par with that in OECD countries. But their coverage—the share of the poorest quintile of households reached by these programs—ranges from less than 20 percent in Azerbaijan to nearly 40 percent in Armenia and could be increased by consolidating other "legacy" privileges. The generosity of means-tested programs—the ratio of the benefits transferred by the program to the beneficiaries' post-transfer consumption—is one-third in Armenia and nearly half in Georgia (Figure 17).

With the exception of the Kyrgyz Republic, means-tested safety nets are less well-developed in Central Asia. Around 70 percent of benefits of the Targeted Social Assistance Program (TSA) in Kazakhstan reach the poorest quintile of households, its coverage is around 5 percent and it transfers only 13 percent of the post-transfer consumption of beneficiaries. Since Kazakhstan spends just over 1 percent of GDP on social assistance and since the TSA accounts for less than 2 percent of total safety net transfers, the program could

11 Hentschel (2009)

Figure 18 **Average Business Environment Constraint: Transition Economies in 1999, 2002, 2005, 2008, and Nontransition Economies**



Source: Mitra, Selowsky and Zalduendo (2009)

be doubled by spending an additional 0.02 percent of GDP[12]. The cost would be less if the expansion of the targeted program were to be accompanied by significant reforms of the overall safety net. While Uzbekistan spends 2 percent of GDP on social assistance, around double the ratio in Azerbaijan, the targeting and coverage of its means-tested program leaves considerable room for improvement. Tajikistan, which spends 0.5 percent of GDP on social assistance, has yet to develop a means-tested program that has high targeting accuracy and reasonable coverage of the poorest households. It takes 12—18 months to develop basic targeting, registry and safety net systems—consonant with the expected length of the downturn—but considerably longer for lower income countries with weaker institutional capabilities.

The Kyrgyz Republic, which spends around 1 percent of GDP on social assistance, transfers nearly 60 percent of that amount through the Unified Monthly Benefit which, at 50 percent, has a targeting accuracy only slightly lower than its counterparts in the Caucasus. The coverage of households in the poorest quintile is however 30 percent and could be increased using the opportunity of the crisis by implementing policies similar to those recommended above.

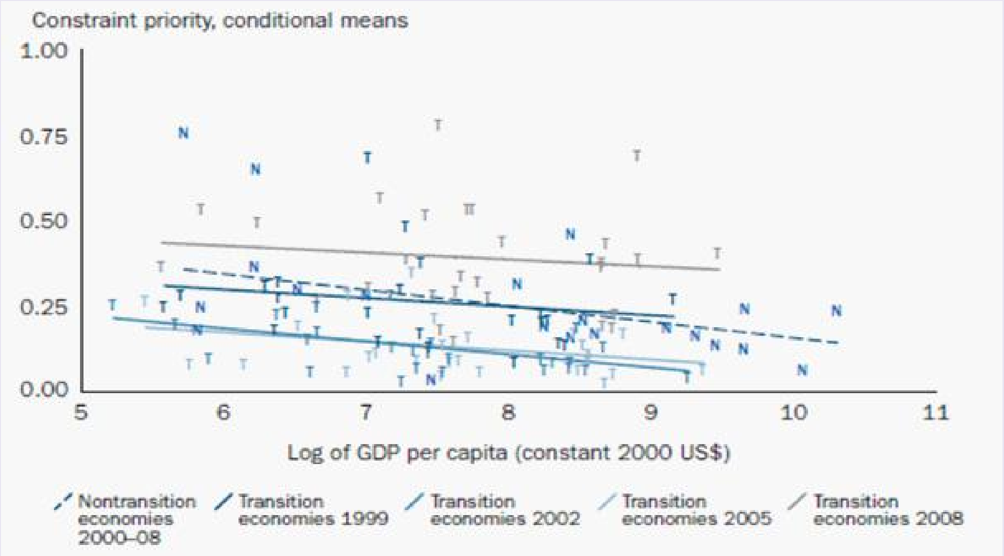
Finally, Mongolia has taken the opportunity of the crisis to undertake a comprehensive reform of social transfers, including consolidation of the number of benefits, a reduction in untargeted universal transfers and the introduction of a new benefit for those in poverty.

VI. Reform

Reform and immediate recovery have so far dominated the policy agenda, but, to remain competitive in a post-crisis world, countries now need to reinvigorate structural reforms in areas that constitute the tightest

12 This calculation does not incorporate administrative costs which may be higher for targeted programs.

Figure 19 | **Infrastructure Composite Bottlenecks, 1999–2008**



Source: Mitra, Selowsky and Zalduendo (2009)

bottlenecks to growth. Despite an uncertain future, it is likely that private capital flows will be considerably lower and that both private and official flows will go to countries with the most attractive business environments.

On the eve of the crisis, firm managers in an enterprise survey conducted in the transition economies of Central and Eastern Europe and the former Soviet Union reported that among all the elements of their business environment, infrastructure and labor skills were the most constraining in terms of their ability to operate and expand their businesses. It is also remarkable that these elements, which are part of the positive legacy of socialism, are also more constraining than in non-transition economies at similar income levels[13 14]. Other elements of the business environment include taxation, labor regulation, customs administration, licensing, the rule of law and finance.

Figure 18 measures GDP per capita on the horizontal axis. The vertical axis measures how costly firms in a country report the impact of inadequacies in elements of the business environment on their ability to operate and expand their businesses. The reading on the vertical axis is the average of firm responses for the country.

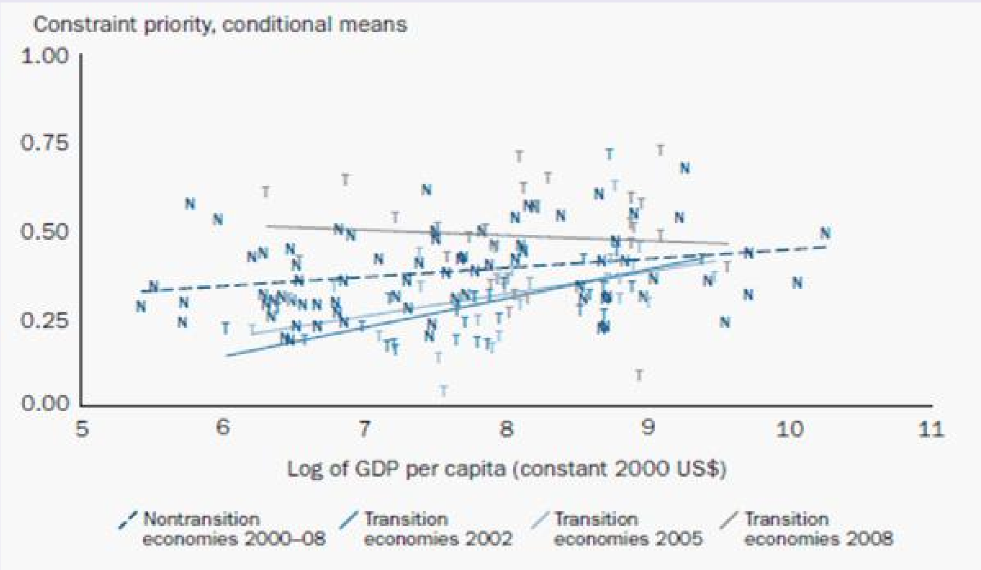
Two types of business indicators are considered.

- The first is the response to the question asking managers to evaluate the importance of each business environment constraint for the operation and the growth of the firm. Answers are scored from 1 (minor) to 4 (very severe). This is referred to as a measure of the "level" of the constraint and is shown along the vertical axis of Figure 18.
- The second is a relative measure of the "priority" of a constraint, where the priority for a responding firm is defined as a value above the average

13 The analysis is based on the Business Environment and Enterprise Performance Survey (BEEPS) conducted by the World Bank and the EBRD every three years since 1999. The responses in 2008 (BEEPS 4) correspond to 10,000 firms in 28 transition countries excluding Turkmenistan. They are contrasted against responses by 51,000 firms in 74 non-transition countries under the World Bank's Investment Climate Assessments.

14 A fuller account is presented in Mitra, Selowsky and Zalduendo (2009)

Figure 20 **Skills Bottlenecks, 1999–2008**



Source: Mitra, Selowsky and Zalduendo (2009)

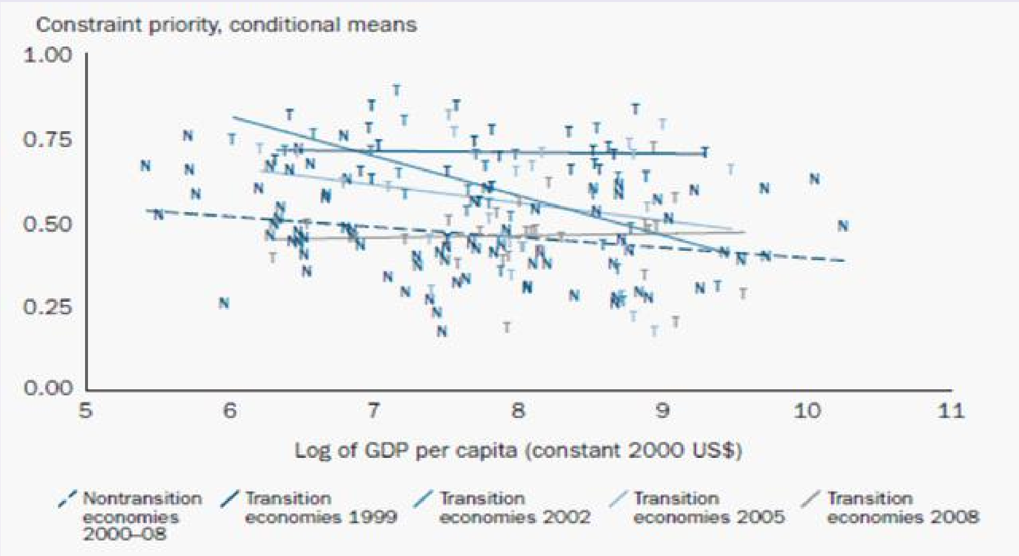
of the firm's answers for the six constraints common to BEEPS 4 and most of the decade's surveys, viz., tax rates, tax administration, labor regulation, licenses, corruption and crime.

To compare countries, it is necessary to control for the fact that the samples of firms for different countries will vary by characteristic such as firm size, their sector, the nature of ownership, whether domestic or foreign. To make the results comparable, these differences are corrected for, and the results presented for a benchmark firm. The benchmark firm is chosen to be a firm in manufacturing employing 30 persons, privately owned with no state-owned predecessor, with less than 10 percent foreign ownership, exporting less than 10 percent of its sales, and with no reported change in employment in the previous three years. The ratings for the benchmark firm are referred to as conditional means because they are corrected for sample composition.

Figure 18 presents conditional means for the level measure of the business environment for transition economies (TEs) for the 4 rounds of BEEPS from 1999 through 2008 and for the averages over 2000—2008 for non-transition economies (NTEs). It shows that, while the business environment in 2008 is on average more difficult for the TEs compare to the NTEs—a higher line for TEs in 2008 than NTEs---it is relatively more difficult for the lower and lower middle income TEs, which include Caucasus and Central Asia excluding Turkmenistan, compared to NTEs at similar income levels.

Furthermore, the survey evidence highlights emerging shortfalls of investment in physical infrastructure, especially in the upper and upper middle income transition countries and in education, especially in the low-income and lower middle-income transition countries. Figure 19 presents the conditional means for the priority measure of the infrastructure constraint. It shows that while infrastructure constraints became tighter for TEs compared to NTEs in 2008, for the first time since the

Figure 21 **Tax Administration: Priority Measure, 1999–2008**



Source: Mitra, Selowsky and Zalduendo (2009)

transition began, the lower and lower middle income TEs (which include the Caucasus and Central Asia) are relatively less constrained compared to NTEs at similar income levels than the upper middle income TEs[15].

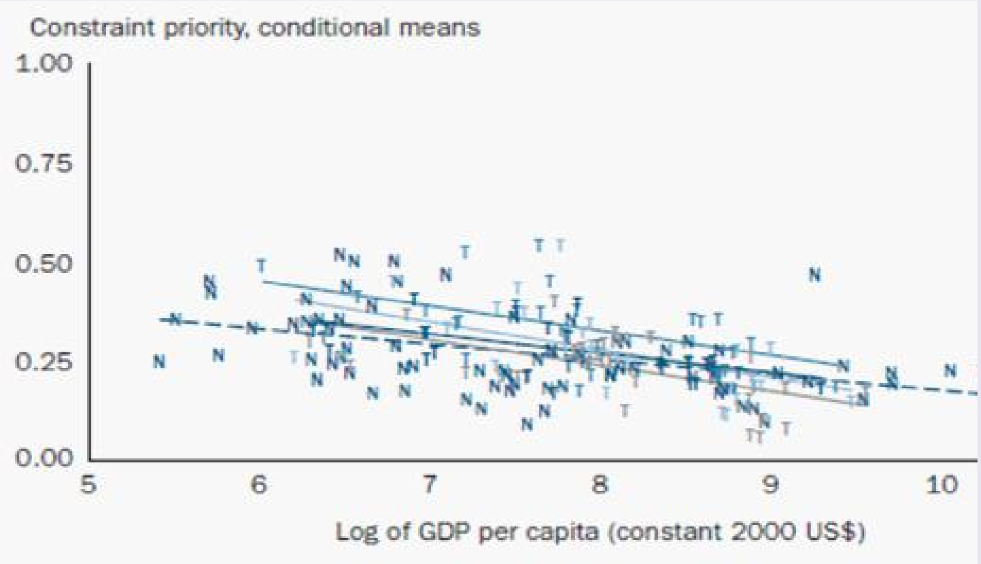
Figure 20 shows that, while constraints on labor skills became tighter for TEs compared to NTEs in 2008, once again for the first time since the transition began, the lower and lower middle income TEs (which include the Caucasus and Central Asia) are relatively more constrained compared to NTEs at similar income levels than the upper middle income TEs.

Thus, while the recession has likely loosened the infrastructure and labor skills constraints in the transition economies, they can be expected to reemerge as binding constraints once economic growth takes hold, underscoring the urgent need for structural reform in those sectors.

Finally, strong economic growth prior to the crisis appears to have increased the cost of weak market economy institutions, especially the legal environment in the lower middle-income transition economies and corruption in the low and lower middle-income transition economies, reversing a trend of improvement in both elements of the business environment observed till 2005. But other institutions of the market economy—such as tax administration and customs regulation, which traditionally ranked high among concerns in transition economies—show progress in 2008, where on both the levels and the priority measures their importance falls into line with non-transition economies at similar incomes (Figures 21 and 22). The 2008 survey also records a fall in concern with customs regulations. Whereas convergence on this measure to the non-transition norm had already taken place for the richer transition economies by 2005, it is recorded only in 2008 for the lower and lower middle income groups.

15 However, when infrastructure is disaggregated into its constituent subsectors and the surveys split into three groups by income, the tightness of the electricity constraint in the lower and lower middle income TEs is comparable to that in the NTEs, whereas in transport it remains lower. But firms in Mongolia, where the survey was also run, report not being less constrained than other transition economies with regard to electricity.

Figure 22 **Customs Regulations: Priority Measure, 1999–2008**



Source: Mitra, Selowsky and Zalduendo (2009)

VII. Conclusions

The effects of the global economic crisis, which have been felt for just over a year in most of the Caucasus, Central Asia and Mongolia, allows the following conclusions to be drawn.

First, countries have been able to draw on external financing to postpone the fiscal adjustment which would have aggravated the recession had it been implemented in 2009. The extent to which this has been done appears to have been constrained either by excessive pro-cyclicality of fiscal policy prior to the crisis or by the need to avoid unsustainable levels of debt rather than the availability of financing. The energy importing countries in the region without stabilization funds, viz., Armenia, Georgia, the Kyrgyz Republic, Mongolia and Tajikistan, have IMF-supported programs which have attracted financing from the multilateral development banks such as the World Bank and the Asian Development Bank and bilateral donors. However, a protracted weak recovery from the crisis, which is not unusual when households and firms in the advanced countries must repair their balance sheets, could complicate this strategy and would call for additional concessional financing.

Second, while the full extent of banking sector distress may not be known as yet, countries have been active in dealing with both the containment and resolution phases of potential or actual banking crises. Experience from earlier crises highlights the need to avoid regulatory forbearance to prevent the emergence of zombie banks. Although private indebtedness in Caucasus, Central Asia and Mongolia is not thought to be high except in sectors such as construction and real estate, bank restructuring should be accompanied by processes to catalyze debt workouts between banks and their corporate and, where relevant, household borrowers, so that problem loans do not impede financial intermediation and the recovery in what is expected to be an environment of weak economic growth.

Third, the experience of credit growth funded by borrowing from external wholesale markets was the result of (a) on the demand side, rapid catch up in living standards by countries that had experienced deep and protracted transition recessions, and (b) on the supply side, fierce competition in international banking and abundant supplies of credit to emerging market economies during a period of unusually high global liquidity. This resulted in loan-to-deposit ratios ballooning to well over one, making countries vulnerable to reversals in market sentiment, as was the case of Kazakhstan in 2007. The challenge for bank regulation and supervision, not only in Kazakhstan, but also in other countries in the region with developing financial sectors is to tie the growth of the banking system to that of domestic deposits. Efforts should be made to develop markets in domestic debt but, given the shallowness of financial systems and the high degree of deposit dollarization, this will happen over the medium-to-long term.

Fourth, well-targeted social safety nets should be scaled up in countries where they exist and the opportunity of the crisis should be taken to introduce poverty-focused programs in countries where they do not, in order to deal with the human dimension of the crisis. Official financing can be used to support such spending.

Finally, infrastructure and labor skills, which have emerged as the tightest bottlenecks to growth, need urgent reform if countries are to stay competitive when the recovery from the crisis takes hold.

VIII. Country Notes

A. Energy Importers/Labor Exporters

Armenia

The sharp downturn in the Russian Federation, which accounts for around three-quarters of remittances to Armenia, led to a fall in remittances—which had reached 18 percent of GDP in 2008—by an estimated 30 percent year-on-year in the first half of 2009[16]. Armenia's export earnings were also hit, not only by the Russian downturn, but a steep fall in copper prices during the latter half of 2008 as well. On the financing side, foreign direct investment in 2009 is estimated to have fallen by nearly two-thirds compared to 2008 levels. Construction, the growth of which had been fueled more by remittances than mortgage credit, and which had come to account for 30 percent of GDP in an economy where pre-crisis growth had been concentrated in a few sectors, contributed in large measure to the fall in GDP in 2009. Indeed GDP is estimated to have contracted by over 15 percent in 2009, making Armenia the country hardest hit by the global economic crisis in the Caucasus and Central Asia. The currency was allowed to depreciate by about 20 percent against the dollar in March 2009 in part to restore competitiveness in the aftermath of the ruble depreciation and to allay uncertainty that was contributing to deposit dollarization, which has since stabilized at around 65 percent.

The contraction in export earnings, remittances and FDI flows caused a squeeze in imports. This contributed to a sharp fall in revenue since imports account for over two-thirds of revenue from the value added tax. Faced with a weakening economy, the authors introduced a broad anti-crisis program, which included measures such as providing government guarantees to and taking equity positions in the private sector, interest rate subsidies for mortgage loans, funding a pan-Armenian bank to finance large national investment projects, protecting social spending, strengthening targeted social safety nets and increasing capital spending on foreign-financed projects. Primary spending has risen by 6 percentage points of GDP in 2009. The fiscal deficit is estimated to be 7.5 percent in 2009.

Expansionary fiscal policy was made possible by financing from the IMF, World Bank and the AsDB as well as bilateral assistance from the Russian Federation. This has increased the public debt. In order to keep the debt dynamics manageable, the looser fiscal stance of 2009 will give way to fiscal consolidation in 2010, when

16 In addition to workers' remittances, employee compensation and migrants' transfers, remittances in Armenia include flows from the Armenian diaspora.

Box 1 **Aiming High to Serve the Poor: Georgia's New Targeted Social Assistance Program**

The TSA, launched in July 2006 after 18 months of intense preparation, has several features worth noting.

- The team: The authorities appointed a team of national experts to develop a targeting mechanism, examining experiences in several countries, including Mexico, Chile, and Turkey.
- Targeting method: A "proxy means test" (complementing data on income with information of possession of durables, quality of the dwelling, education level of the household, and so on) was selected because of the high informality of the Georgian economy. The test was then finetuned through additional surveys. The formula accommodates differences in consumption across geographical locations. It combines both objective (measurable) variables and subjective assessment of the household situation by social workers.
- Administrative arrangements: The application process has two stages. First, households register and give their consent to further collection of information. The blank registration forms can be obtained at many points across Georgia. In the second phase, the Social Service Agency visits the household to collect the additional information. The data are entered in the database and locked for changes. Further processing is done centrally, including information verification and cross-checks, as well the assignment of the proxy score. The entire process is automated to assure objectivity and minimize the risk of bribery.
- Informing households: Each "scored" household is issued a card with the case number and score, allowing households to find out immediately whether they qualify for assistance.
- Program flexibility: The program is open-ended. Households can apply—at any time—if their score is below the cut-off point they automatically become included in the program. This poses a challenge for forecasting the required resources and calls for budgetary flexibility.

Source: Mitra, Selowsky and Zalduendo (2009)

the economy is expected to be stronger, and the fiscal deficit is projected to fall to below 6 percent of GDP. This phasing of adjustment causes the public debt, which was less than 16 percent of GDP in 2008, to peak in 2011 at about 47 percent of GDP, before falling to under 40 percent of GDP in 2014. While this is manageable, it would be rendered more difficult in the event of a weak rebound in growth, which depends greatly on the pace of recovery in the Russian Federation. The availability of concessional lending would help ensure that debt levels remain sustainable.

The response to the crisis aims to protect social spending and strengthen targeted safety nets. Armenia spends around 1.75 percent of GDP on social assistance. Over 55 percent of this amount is devoted to the means-tested Family Benefit Program, which transfers nearly 60 percent of its benefits to the poorest quintile of households, covers 35 percent of them and accounts for one-third of the post-transfer consumption of beneficiaries. This provides a strong basis for expanding coverage by enhancing outreach, such as proactive registration of potentially poor households, communications campaigns and social worker involvement.

Annual growth in credit to the private sector fell from 67 percent in 2008 to 25 percent in the first quarter of 2009, due both to tighter lending standards as well as weaker demand. The authorities have reduced the policy rate and attempted to overcome a weakening normal channel of transmission of monetary policy by purchasing government securities and increasing the maturity of repo operations to provide dram liquidity to the banking system. However this has raised liquidity in the banking system rather than leading to credit growth and bank lending rates remain high. Liquidity has more recently been mopped up to prevent short-term interbank rates from falling below the policy rate and limiting speculation in the foreign exchange market. The banking sector is also part of the anti-crisis program, on-lending donor funds to small and medium enterprises. Furthermore, the central bank has provided funding for a mixed public-private National Mortgage Fund designed to on-lend to the mortgage market.

In addition to providing liquidity to the banks, the authorities have strengthened the Deposit Insurance Fund to boost confidence. The banking sector has seen deterioration in the quality of assets, with non-performing loans as a proportion of loans rising and expected to rise further and increased loan-loss provisions in part due to the negative balance sheet effects of the dram devaluation[17]. However the banking system has a capital adequacy ratio of close to 30 percent. Steps are underway to strengthen bank regulation and supervision. For example, consideration is being given to limiting banks' net open foreign exchange positions which will require careful monitoring if it is not to be circumvented as Armenia integrates into international financial markets.

Georgia

Georgia was hit by the global economic crisis in the wake of its August 2008 conflict with the Russian Federation at a time when ebbing confidence had caused Georgian banks to lose access to capital markets and the country's fiscal and balance of payments needs had increased as well. The effects of the global downturn were felt through a contraction in workers' remittances, which had shrunk by around 20 percent year-on-year in the first half of 2009 and falling export demand. Foreign direct investment, which had played an important role in Georgia in recent years, is estimated to have fallen by 70 percent during the same period and there was a net outflow of non-FDI capital. The lari was devalued by about 16 percent in November 2008. The combination of restricted availability of external capital and sluggish export demand led to imports falling by over 25 percent year-on-year in the second quarter of 2009 compared to a year earlier. GDP is expected to contract by 4 percent in 2009 after having grown by an estimated 2 percent in 2008.

Losses in tax revenue due to a sharper-than-expected recession, but also in part to cuts in tax rates, have exerted considerable pressure on public finances despite strict control over expenditures. However, the authorities have chosen to support demand and avoid a deeper downturn by maintaining expenditures in 2009 and postponing the fiscal consolidation necessary to restore debt sustainability to 2010, when the economy is expected to recover. Overall spending was contained by reallocating resources to social and capital spending from other less urgent needs, such as defense spending, which was reduced by 3.5 percentage points of GDP. The overall fiscal deficit in 2009 is 9.4 percent –an increase of 3 percentage points from its level in 2008. The fiscal consolidation in 2010 is expected to include substantial real reductions in administrative costs across the board, with only a few exceptions, cuts in subsidies to semi-public institutions, capping the wage bill in real terms, reduction in cofinancing of investment projects and cuts to the investment budget in connection with the winding down of large infrastructure projects. Beyond 2010, consolidation will continue to focus on expenditure, with revenue measures introduced, if necessary, by broadening the tax base and further reductions in income tax rates when possible. Furthermore, the institutional reform of budget preparation, execution and audit is also underway.

Georgia faces a bunching of external debt service payments in 2013-14 due to the maturing of a $500 million Eurobond and repayments to the IMF. The public debt to GDP ratio is expected to peak at 47 percent

17 NPLs have stabilized according to the central bank's definition, since the latter includes loans in the "watch" category, but are rising according to the IMF definition as more loans move to the "loss" category.

in 2011 and. with fiscal consolidation starting in 2010, decline gradually to 41 percent by 2014. With much of the debt accumulated since 2003 being private, public debt had fallen to 22 percent of GDP by 2007. However official loans and grants made available at the October 2008 donors' conference in the aftermath of the conflict with Russia were used to meet growing fiscal and balance of payments needs as well as repayment obligations of banks which had lost access to capital markets. This has implied a substantial increase in public debt in 2009, which will continue for the next two years as official financing from the IMF, the World Bank and the Asian Development Bank, as well as bilateral donors, makes possible an accommodative fiscal policy in 2009, with fiscal consolidation starting in 2010. While the public debt dynamics is manageable with Georgia's track record of policy implementation, it would become more challenging if the recovery from the global economic recession were to be weak and remain so for a considerable period of time, as is not unusual for recessions that are associated with financial crises. It would also become more difficult if issues of confidence were to delay the restoration of access to international capital markets and complicate the rollover of the Eurobond. More concessional financing would allow the tradeoff between fiscal accommodation and debt sustainability to be alleviated. Generous donor financing has allowed Georgia to run a current account deficit of 15.1 percent of GDP in 2009.

Although the recession has the potential to exact a high social toll, Georgia has in place a means-tested program—the Targeted Social Assistance Program—that ensures around two-thirds of its benefits reach the poorest quintile of households—a targeting accuracy on par with OECD countries—while transferring benefits that account for nearly a half of the recipient household's posttransfer consumption. It accounts for over half of Georgia's spending on social assistance, where the latter equals around 1 percent of GDP. The program was introduced in 2006 after careful preparation (Box 1). However the program, which has many desirable properties, covers just over 20 percent of the poorest quintile of households, and could be expanded by enhancing outreach, such as proactive registration of potentially poor households, communications campaigns and social worker involvement. Furthermore, as noted, public social spending—health, pensions, social assistance and assistance to internally displaced persons from the 1990 and 2008 wars—has been increased as part of the fiscal response to the crisis.

Private sector credit expanded in real terms at an annual rate of nearly 50 percent between 2005 and 2008. It was underwritten by bank borrowing from abroad and is reflected in part in a loan-to-deposit ratio of over 200 percent in 2008. However, the crisis has seen a sharp fall in bank lending due to both supply and demand factors. The main constraint on the resumption of credit is banks' reluctance to take on credit risk and the need to shrink balance sheets in order to bring about more prudent loan-to-deposit ratios, a task that is made more difficult by a deposit squeeze due to a drawdown of financial savings by households and enterprises. Repeated lowering of the policy rate and liquidity injections have had little impact. Banks have preferred to remain liquid and real lending rates reached levels as high as 20 percent before more recent declines. With deposit dollarization around 75 percent which, however has stabilized with the lessening of pressure on the exchange rate, commercial banks rely heavily on foreign currency funding. Since normal channels of transmission of monetary policy have been rendered ineffective, the central bank has engaged in swaps to allow banks that have access to foreign exchange liquidity to finance lari loans to borrowers who cannot hedge the currency risk of dollar borrowing. Loan dollarization in Georgia is estimated to be 75 percent.

Non-performing loans (using a national definition) and loan loss provisions have both been rising, a process that could continue since asset quality could deteriorate further in the event of a more prolonged recession than expected. There have been capital and liquidity injections into the two largest banks. Bank supervision is being strengthened as the authorities move towards consolidated and risk-based supervision. The overwhelming bulk of the banking sector's assets are foreign-owned and memoranda of understanding have been signed with home country supervisors to clarify the role of cross-border banks in a financial crisis. A financial stability plan has been developed to deal with situations of financial stress. However, the introduction of deposit insurance to boost confidence is not being considered at this time.

Mongolia

Fed by a sustained run up in copper and gold prices, Mongolia enjoyed a classic commodity boom which saw cuts in taxes and social security contributions, generous increases in civil service wages and a dramatic expansion of untargeted social transfers, resulting in a deterioration of the nonmineral fiscal balance amounting to some 10 percent of GDP. Private sector credit expanded rapidly and outran the growth of deposits in the banking system. Inflation reached nearly 30 percent. A plunge of 60 percent in copper prices between its peak in mid-2008 and January 2009, together with a slowdown in world trade on account of the global economic recession, brought this to a halt. A precipitous fall in export earnings and limitations on available external financing led to a sharp squeeze in imports. The erosion of confidence associated with the crisis saw outflows from the banking system and depletion of foreign reserves. After several years of growth rates in the high single digits, the economy slowed more than expected and GDP is estimated to have grown by 0.5 percent in 2009. The current account deficit, which had widened to 13.1 percent of GDP in 2008, fell to an estimated 6.9 percent of GDP in 2009. After initial unsuccessful attempts at maintaining a peg, the currency was allowed to depreciate by 40 percent against the US dollar between November 2008 and March 2009. While this helped reverse its inflation-induced appreciation since 2007, it had a negative impact on the balance sheet of banks.

Key to the restoration of a sustainable nonmineral fiscal balance has been spending restraint which has emphasized a wage and hiring freeze and cuts in capital expenditures. However, since the economy weakened more than expected, there has some fiscal relaxation compared to original plans in 2009, with the fiscal deficit target increased by 0.5 percent of GDP in order to support demand to the economy, with the intention of tightening by 0.5 percent of GDP more than had been envisaged from 2010, when the economy is expected to recover. But notwithstanding timely support from the IMF, the World Bank, the Asian Development Bank and Japan, the extent of loosening has constrained both by the availability of financing and excessive pro-cyclicality of fiscal policy during the boom years. The overall fiscal deficit (excluding the estimated fiscal cost of bank resolution of around 3 percentage of GDP) is estimated to be 6.5 percent in 2009, which includes an improvement in the nonmineral balance of nearly 3 percent of GDP compared to 2008.

With more than one-third of the population living below the poverty line, the authorities have taken the opportunity of the crisis to undertake a comprehensive reform of social transfers, which include consolidation in the number of social benefits from over 60 to less than 20, a reduction in untargeted universal transfers and the introduction of a new benefit for those in poverty. These steps are expected to make social transfers more pro-poor while bringing about fiscal savings.

Monetary policy had been tightened to contain inflation, which had been running at 23 percent in 2008, and stem capital outflows. With the easing of food and fuel price increases and the onset of the world recession, inflation is expected to have fallen to 8.5 percent. This, together with the restoration of confidence brought about by improvements in the deposit guarantee system, was reflected in deposits flowing back onshore into the banking system, and allowed the central bank room for some cuts in the policy rate. The normal channels of transmission of monetary policy have however been ineffective. Concerns about credit quality constrain banks' willingness to lend and the slowing economy has dampened the demand for credit. Asset quality continues to worsen. Loan dollarization of around one-third in a situation where there has been a large currency depreciation could make it difficult for borrowers without effective hedges to service their debt. The three largest banks, which account for 60 percent of the market, exceed the minimum capital adequacy ratio (12 percent). Banks that do not satisfy these requirements have submitted recapitalization plans to the financial supervision authorities.

The collapse of the boom has uncovered weaknesses in bank regulation and supervision. The authorities have sought to contain an incipient banking crisis by developing deposit guarantees, while seeking to limit its potential for abuse and strengthening the legal framework for bank resolution. The fourth-largest bank experienced a deposit run in October 2008 and was taken over by the authorities. Fixing the financial system is a high priority and the authorities are taking steps to strengthen on-site enforcement, introduce legal protection for supervisors, strengthen fit and proper review process for new shareholders. Progress also needs to be made with bank restructuring so that credit to the private sector, which has been declining year-on-year during 2009 can revive as the economy begins to recover.

A potentially important structural reform is the planned adoption of a Fiscal Responsibility Law and an organic budget law. These are intended to ensure that a higher proportion of copper revenue is saved, hence limiting procyclicality in fiscal policy and strengthening the institutions of budget management. Effective management of revenue from the massive Oyu Tolgoi mining project, one of the world's largest copper mining projects, the development of which is currently under negotiation, will require that such institutions are in place before the export earnings and fiscal revenue from the project come on stream.

Tajikistan

With a remittances-to-GDP ratio of 47 percent in 2008 Tajikistan, which has an estimated 1 million migrant workers abroad, is one of most remittance-dependent countries in the world. It was strongly affected by the economic downturn in Russia, in particular the slowdown in that country's construction sector and remittances during the first half of 2009 are estimated to have fallen by 30 percent year-in-year. Exports have been another channel of transmission, as the demand for Tajikistan's principal exports, viz., aluminum and cotton, weakened as well. Both developments, together with the ruble depreciation, put pressure on the exchange rate and the somoni, which is virtually pegged to the dollar, was allowed to depreciate by nearly 30 percent in 2009. The IMF estimates that the currency depreciation in Tajikistan has caused the somoni to depreciate the most against the US dollar and the least against the Russian ruble among countries in the region. GDP growth, which had averaged between 7 and 8 percent in the three preceding years and had been driven by the remittance-driven service and construction sectors, as well as non-cotton crops and livestock, is expected to slow to 2 percent in 2009.

By maintaining the share of expenditures in GDP, fiscal policy accommodated a sharp decline in tax revenue, which was caused in part by the VAT being affected by a collapse in imports, but also by the domestic recession induced by the fall in remittances and exports. Furthermore, the VAT rate was cut by 2 percentage points and the corporate income tax was reduced for certain industries from July 1 as part of an anti-crisis plan. This led to the overall fiscal balance (excluding the externally-financed public investment program and grants) to move into deficit in 2009 after three years of surpluses. Furthermore, expenditures were reallocated towards boosting social spending, strengthening social safety nets and easing key infrastructure bottlenecks. A virtual fund has been set up within the State budget to ensure that expenditures on basic services such as primary education and primary healthcare are protected

Box 2 | Tajikistan's Declining Remittances Can Hurt the Poor Disproportionately

The inflow of remittances to Tajikistan in 2008 amounted to 48 percent of the country's GDP, the highest share worldwide. The Russian Federation is the principal country of origin for such remittances, accounting for about 80 to 90 percent of officially recorded remittances.

The box table shows that low-income households in Tajikistan rely heavily on migrant flows. Almost half of the families in the bottom quintile in the income distribution have an absent migrant abroad. The difference is very sharp relative to the other quintiles. The income dependency seems to be critical for low-income rural households. In the bottom quintile, remittances account for almost 80 percent of rural household consumption in cases where they have a migrant abroad.

Although estimates of the magnitude of the decline in remittances during the crisis vary, a range of a 30–35 percent decline is commonly used. A 30 percent decline will result in a 25 percent decline in the consumption of the poorest rural households and an 18 percent decline for the poorest urban households and increase headcount poverty in Tajikistan from 53 to 58 percent.

Box Table 1. Share of households with migrants, by preremittance consumption quintile

Preremittance consumption quintile	Share of households with currently absent migrant	Remittances as a share of total household consumption	
		Urban	Rural
1	46.5	55.9	78.8
2	7.5	35.9	66.5
3	4.9	36.2	65.1
4	4.6	45.0	63.9
5	6.3	44.6	60.1
Average	14.1	39.5	66.4

Source: Mitra, Selowsky and Zalduendo (2009)

from cuts. Concessional assistance from the IMF, the World Bank, the Asian Development Bank and bilateral donors has helped Tajikistan run an accommodative fiscal policy but a tightening will be necessary in 2010. China is financing about 30 percent of public investment in 2009. The current account deficit is estimated to be 13.7 percent of GDP in 2009—nearly 6 percentage points of GDP higher than in 2008.

Public debt, which had fallen to 30 percent of GDP in 2008, is on an increasing path in 2009 and 2010, placing Tajikistan at high risk of debt distress. Furthermore, the global economic recession hit Tajikistan while it was dealing with longer standing problems such as the resolution of its cotton sector debt and governance issues. A complete write off of cotton farmers' debt would require recapitalization of the central bank, putting further pressure on Tajikistan's public debt dynamics. However, the authorities have introduced an external debt ceiling of 40 percent of GDP, which should keep public debt at sustainable levels. The country would benefit from more grant financing.

The decline in remittances will have a strong adverse impact on the poor in what is the poorest country in the region. The table shows that low-income households in Tajikistan rely heavily on migrant flows. Almost half of the families in the bottom quintile of the income distribution have an absent migrant abroad. The difference is very sharp relative to the other quintiles. The income dependency seems to be critical for low-income rural households. In the bottom quintile, remittances account for almost 80 percent of rural household consumption in cases where they have a migrant abroad. A 30 percent decline in remittances during the crisis will result in a 25 percent decline in the consumption of the poorest rural households and an 18 percent decline for the poorest urban households and increase headcount poverty in Tajikistan from 53 to 58 percent (Box 2).

However Tajikistan, which spends roughly 0.5 percent of GDP on social assistance, has yet to develop a means-tested safety net program that has high targeting accuracy and reasonable coverage of the poorest households. It is important that the opportunity of the crisis be taken to develop a new well-targeted program. Some programs to consider are (i) direct cash transfers, which have low administrative costs and do not distort prices; (ii) conditional cash transfers, which have additional administrative requirements compared with direct (unconditional) cash transfers since they also require some sort of monitoring of education or health conditionalities or both; and (iii) public works schemes, such as workfare and cash-for-work, which could be particularly attractive when faced with an influx of returning migrant workers; these can have lower net costs than direct transfer programs, since they can improve key infrastructure. It takes 12—18 months—and longer for countries with limited institutional capacity—to develop basic targeting, registry and safety net systems.

Banks are experiencing shortages of liquidity in both somoni and dollars. Channels of transmission of monetary policy have limited effectiveness in Tajikistan, even in normal times, since the domestic interbank market is not well developed. Attempts to ease monetary policy through reductions in the central bank's refinancing rate have not eased liquidity shortages. Credit growth has slowed and lending rates have gone up despite a lower refinancing rate. Banks are vulnerable: they have seen deterioration in their asset quality, which is reflected in rising non-performing loans. in part due to the slowdown in economic activity but also the depreciation of the somoni in an environment of loan dollarization, estimated at nearly 60 percent, where not all borrowers have effective hedges[18]. A further worsening of banks' portfolios would occur should external adjustment call for additional depreciation. On the liability side, the somoni deposit base is vulnerable to erosion due to uncertainty. Over the medium-term Tajikistan faces an agenda of modernizing banking sector institutions.

B. The Financially Integrated

Kazakhstan

Kazakhstan, which is financially the deepest and most integrated among the economies considered here, experienced two sets of external shocks: first, a sudden stop in external capital flows in August 2007, precipitating a capital account crisis and leading to a sharp slowdown in growth in 2008, and second, a collapse in its external terms of trade as oil prices fell rapidly in the latter part of 2008 from a high of nearly $150/bbl to $40/bbl as the global economic recession took hold. Both would exert pressure on the currency. During the first episode, as capital flows reversed, the National Bank of Kazakhstan used 25 percent of its reserves to defend the currency, both to maintain depositor confidence and limit risks to corporate balance sheets and then pegged the tenge to the dollar. The second episode was to lead to a devaluation of the tenge by 20 percent in February 2009, since the rapid fall in oil prices also coincided with

18 Nonperforming loans include three loan classifications: watch, doubtful and loss.

a substantial depreciation of the Russian ruble. The devaluation of the tenge broadly restored the real effective exchange rate to its level prior to the ruble devaluation and the rate is now supported by the recovery in oil prices and external financing for the energy sector. The current account deficit is expected to be around 2 percent of GDP in 2009. However, the combination of reduced external capital flows, lower earnings from oil exports and restrained demand for Kazakhstan's exports due to the global recession in importing countries contributed to a squeeze in imports. Growth slowed sharply from the high single digits attained since the turn of the century to just over 3 percent in 2008 as construction activity decelerated and industrial production fell. The economy is expected to contract by 2 percent in 2009.

Much of the policy response has been focused on resolving problems in the banking sector precipitated by the capital account crisis and using fiscal and other policies to provide stimulus to the economy in the face of the recession. As with other countries in the former Soviet Union that had undergone deep and protracted transition recessions, real private sector credit had grown very rapidly since the turn of the century: at 43 percent per annum during 2000—2004 and 36 percent per annum during 2005—2008. A substantial proportion of that growth was financed by borrowing by commercial banks from abroad, mostly in wholesale markets, reflected in the loan-to-deposit ratio reaching 200 percent in 2007. Moreover, half of all lending was in foreign currency. Although households benefited from the expansion in credit—their share in lending to the private sector, starting from a low base, grew to 30 percent by 2008—much of the lending was to corporates and was primarily directed to the nontradables sector. The crisis was precipitated by the drying up of external wholesale funding, typically the most volatile funding source for banks, compared to deposits and parent bank funding. Banks owe nearly 40 percent of GDP in external liabilities, a quarter of which matured in 2009. Of the four banks which together account for 70 percent of banking sector assets two, together with a third smaller bank, had stopped making payments on principal.

Containing the banking crisis has taken the form of lowering policy rates and the provision of liquidity support from the central bank through easing of reserve requirements, repurchase agreements and foreign exchange swaps, the active placement of bank deposits by companies under the umbrella of Samruk-Kazyna (formed from the merger of the state holding company and the sustainable development fund) and recapitalizing the Deposit Insurance Fund by increasing the size of retail deposits guaranteed sevenfold to boost depositors' confidence. The bank resolution framework was strengthened and has been used to intervene in distressed banks, including the largest bank in Kazakhstan.

Resolution of the banking crisis has involved Samruk-Kazyna's injecting capital into the top three banks, in the course of which it has taken a controlling share in the largest bank. Agreement involving burden-sharing with creditors has recently been reached on restructuring of both banks that had been in default, with approval of all creditors pending in one case. However, the sharp squeeze in credit growth caused by deleveraging by banks in response to the funding squeeze and deteriorating asset quality, which is reflected in rising nonperforming loans and loan loss provisions, can only be reversed once processes to restructure corporate and household debt are set in motion. Efforts are being made to restructure foreign currency mortgages and loans to small and medium enterprises into local currency. While the authorities can facilitate negotiations between creditors and debtors, there is no reason to commit public resources to restructure private sector debt. Household debt in Kazakhstan represents just under 20 percent of GDP and an estimated 40 percent of it is denominated in foreign currency. The share of indebted households is higher in the upper income quintiles and debt service as a share of income generally decreases with income.

Fiscal policy has been accommodative as the government has sought to maintain normal budgetary expenditure in the face of a collapse in non-oil revenue. In order to stimulate the economy, the authorities have introduced a $10 billion anti-crisis plan, with Samruk-Kazyna playing a prominent role in its implementation. Key elements of the plan include (1) public support to the four top banks, (2) completion of unfinished residential construction projects and refinancing mortgages at lower interest rates, (3) financial assistance to small and medium enterprises through the banking sector through refinancing existing loans at lower interest rates and providing new credit and the agriculture sector and (4) increased public investment in the industrial sector. The overall fiscal balance in 2009 will be in deficit for the first time in nearly a decade, in an amount expected to be 2.1 percent of GDP and will be financed by the Oil Fund (NBRK). Spending under the anti-crisis program, together with improving external conditions, including bilateral financing from China of up to $5 billion compared to gross external financing needs of $16.5 billion in 2009, as well as rising oil prices, which stood at around $72/bbl in early December 2009, should contribute to growth in Kazakhstan turning positive in 2010.

The social consequences of the crisis, which are manifested in part through increases in open as well as hidden unemployment, are sought to be addressed through emphasis on job creation under the "Strategic Employment Program" by providing financial support to small and medium enterprises and the agriculture sector. However targeted social safety nets could benefit from strengthening. Although around 70 percent of the benefits of means-tested Targeted Social Assistance program reach the poorest quintile of households, indeed much more than is the case for well-targeted programs in Armenia, Azerbaijan and Georgia, coverage of the poorest quintile is less than 5 percent and the program accounts for a negligible proportion of total safety net spending in Kazakhstan. Improving coverage and increasing the benefits transferred by the program would direct more assistance to individuals rather than through support for sectors, which is the focus of the anti-crisis program.

There is a substantial agenda in strengthening bank regulation and supervision in the direction of raising bank capital requirements, limiting banks' borrowing in foreign wholesale markets through higher provisioning requirements on loans to unhedged borrowers, improving corporate governance in the banking sector and upgrading supervision. Given the demonstrated volatility of external wholesale funding in the present crisis, the growth of the banking system should be based mainly on domestic deposits, with steps being taken towards the medium-term objective of financial markets in tenge debt.

C. Energy Exporters

Azerbaijan

The relatively modest size of its financial sector and its limited integration into world financial markets has implied that the global economic crisis was transmitted to Azerbaijan through the trade and remittance channels. Given its undiversified economic structure, around 95 percent of Azerbaijan's merchandise exports are accounted for by oil and the fall in its price in the latter half of 2008 affected export earnings. Remittances, which equaled 3 percent of GDP in 2008, and over half of which originated in Russia, fell sharply as well. These shocks occurred at a time when public spending which, as a share of non-oil GDP, had risen from 37 percent in 2004 to over 80 percent in 2008, began to slowdown toward more sustainable rates. The boom in public spending, which was the result of a strategy of using oil revenue to create a high-productivity economy at the cost, if necessary, of temporarily high inflation and loss of external competitiveness, had fueled a massive expansion in sectors such as construction, services and agriculture and non-oil GDP grew at an average of around 11 percent between 2004 and 2007. Growth rates, which had reached a peak of 30 percent in 2006, falling back to 23 percent in 2007 and nearly 12 percent in 2008, declined to an estimated 7.5 percent in 2009.

Azerbaijan entered the crisis with a strong fiscal and foreign exchange position. Despite a non-oil deficit estimated at almost 60 percent of nonoil GDP in 2008, the overall fiscal surplus was nearly 30 percent of GDP in 2008. International reserves and Oil Fund assets amounted to $18 billion in 2008, which may be compared to a figure $2 billion of external debt owed by Azeri commercial banks in 2008. Faced with accelerating inflation from food and other commodity prices till 2008 and extremely high credit growth due to a policy of a managed float against the dollar, the central bank had tightened liquidity. It had introduced a number of prudential measures, such as reserve requirements on foreign borrowing, tighter asset classification standards, higher provisioning requirements for non-performing loans, restrictions on the use of subordinated debt in meeting capital adequacy requirements, increased risk weights for mortgage loans and more stringent criteria for collateralized loans. The central bank reviewed banks' risk management systems and pushed them to reduce credit growth targets. Hence banks were generally in a solid position when the crisis struck.

However, when the global economic crisis caused foreign banks to refuse rolling over maturing external debt of Azeri banks, the central bank reversed course, reducing reserve requirements and making liquidity available to banks that were deemed solvent but in temporary difficulty. Policy rates were cut, a move facilitated by inflation falling from 20 percent in 2008 to 2 percent in 2009 due in part to a decline in international food and commodity prices. These measures were effective in dealing with the containment phase of bank distress. But they did not succeed in affecting banks' lending rates. This was because the extraordinarily rapid growth of private sector credit—nearly 40 percent annually in real terms during 2005—2008—in a situation of limited risk management capacity in banks implied that the slowdown in the economy has led inevitably to deteriorating asset quality, increased provisioning and lower credit growth. Indeed, banks have considerable exposure to property as a result of substantial lending to the construction sector, the growth of which slowed sharply in the second half of 2009, and the use of property as collateral for other loans.

While the authorities had sought to introduce flexibility in the exchange rate by using a two-currency basket regime comprising euros and dollars to peg the manat, a change to which market participants had begun to adapt, the volatility between the two basket currencies during the crisis caused it to be suspended, amid concerns that the large depreciation against the dollar implied by the arrangement could lead to a loss of confidence and encourage re-dollarization. Azerbaijan continues to maintain its dollar peg.

As unemployment rises in the wake of the slowdown, policy attention will focus on social safety nets. Azerbaijan spends around 1 percent of GDP on social assistance. It has at least one means-tested program—the Targeted Social Assistance Program—that is quite effective in basing eligibility on income testing and home visits and delivers around 55 percent of its benefits to the poorest quintile of households. Coverage—the share of the poorest quintile of households covered by the program—is however a modest 15 percent. Hence the country is well-positioned to scale up its means-tested programs by raising benefits and expanding coverage by enhancing outreach, such as proactive registration of potentially poor households, communications campaigns and social worker involvement, in order to cushion the poor from the effects of the crisis.

The principal structural challenge facing Azerbaijan is one of diversification. However, non-oil trade relative to non-oil GDP has been declining since 2006. At the same time, non-oil private investment and non-oil foreign direct investment relative to non-oil GDP have been falling. The share of non-tradables in non-oil GDP has been rising, suggesting that diversification may have stalled. The crisis could provide an opportunity to recalibrate policy towards lower spending from oil revenue to mitigate its crowding out effects and devote renewed attention to improving the business environment to develop the non-oil economy.

Uzbekistan

With a banking sector predominantly under state ownership and not integrated into global finance, Uzbekistan was not directly affected by the crisis that erupted in advanced country financial markets. Instead the impact was to occur first, through a shrinking of markets in the Russian Federation and Kazakhstan, which are among its top three export destinations owing to capital account crises in both countries and exports of goods and services are expected to decline by around 17 percent in 2009. Second, given that commodities account for 80 percent of merchandise exports, Uzbekistan has been hit by declining commodity prices. However, the latter channel was somewhat less important: while exports of cotton, chemicals and automobiles fell sharply during the first half of 2009, export revenues from gold remained broadly stable, while natural gas revenues doubled, reflecting a substantial increase in the price agreed between the government and the Russian Federation's Gazprom at which Uzbek gas is bought for re-export to Europe. A third channel of transmission was remittances, the bulk of which originate in the Russian Federation and which accounted for 7 percent of GDP in 2008. These inflows, which play the role of a safety net for poor households in rural areas where unemployment has become a significant problem since the transformation of collective farms, are estimated to have fallen by around a half in 2009, potentially intensifying a social problem in Uzbekistan. Faced with these shocks and the depreciation of the Russian ruble, Uzbekistan devalued the sum by around 15 percent in May 2009.

Growth rates of GDP, which had been in the high single digits in the preceding three years, have fallen in 2009 but, according to preliminary indications, not below the 7 percent targeted by the authorities. The reason is a significant stimulus package which the authorities adopted in phases in November 2008 and January 2009 and which was enabled by the country's strong fiscal and foreign exchange position. Uzbekistan entered the crisis with a strong fiscal position, having run a fiscal surplus of 5 percent of GDP in the three preceding years, and accumulated 11 percent of GDP in the Fund for Reconstruction and Development (FRD) which had been set up in 2006 to ensure intergenerational redistribution of commodity revenues and the provision of insurance in times of crisis. Foreign exchange reserves equaled 40 percent of GDP. The stimulus package includes measures to enhance export capacity, support small and medium enterprises, increase social spending to counter the effects of decreased labor migration and loss of remittances, undertake repair and maintenance projects in public health and education, and increase public investment and maintenance on roads, irrigation and drainage, energy and other infrastructure and local rural projects. The instruments to be used include targeted provision of subsidized credit, temporary tax reductions and customs tariff reductions for inputs into priority production, as well as support for switching lands sown to food crops at the expense of cotton production, public resources for rural infrastructure projects and creation of special economic zones. The measures are intended to support domestic demand by promoting public investment directly and boost private investment through the provision of credit and easing of administrative burdens for small and medium enterprises, as well as confirmed commitments made by major foreign companies, such as General Motors and Gazprom. Importantly in addition, increases in private consumption are expected to flow from a 50 percent increase in wages, benefits and pensions which, together with steps to increase domestic production of consumer goods, are part of the stimulus package. The current account balance, which is estimated to have reached 12.8 percent of GDP in 2008, is expected to fall to less than 5 percent of GDP in 2009.

Uzbekistan spends over 2 percent of GDP on social assistance, a figure higher than in the other countries in Caucasus and Central Asia for which comparable data are available. However, no measures appear to have been adopted to enhance the targeting of social safety nets as part of the announced package. Analysis of the 2003 Household Budget Survey shows that 25 percent of the benefits of means-tested social safety net programs in Uzbekistan reach the poorest quintile of households, while they cover 3 percent of poor households and transfer nearly 28 percent of the households' post-transfer consumption. Hence there is considerable room to improve targeting and coverage of social safety nets even within existing fiscal envelopes by eliminating most untargeted privileges, refocusing design and eligibility criteria, developing and applying targeting tools, improving implementation arrangements and strengthening monitoring, oversight and evaluation.

References

Bubula, Andrea and Inci Otker-Robe, 2002. The Evolution of Exchange Rate Regimes since 1990: Evidence from De Facto Policies, IMF Working Paper 02/155, International Monetary Fund, Washington DC

Beck, Thorsten and Asli Demirguc-Kint, 2009. Financial Institutions and Markets across Countries and over Time. World Bank, Washington DC

EBRD (European Bank for Reconstruction and Development) 2009. *Transition Report: Transition in Crisis* London

Hentschel, Jesko, 2009. Using Crisis Response Surveys to Assess the Social Impact of the Global Economic Crisis, World Bank, Washington DC

IMF (International Monetary Fund), 2009. *World Economic Outlook: Crisis and Recovery* Washington DC:

IMF (International Monetary Fund). Various country reports. IMF website`

Maurel, Mathilde, 2009. Background paper for Turmoil at Twenty, World Bank, Washington DC

Mitra, Pradeep, Selowsky, Marcelo and Juan Zalduendo, 2009. Turmoil at Twenty: Recession, Recovery and Reform in Central and Eastern Europe and the Former Soviet Union, World Bank, Washington DC

World Bank. *World Development Indicators,* Washington DC

The Emerging Markets Forum was created by the Centennial Group as a not-for-profit initiative to bring together high-level government and corporate leaders from around the world to engage in dialogue on the key economic, financial and social issues facing emerging market countries.

The Forum is focused on some 70 emerging market economies in East and South Asia, Eurasia, Latin America and Africa that share prospects of superior economic performance, already have or seek to create a conducive business environment and are of near-term interest to private investors, both domestic and international. Our current list of EMCs is shown on the back cover. We expect this list to eveolve over time, as countries' policies and prospects change.

Further details on the Forum and its meetings may be seen on our website at http://www.emergingmarketsforum.org

The Watergate Office Building, 2600 Virginia Avenue, NW, Suite 201

Washington, DC 20037, USA. Tel:(1) 202 393 6663 Fax: (1) 202 393 6556

Email: info@emergingmarketsforum.org